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GEORGIA

THE LEGAL FRAMEWORK FOR THE PROMOTION OF HYDROPOWER INVESTMENT IN GEORGIA

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(HIPP)

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THE LEGAL FRAMEWORK FOR THE PROMOTION OF HYDROPOWER INVESTMENT IN GEORGIA

NOTE

This Report presents an outline of Georgian law and practice that is general in nature and in force at the date hereof. This Report should be regarded as a basic guideline to assist investors in understanding Georgia's overall investment climate. It should not be relied upon as legal advice in relation to any transaction or as a substitute to seeking specific legal advice. Because many laws in Georgia are currently being revised and modernized in furtherance of the government's continuing program to promote development, readers should ensure that all information of a legal nature related to an investment is up to date.

INTRODUCTION

This Report is divided into three Parts and each Part is divided into Chapters. Part One provides a general overview of the country of Georgia. Part Two focuses on the laws and secondary legislation specifically applicable to the nation's electricity sector. Part Three is a review of discrete pieces of Georgian primary and secondary legislation that will have an effect on a hydro investment in Georgia.

PART ONE **GEORGIA — AN OVERVIEW**

Chapter 1 **Geography**

Georgia is situated between the Black Sea, Russia, Armenia, Azerbaijan, and Turkey. The country is rapidly developing as a gateway from the Black Sea to the Caucasus and the larger Caspian region. It also serves as a buffer between Russia and Turkey. Georgia is a sovereign and democratic state. With the exception of the autonomous regions of Abkhazia and South Ossetia¹, which lie outside the central government's current area of control, the Georgian state institutions are highly centralized. Georgia's natural resources include forests, hydropower, manganese deposits, iron ore, copper, gold, minor coal and oil deposits. The coastal climate and

¹ The precise legal status of Abkhazia and South Ossetia, special autonomous regions during the Soviet period, remains undetermined. Since the breakup of the Soviet Union the regions have undergone ethnic and political conflicts of varying intensity and during the early 1990s they were in armed conflict with Georgia.

soil allows for tea and citrus growth. Other important agriculture products include wine and grapes, and other fruits and vegetables.

Chapter 2 **Population**

Georgia covers area of approximately 69,700 square kilometers and has 310 kilometers of coastline along the Black Sea. Nearly 84% of the nation's approximately 4.6 million population are ethnic Georgian. A large percentage of the population lives in cities and towns. The three largest cities are Tbilisi, Kutaisi and Batumi. By unofficial count, the population of Tbilisi, the capital of Georgia, exceeds 1.5 million.

Chapter 3 **History**

Georgia's history can be traced back to the ancient kingdoms of Colchis and Iberia. In the 4th century it was one of the first countries to adopt Christianity. After a brief period of independence following the Russian Revolution of 1917, the country was annexed by Russia in 1921. In 1922 Georgia was incorporated as a republic of the Soviet Union, where it remained until the Soviet Union's breakup in 1991. Like many countries in the former Soviet Union, during the 1990s Georgia suffered economic crises and civil unrest. In 1995 Eduard Shevardnadze was elected as Georgia's president. Concurrently, long-simmering disputes between local separatists and Georgia's majority populations in Abkhazia and South Ossetia erupted into widespread inter-ethnic violence and wars. Supported by Russia, Abkhazia and South Ossetia achieved *de facto* independence from Georgia in the early 90's.

Following the Rose Revolution in 2003, Georgia launched a series of reforms to strengthen the country's military and economic capabilities. The new government's successful efforts to reassert Georgian authority in the southwestern autonomous republic of Adjara led in 2008 to intensified efforts to regain control over the breakaway province of South Ossetia. These attempts resulted in open military conflict with Russia. Today, Abkhazia and South Ossetia remain outside of the control of the Government of Georgia ("GoG").

Chapter 4 **External Relations**

Georgia has established formal diplomatic relations with 117 countries and has embassies in 30 of these. Among others, China, France, Germany, Great Britain, Greece, Italy, Russia, Switzerland, and Turkey maintain embassies in Tbilisi.

Georgia is a member of, or has agreements with, 27 international organizations including the United Nations, the Council of Europe, the Organization for Security and Cooperation in Europe, the European Community (cooperation agreement), the North Atlantic Treaty Organization (partnership for peace program), the World Trade Organization, the Organization of the Black Sea Economic Cooperation, the Organization for Security and Cooperation in Europe, the Community of Democratic Choice, the GUAM Organization for Democracy and Economic Development, and the Asian Development Bank.

Chapter 5 **Economy and Business Environment**

Two principal elements of the GoG's development policies are economic liberalization and privatization of state-owned assets. The government's goal is to create a favorable business climate for Georgian and foreign entrepreneurs and investors. On the basis of its business infrastructure, strong and improving legal framework, educated and skilled work force and strong financial, legal and other professional services, Georgia has been rated as one of the world's best countries for doing business.

Key sectors of economic activity in Georgia include energy, agriculture, trade, tourism, and transport. There are also significant ongoing projects in the food processing and telecommunications industries. In recent years companies from the United States, Russia and Kazakhstan have been the largest foreign investors in Georgia.

Georgian agricultural production continues to recover from the devastation caused by conflicts with Abkhazia and Ossetia, the civil war and the industrial restructuring that followed the break-up of the Soviet Union. Livestock production has rebounded and domestic grain production is increasing. Supported by assistance from the European Union, Georgia has also taken steps to control and market its natural spring water. Georgian viticulture, an important export item until the recent Russian embargo, has also incorporated new technologies, management techniques and been the focus of foreign investment.

Economic Indicators (2009)

GDP:	US\$ 10.7 billion
GDP (Real Growth Rate):	Real Growth Rate 3.9%
GDP (Per Capita):	US\$ 2,450.10
Inflation rate (average annual):	1.7%
Projected 2010 GDP Real Growth Rate:	+4-5%

Chapter 6 **Credit and Economic Rating**

In 2006, Standard and Poor's, the international credit rating agency, assigned 'B plus' long-term and 'B' short-term sovereign credit ratings to Georgia with a positive outlook. After the conflict with Russia the outlook changed from 'positive' to 'stable' and long-term sovereign credit was downgraded to 'B'. In April 2010, citing its relative economic strength and growth prospects, Standard and Poor's raised its foreign long-term sovereign credit rating on the GoG from B to B-plus.

Chapter 7 **Legal Tradition**

(a) Civil legislation

Georgia's legal system is based upon civil law and the *Civil Code* is the foundation for all of the country's civil legislation.² It also forms the basis for corporate structures as well as the right to ownership. The *Civil Code* guarantees freedom of contract and provides guarantees against arbitrary interference in private matters and freedom of entrepreneurial activity. Under the *Civil Code*, foreign investors have the same rights and obligations as do Georgian citizens and legal entities.

(b) Company law

The *Law On Entrepreneurs*, adopted in 1995, regulates the formation and organization of commercial legal entities and establishes the rules for setting up an enterprise and carrying out commercial activities. Commercial activities may only be undertaken under one of the legal forms prescribed by that Law. The law provides legal and organizational forms suitable for a number of commercial competencies and responsibilities. The two most common legal structures for capital businesses, the JSC and LLC, allow for limited liability.

(c) Judiciary and Enforcement

Since 1998 and with the assistance of international donor institutions, the Georgian judicial system has undergone major reforms. Changes have affected among others, judicial qualifications, judicial independence, social guarantees, court jurisdiction, court administration and case flow management. The court system's physical infrastructures have also been significantly improved, both in Tbilisi and in the regions. These efforts have led to increased confidence in the Georgian judiciary.

² The *Civil Code* is the systemized and codified law used as the legal basis for the regulation of all types of property and personal related transactions between citizens, legal entities and the State.

PART 2 THE LEGAL FRAMEWORK OF THE ELECTRICITY SECTOR

Chapter 1 Electricity Sector Policy

(a) The Energy Policy

In 2006 the Parliament of Georgia adopted the *Main Directions of State Policy in the Electricity Sector of Georgia* (the “Energy Policy”), a document that establishes the government’s long-term policy for the sector. The Energy Policy’s principal objective is to employ Georgia’s domestic hydro power resources to fully satisfy domestic demand for electricity. The salient elements of the Energy Policy include:

- commercialization of the electricity sector through privatization;
- improvement of the electricity sector’s economic viability;
- attraction of domestic and foreign investment to the electricity sector;
- development of sector competition;
- reduction of bureaucratic burdens on local and foreign sector participants;
- simplification of licensing procedures;
- the gradual deregulation of power plants that began commercial operation after January 1, 2007;
- improvement of the sector’s economic sustainability by, among other means, expanding the use of direct contracts between power generators and wholesale purchasers;
- application of tariffs and tariff policies that ensure the long-term sustainability of service providers and protect consumers from monopolies and the abuse of monopoly power;
- establishment of tariffs comprising various customer classes;
- third party access to transmission and distribution networks;
- improving technical capacity to facilitate increased cross-border energy trade;
- harmonization of sector legislation;
- expansion of interconnections (Europe-Asia, East-West and North-South); and
- diversification of electricity generation sources.

(b) The Ministry of Energy

The Minister of Energy (“MoE”) is the policy making institution for the electricity sector. The MoE’s obligations include:

- promotion of medium and long-term investment in the sector;
- identification of credit resources;
- rehabilitation and development of the energy sector through the use of state funds;

- participation in the development of an appropriate legal and regulatory framework;
- promotion of environmental protection;
- support for the development of transit and import/export relationships in the electricity sector; and
- implementation of state programs to increase energy efficiency.

By law, the MoE has no ownership in electricity sector assets. Neither does it have any electricity sector operational or regulatory functions.

The MoE approves:

- the Electricity (capacity) Balance;
- the Electricity Market Rules; and
- the rules of operation, arrangement and use of energy facilities and other technical equipment in the electricity sector.

Chapter 2

Laws and Secondary Legislation

The legal framework for Georgia's electricity sector comprises the following principal laws and subsidiary legislation:

- The Law of Georgia *On Electricity and Natural Gas* (June 27, 1997, No 816) ("the Electricity Law");
- Resolution of the Government of Georgia No 107 and Order of the Minister of Energy of Georgia No 46 (April 23, 2008);
- The Law of Georgia *On Independent Regulatory Bodies* (September 13, 2002, No 1666);
- The Law of Georgia *On Licenses and Permits* (June 24, 2005, No 1775) ("the Licenses and Permits Law");
- The Law of Georgia *On Normative Acts* (October 22, 2009, No 1876);
- The Law of Georgia *On Water* (October 17, 1997, No 936) ("the Water Law");
- The Law of Georgia *On State Promotion of Investments* (June 30, 2006) ("the State Promotion of Investments Law");
- The Law of Georgia *On Environmental Protection* (December 10, 1996, No 519) ("the Environmental Protection Law");
- The Law of Georgia *On Environmental Impact Permit* (December 14, 2007 No 5602) (the Environmental Impact Permit Law");
- The Regulation on Approval of the Preliminarily Determined Long-term Fixed Tariffs for the Purposes of Creating a Stable Investment Environment in Energy Sector of Georgia endorsed by GNEWRC (Resolution No 26, September 24, 2008);

- The Regulation on Procedures of Settlement Disputes between Licensees, Licensees and Consumers endorsed by GNEWRC (Resolution No 4, April 6, 2000);
- The Regulation on Licensing and Control of Power, Natural Gas and Water Sector Activities endorsed by GNEWRC (Resolution No 23 of September 18, 2008) (“the Licensing Regulation”);
- The Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters (“the Aarhus Convention”)
- The Rules of Electricity (Capacity) Wholesale Trading (Ministry of Energy Order No 77, August 30, 2006) (“Market Rules”);
- The Regulation on Methodology, Rules and Procedures of Tariff Setting endorsed by GNEWRC (July 1, 1998) (the “Tariff Methodology”); and
- The Regulation on Electricity Tariffs endorsed by GNEWRC (Resolution No 33, December 4, 2008).

Chapter 3 **The Electricity Law**

The Electricity Law, passed in 1997, governs all activities related to:

- electricity system operation;
- the trade in wholesale electricity (capacity);
- electricity generation;
- transmission and dispatch;
- distribution;
- import and export; and
- consumption.

The Electricity Law is intended to:

- promote the development of competition in order to accurately reflect the costs of generation, transmission, dispatch, distribution, import, export and consumption;
- promote foreign and domestic investments in order to rehabilitate Georgia’s electricity and natural gas sectors;
- encourage the priority use of indigenous hydropower resources, renewable, alternative sources of energy and natural gas;
- establish the main principles of generation;
- establish an independent regulatory framework for the electricity sector;
- ensure that consumers are protected; and
- promote the long-term financial stability and development of the electricity sector.

Chapter 4

Resolution of the Government of Georgia no 107 and Order of the Minister of Energy of Georgia no 46 of April 23, 2008³

(a) Overview

The purpose of Resolution 107 and Order 46 (jointly “the Resolution”) is to attract foreign investments to support the development of small and medium new renewable energy (“RE”) generation sources in Georgia. By promulgating the Resolution, the MoE has announced its support for the construction, operation and ownership of RE power plants under the principle of Build, Own, and Operate (“BOO”). Pursuant to the Resolution, the MoE will approve potential sites for exploitation, receive expressions of interests from investors and enter into contracts to facilitate the promotion of investment in the identified sites. The Resolution comprises the following principal features:

- It applies only to new sources of RE, specifically hydropower. Although the Electricity Law of Georgia does not specifically define the term “Renewable Energy”, those words as used in Resolution 107 mean hydro power.
- It does not cover a power plant or a cascade of power plants with a capacity of 100 MW or above.
- The list of potential RE sources/sites is attached to Order 46. It includes locations, exploitation schemes and principal technical parameters. The list is subject to regular updates by the MoE and can be accessed on the MoE web-site.
- Investors are invited to express interest in RE power sources based on the BOO principle.
- During the 10-year period following the commercial operations date (“COD”), during the winter season of each year (October, November, December), electricity produced by the power plant must be utilized solely for domestic consumption and may not be the subject of an export sale. During the winter months described above, at the seller’s discretion, the electricity may be sold:
 - to any buyer in Georgia under a free (deregulated) tariff; and/or
 - under a guaranteed Power Purchase Agreement (“PPA”), concluded between the generator and Electricity System Commercial Operator (“ESCO”) (the price term in the PPA being the tariff approved by GNEWRC pursuant to applicable law).

³ Resolution of the Government of Georgia No 107 of April 18, 2008 – the State Program on Renewable Energy 2008 – Rule of Ensuring Construction of New Sources of Renewable Energy in Georgia (“Resolution 107”) and a follow on Order of the Minister of Energy of Georgia No 46 of April 23, 2008 on Expression of Interest for the Construction, Operation and Ownership of the Power Plants provided in the List of the Potential Sources of Renewable Energy in Georgia (“Order 46”).

- During all other months of the year, the producer is free to sell its electricity either locally or by way of export.

(b) Procedures prescribed by Resolution 107 and Order 46

The following procedures describe in more detail the information found in Part 3(b) of this Report.

(i) Application Procedures

- A potential investor submits an application to the MoE in the form prescribed by Order 46.
- An application to invest in a site listed by the MoE pursuant to Order 46 may be submitted at any time, unless a deadline for submission has been published by the MoE.
- An application should include:
 - information about the party expressing interest;
 - the name of the power plant(s) listed in the updated list of potential RE sources;
 - forecasted dates for commencement and completion of construction and for the commencement of commercial operations; and
 - the applicant's agreement to be bound by the terms of the MOU as amended by the MoE from time to time.
- An applicant may not submit an expression of interest in more than 7 power plants at one time. After completion and commercial operation of the plants comprising the initial investment, applications for additional plants may be submitted.

(ii) Publication by the MoE

- Not later than two business days after the MoE's registration of the potential investor's application, the MoE shall publish on its web-site relevant plant information and a deadline for the MoE's acceptance of any other expressions of interest related to the same plant site(s) which must be received no later than 30 calendar days following such web-site publication.
- The MoE will not accept any other applications in respect of the site(s) published after the expiration of the 30-day period.
- Not later than five days following the expiration of the 30-day deadline, the MoE will review the original application and any additional applications received.
- If only one application is received and all requirements have been fulfilled, the MoE will set a deadline within which the applicant must submit a bank guarantee.

- Once the bank guarantee in the form prescribed has been delivered, the MoE submits the application to the GoG for its adoption.

(iii) Competing Applications

- If more than one application is filed with the MoE for a given site, the MoE gives preference to the potential investor:
 - that proposes the shortest period for construction and commercial operations (10 points in evaluation); and
 - that submits the largest bank guarantee for each MW of the plant capacity (10 points in evaluation).
- The MoE's shall base its decision solely on the accumulated scores for time frame and amount of bank guarantee.
- In the event that scores are identical, pursuant to a decision of the GoG, the MoE may invite applicants to, within 10 business days, re-submit an improved application to the MoE.
- Upon receipt, the MoE shall deliver the revised applications to the GoG for review and a final decision.

(iv) Award of the MOU

- After the GoG has made a decision in accordance with the above-described processes, it will establish a time frame for executing an MOU with the applicant, and the conclusion of such MOU shall occur not later than three months after the GoG's decision has been taken.
- If the GoG determines that the timeframe for construction and commercial operations suggested by the applicant is unreasonable, the GoG may decide not to conclude an MOU.
- In the event that the GoG determines not to issue and conclude an MoE, it shall notify the applicant of that fact and return the applicant's bank guarantee.
- If the application is acceptable, the MoE prepares a draft of the MOU for signature by the GoG.
- If the draft is acceptable to the GoG, the MoE executes it on behalf of the GoG.

(v) MOU Provisions

- There are three signatories to the MOU:
 - the potential investor (the applicant);
 - the GoG; and
 - ESCO.

- The MOU is intended to bind the potential investor to the commitments it has undertaken to the GoG related to implementation of the investment project. These commitments comprise:
 - the site location;
 - the capacity of the plant;
 - the investment amount and recovery period;
 - time frames:
 - for obtaining a construction permit;
 - for completing construction;
 - for commencing commercial operations; and
 - the plant's annual generation capacity.
- The principal conditions identified in Resolution 107 and Order 46 are also reflected in the MOU.
- By executing the MO, the potential investor/applicant binds itself to:
 - comply with all technical economic, financial, legal and other terms related to the plant (provided in an annex of the MOU);
 - conduct a feasibility study (technical, economic, commercial and legal) and deliver a report thereon to the GoG;
 - procure the total investment amount needed to implement the project;
 - implement the project within the time frame agreed;
 - submit quarterly progress reports to the GoG; and
 - restrict electricity exports during winter months.
- By executing the MOU, the MoE binds itself to:
 - provide due assistance to the potential investor/applicant to obtain reports and information it requires to implement the project;
 - assist the potential investor or applicant to secure relevant permits, licenses and, as required, allocation of land plots.
- By executing the MOU, ESCO binds itself to purchase electricity during three winter months of each year during the first ten years of commercial operation.⁴
- A standard form PPA is appended to the MOU.
- The potential investor/applicant is responsible for all costs associated with the project.

Upon conclusion of the MOU by all parties, the potential investor/applicant becomes “an investor”.

⁴ ESCO's authority to make the above commitment is found in the Electricity Law, which provides that if an MOU is executed, ESCO shall enter into a direct contract (Guaranteed Power Purchase Agreement) with the Investor.

(vi) Bank Guarantee

- In the event that an investor breaches a condition of the MOU, the GoG may call the investor's bank guarantee in the proportion defined under Resolution 107.
- The GoG will not call the bank guarantee if an investor's failure to perform is as a result of *force majeure* or unlawful actions by the GoG or any state body.

(vii) Termination of the MOU

- In the event that an investor breaches the time frames set out in the MOU, the GoG is entitled unilaterally to terminate MOU.
- Upon termination of the MOU, if the land plot transferred to the investor had previously been State property, or in the possession of a local self-governing body, such property shall be returned to the state or to such local self-governing body without compensation.
- As a final consequence of the termination by the GoG, an investor shall cease to have the right to complete the project.
- The MOU is governed by Georgian law and any disputes, if not settled through negotiations, will be subject to the jurisdiction of the Georgian courts.

(c) Large Hydropower Plants

For HPPs of 100 MW and over, the BOO structure is the same but the process is less standardized. For some large projects, the MoE has actively promoted projects by funding pre-feasibility and, on occasion, feasibility studies, as well as environmental and social impact assessments, prior to tendering the sites. Others have older data associated with them.

Large HPPs of 100 MW or more are tendered through a notice inviting Expressions of Interest ("EOI") by a date certain. The notice incorporates Terms and Conditions that have been approved by an order issued by the MoE specific to the particular HPP site being tendered. Those Terms and Conditions set forth the investor's rights and obligations, including the amounts of the guarantees required to be posted. Each HPP of 100 MW or more for which an EOI has been posted on the MoE's website has been preceded by an Order from the MoE stipulating specific Terms and Conditions for that particular tender.

In the event competing applications are received for a specific site, the selection process is the same as for HPPs of under 100 MW. As with smaller HPPs, applicants may also select sites not currently on the list that are identified by potential developers themselves and bring them to the MoE's attention, at which point the MoE will perform a technical analysis of the site and, if it meets the MoE's criteria, add the site to the list and the selection process proceeds as detailed above.

Chapter 5 **Regulatory Oversight and Enforcement**

The Georgian National Energy and Water Regulatory Commission (“GNEWRC”, or “the Commission”)⁵ has five commissioners. Its Chairman is appointed by the President of Georgia.

The GNEWRC is authorized to issue subsidiary legislation in the form of rules or orders of general or specific applicability. Decisions adopted by GNEWRC are subject to judicial appeal in accordance with applicable law.

Pursuant to the Electricity Law, the GNEWRC:

- establishes rules and procedures for the granting of licenses;⁶
- regulates activities of licensees, importers, exporters, the Electricity System Commercial Operator (“ESCO”) and suppliers;
- on the basis of its rules and government policies, sets and regulates tariffs for generation, transmission, dispatch, distribution, import, export and consumption of electricity;
- settles consumer complaints;
- monitors and enforces license terms and applicable law; and
- oversees the certification of electrical technicians.

Chapter 6 **Licensing**

Substantive and procedural matters related to licensing are governed by the Law on Licenses and Permits. On issues specific to the electricity sector, that legislation is supplemented by the Electricity Law. The Electricity Law establishes the terms and conditions pursuant to which the GNEWRC issues all electricity licenses. The rules governing the monitoring and control of licensed activities are addressed in detail in GNEWRC’s Licensing Regulation.

(a) Types of Licenses

GNEWRC issues licenses for the following activities:

- electricity generation;
- electricity dispatch;
- electricity transmission; and
- electricity distribution.

⁵ GNEWRC is established pursuant to the Law of Georgia on Independent Regulatory Bodies (September 13, 2002, No 1666)

⁶The Electricity law identifies the following licensed activities: generation, transmission, dispatch and distribution.

The import and export of electricity is carried out pursuant to direct contracts and is not regulated or subject to licensure. Direct contracts are registered with the Dispatch Licensee which, in order to protect the reliability of the system, may hold in reserve a certain amount of the transmission line capacity.

Under the Electricity Law, electricity generation for one's own use is not subject to licensure provided the generating plant is not connected to a transmission or distribution grid.

For any other purpose, licensed activities, as defined by the law, may only be carried out upon receipt of a license.

(b) Deregulation

The MoE is authorized to declare partial or full deregulation.

- The Electricity Law establishes a legal framework for the full or partial deregulation of certain electricity sector participants, including generation licensees.
- Deregulation occurs by way of an administrative order issued by the MoE.
- On the generation side, full deregulation means granting a generator the right to sell electricity without applying to GNEWRC for a tariff.
- Partial deregulation means granting a generator the right to sell under a marginal tariff, that is, one that has been approved by GNEWRC and that has an upper limit only.
- For small capacity power plants, full deregulation means granting a generator the right to operate without a license but under the marginal tariff.

(c) Obligations of a Generation Licensee

The term for a generation license is indefinite. A license entitles the holder to generate electricity and to connect to the transmission or distribution network pursuant to an agreement with the transmission or distribution licensee.

A generation licensee must:

- be a sole proprietor or a commercial entity, fully formed and registered under applicable law (see Chapter 3 Part 5 of this Report on types of businesses organizations);
- fulfill the terms of its license;
- comply with subsidiary legislation and orders of the Ministry and GNEWRC;
- comply with the Market Rules as they relate to generation issues; and
- comply with the requirements of the Dispatch Licensee regarding operation of the transmission and distribution facilities;

- make its generation facilities available to the Dispatch Licensee at the connection point pursuant to the terms of the power purchase contracts or approved prices, terms and conditions of service;
- except for technical or safety reasons or where a counterparty defaults on a payment obligation, not terminate, reduce or increase licensed services without the consent of GNEWRC;
- comply with all applicable laws;
- conduct its activities in an economically efficient manner;
- insofar as may be practicable, minimize costs.
- as requested, make the following information available to the MoE or to GNEWRC:
 - information about past activities (annual activity report);
 - future plans; and
 - any other information that may be required;
- fully meter electricity flowing through its facilities and make information about such metering available to the MoE, GNEWRC, or the Dispatch Licensee.
- pay its regulatory fees⁷ in a timely manner; and
- maintain separate records in respect of its licensed and unlicensed activities.

(d) Licensing Procedures

Licensing procedures are governed by the Law on Licenses and Permits and by the Electricity Law. In order to obtain a generation license, an applicant must submit a standard application form to GNEWRC, together with the following information:

- a report certifying possession (usage of generation assets);
- a report on compliance of the technical condition of the generation assets with standards;
- a list of fixed assets and audit report on the enterprise;
- an environmental impact assessment report (which should be procured under the one-stop shop available under the Law on Licenses and Permits);
- technical conditions for connection to the electricity network; and
- a scheme of the electricity network, relevant to the license application.

Issuers of the above-described reports are identified in the Licensing Regulation.

(e) Preliminary Licenses and Permits

Pursuant to the State Promotion of Investments Law, a person may apply for a preliminary license or permit. The granting of a preliminary authorization guarantees

⁷As determined by the GNEWRC on an annual basis under the Regulation No 24, September 18, 2008.

to the holder all of the rights that will ultimately be conferred by the permanent license or permit, provided that the holder complies with the relevant terms and conditions. A preliminary license entitles the holder the right to conduct certain activities during a period of time established by the grantor.

Together with the Reports required by the Licenses and Permits Law, an applicant for a preliminary license or permit files with the relevant authority a preliminary detailed proposal of the licensed or permitted activity. This list enables the granting authority to clearly identify terms and conditions, including:

- type of the activity;
- the amount of investments;
- the schedule and categories;
- location;
- engineering processes;
- description and types of used equipment;
- the implementation schedule; and
- any other data deemed relevant by the applicant.

A preliminary license or permit becomes effective after the license or permit holder presents reports confirming compliance with established license or permit terms which is confirmed by issuance of administrative-legal act by a relevant licensing authority.

The benefit of obtaining a preliminary license or permit is that the terms of such preliminary license or permit may not be revised or amended without the consent of the holder. Further, if legislation enters into force which has the effect of worsening the position of an investor, the changes brought about by such legislation shall not affect the holder of a preliminary license or permit without its consent during the five-year period following the date of issuance.

Chapter 7 **Dispute Resolution in the Electricity Sector**

(a) Court System (Material and procedural law, cost of litigation and enforcement)

The Georgian court system is comprised of courts of general jurisdiction which adjudicate civil, criminal and administrative matters. Depending on the nature and gravity of a case, city courts and regional (area) courts serve as courts of first instance. Courts of appeal are only found in large regional centers and in Tbilisi. The Supreme Court of Georgia is the highest court in the land. It deals with constitution-related issues and in cassation, reviews certain matters from the courts of first and second instance.

Georgian courts apply Georgian substantive law. Litigation procedures are governed by Georgia's civil, administrative and criminal procedural codes. Panels of one or three judges adjudicate, on one hand, criminal cases, and on the other, civil and administrative cases.

For the cases having an international character, the Law of Georgia *On International Private Law* ("the Law on International Private Law")⁸ governs conflict of laws issues. International treaties on matters of private international commercial law that have been ratified by Georgia are incorporated directly into Georgian law.

State fees payable for litigation by the plaintiff are 3% of the amount of the claim in the court of first instance, 4% for the adjudication by the court of appeal and 5% for review by the Supreme Court of Georgia sitting in cassation.

A plaintiff in the first instance will normally pay a state litigation fee in the amount of 3% of the amount of the claim. On appeal, the fee will be 4% and on at the Supreme Court of Georgia sitting in cassation, the amount will be 5% of the amount in dispute. The losing party normally pays court costs.

The Enforcement Department of Georgia (under the Ministry of Justice of Georgia) is the public entity responsible to enforce a judgment, although under the Law of Georgia on *Enforcement Proceedings*,⁹ private enterprises are also allowed to provide enforcement services. The range of the fees payable for enforcement are capped at 7%. Police and other state enforcement powers are also available to support the enforcement process.

(b) Arbitration (Substance and Procedures, Costs and Enforcement)

Under Georgian law, as an alternative to public litigation, parties are entitled to resolve their disputes by way of private arbitration. Specific procedures and the costs associated with private arbitration vary significantly. As a result of recent changes to the Law of Georgia *On Arbitration*,¹⁰ costs associated with enforcing an arbitral award are somewhat higher than they are for an enforcement proceeding arising as a result of litigation.

As with public litigation, the arbitral award may be referred for enforcement to the Enforcement Department of Georgia or private enterprises providing enforcement services. Police and other state enforcement powers are also available to support enforcement process.

(c) Foreign Litigation (Substance and Procedures, Costs and Enforcement)

⁸ Law of Georgia on *International Private Law*, April 29 1998, No 1362.

⁹ Law of Georgia on *Enforcement Proceedings*, April 16, 1999, No 1908.

¹⁰ Law of Georgia on *Arbitration*, June 19, 2009, No 1280.

Georgian courts will not directly enforce a foreign judgment in the absence of a treaty providing for reciprocal recognition and enforcement of court judgments between the rendering country and Georgia. As of the date of this report, Georgia is not a party to any multilateral or bilateral treaty providing for such reciprocal enforcement.

In the event that a judgment is obtained from a court in a foreign jurisdiction, it may nevertheless be given effect in Georgia after review by the Supreme Court of Georgia pursuant to the Law of Georgia on *International Private Law*. Police and other state enforcement powers are available to support enforcement process.

(d) Foreign Arbitration (Substance and Procedures, Costs and Enforcement)

In 1994 the Georgian Parliament ratified the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).¹¹ As a result, Georgia will recognize and enforce a foreign arbitral award pursuant to rules of the Georgian Supreme Court. Pursuant to those rules, the Georgian Supreme Court may decline to recognize the award, if pursuant to the country's legislation, the subject of the dispute was not a proper subject for arbitration or if the execution of the judgment violates Georgian norms of public policy.

Once an arbitral award has been approved by the Georgian Supreme Court, the decision will be enforced pursuant to the Law of Georgia on *Enforcement Proceedings*. The process of enforcing a foreign arbitral award may be undertaken by a public or a private enforcement body. Police and other state enforcement powers are available to support enforcement process.

Chapter 8 **Market Rules and Wholesale Trade**

(a) The Role of ESCO

- Trading in electricity and capacity generated by generation plants connected to the Georgian Power Grid and imported to Georgia is carried out by way either of a direct contract or by the ESCO.
- In 2006 the MoE established a framework for operation of the electricity market in Georgia when it adopted the Electricity (Capacity) Market Rules ("the Market Rules").¹² The Market Rules govern:
 - the operation of the electricity market and the role of the ESCO;

¹¹ 1958 New York Convention on Enforcement of Foreign Arbitral Awards ratified by the Parliament of Georgia by Resolution of February 3, 1994.

¹² Order of the Minister of Energy of Georgia No 77 on August 30, 2006.

- commercial, financial and technical relations arising from direct contracts and electricity purchase and sale, transmission, dispatch, operation of electricity system in parallel regime and consumption of generated electricity by Generation licensee for its own needs through the ESCO;
- the establishment of electricity (capacity) balances and rules for their implementation;
- terms of execution, enactment, validity and termination of the direct contracts;
- terms for conclusion of direct agreements and their enforcement;
- definition of the categories of electricity sellers for the establishment of terms of sale;
- the registration of Qualified Enterprises; and
- the General Principles of Technical Standards for Wholesale Trading.

The Market Rules require parties to direct agreements for the purchase and sale of electricity and capacity to register their contracts with the Dispatch Licensee.

The ESCO¹³ is licensed by GNEWRC and governed principally by the Market Rules. Pursuant to the Electricity Law and the Market Rules, the ESCO:

- sells and buys balance electricity and capacity (including through signing the medium and long-term import/export contracts);
- provides the electricity system with reserve capacity;
- supplies the Dispatch Licensee with the information it requires to carry out supply and consumption planning;
- creates and manages unified data (including the unified metering register) on wholesale trade;
- identifies the volume of electricity sold and purchased by electricity sellers and buyers and submits the information for settlement purposes; and
- on the basis of information provided by the Dispatch Licensee, identifies the number of electricity sellers and buyers and the quantity of electricity sold and purchased and provides that information for settlement purposes.

ESCO fulfills its legal obligation on the basis of information received from Qualified Enterprises and parties to transit arrangements. A Qualified Enterprise is an entity authorized under the Market Rules to participate in the wholesale trade of electricity. Qualified Enterprises include:

- Generation and Distribution Licensees;
- Direct Customers;
- Importers;
- Exporters;
- Small hydro power plants; and
- The ESCO.

¹³ The ESCO was established in 2006 pursuant to the corresponding amendment made to the Electricity Law. ESCO is organized as a limited liability company and 100% of its share is owned by the State represented by the Enterprise Management Agency.

(b) System Capacity Reserve and Energy Balances

- GSE is licensed by GNEWRC to conduct dispatching activities. It does so pursuant to the Electricity Law, its license and the Market Rules.
- The Market Rules require specifically identified market participants (distribution licensees, direct consumers and exporters) to provide system capacity reserve to the Dispatch Licensee who uses it to balance electricity supply and consumption.
- In order to ensure the reliable operation of the power grid and to balance supply and consumption, ESCO tops up reserves that have not been covered by Qualified Enterprises. The costs related to such top up are for the account of such enterprises.
- ESCO is required by its license and the Market Rules to submit forecast energy balances to the MoE.
- On the basis of approved balances and in the interest of the reliable operation of the power system, the Dispatch Licensee conducts daily and hourly planning of electricity supply from generation facilities and other sources of power.

(c) Electricity Trading by Small Capacity Power Plants

- The Electricity Law defines a small capacity power plant as a plant with a design capacity of less than 13 MW.
- A small capacity power plant may sell electricity to a Qualified Enterprise or a retail consumer. The *Electricity Law* defines a retail consumer as any person, other than a direct consumer that receives electricity (capacity) from a generation, transmission or distribution licensee for its own consumption and not for re-sale.¹⁴

Chapter 9 **Tariffs**

(a) Government Policy

The GoG's tariff policy is that:

- electricity generation prices should be gradually deregulated; and
- until deregulation occurs, tariffs should reflect the separate costs associated with separate categories of customers.

¹⁴ The minimum volume of such consumption is defined from time to time under the State Energy Policy.

That policy is reflected in tariff regulations¹⁵ adopted by GNEWRC.

(b) Legal Principles

The Electricity Law establishes the following tariff setting principles:

- customers should be protected from monopolistic prices;
- service providers are entitled to full cost recovery including:
 - the cost of fuel purchased at a reasonable price;
 - operation and maintenance costs;
 - the current and capital repair costs;
 - payments of the principal amount and interest on loans taken as liquid assets;
 - costs of licenses and other regulatory costs including fees; and
 - reasonable and fair investment revenue sufficient to attract investments for sector rehabilitation and development.
- economic efficiency within the electricity and natural gas sectors should be improved:
 - by setting short-run and long-run marginal costs; and
 - by forecasting dynamics of prices with regard for probable surpluses or deficits of electricity generation;
- the national energy policy should be taken into account, particularly as it relates to priorities established in respect of the categories of electricity consumers;
- a service provider should be entitled to require a consumer to pay for services and to disconnect a customer for failure to meet its payment obligations;
- the national policy on tariff preferences should be taken into account, provided, however, that subsidizing of tariff preferences for any category of consumers at the expense of a licensee, importer, ESCO or a supplier should be prohibited;
- tariffs should reflect different service fees for different categories of customers; and
- service costs incurred by a licensee, importer, system commercial operator and supplier shall be covered from the amounts received from each category of customers in proportion to the costs of services rendered to that category.

¹⁵ Tariff Methodology adopted by GNEWRC on July 1, 1998 under Resolution No 3.

(c) GNEWRC as Tariff Setting Body

The Electricity Law authorizes the GNEWRC to set electricity tariffs. GNEWRC sets tariffs pursuant to the Tariff Methodology in observance of which it receives and responds to a tariff application. GNEWRC sets tariffs pursuant to:

- its published tariff-setting principles;
- the national energy policy; and
- any other secondary legislation or administrative orders issued pursuant thereto.

(d) Procedures

GNEWRC's tariff setting process commences upon receipt of a completed tariff application which comprises specifically identified substantive and financial information, some of which must be audited.

The following are entitled by the Electricity Law to file a tariff application:

- licensees;
- importers;
- ESCO; and
- direct customers.

GNEWRC will consider a tariff application in a public hearing held by GNEWRC pursuant to its rules. Those rules address:

- the tariff review process;
- the issuance of relevant resolutions;
- the receipt of comments by consumers and other interested parties;
- the acquisition of additional information necessary to assessing tariff applications; and
- financial reimbursement for regulatory costs.

GNEWRC must complete its tariff application procedures not later than 150 days after it has received a complete tariff application.

The tariff applicant is required to reimburse GNEWRC for all costs associated with its tariff setting services.

(e) Tariff Methodology

GNEWRC's tariff methodology is based on the principle of full cost recovery for the generation and supply of electricity. Depending on the type of customer involved, the Commission's tariff methodology includes (depending on the type of customers):

- seasonal tariffs;

- peak load (day and night tariffs);
- step tariffs (based on consumption volume);
- long-term pre-set tariffs (including marginal tariffs); and
- marginal tariffs.

GNEWRC's tariff methodology has also taken into account the risks and interests of specific investors.

- In the past, GNEWRC has allowed a rate of return of 14%.
- In one case, GNEWRC has agreed to a six-year period for return of investment.

GNEWRC sets:

- marginal generation tariffs;
- system capacity reserves;
- transmission tariffs (except for the transit of power through Georgia, which, under the Electricity Law, is not subject to the Commission's tariff setting powers);
- consumer tariffs; and
- fees and tariffs for the connection of new consumers.

GNEWRC sets a double-rate tariff for generation reserves, including:

- the system capacity reserve tariff (which compensates constant cost of reserve source); and
- used reserve electricity generation tariffs.

The double-rate tariff set for reserves is applicable during the full term of the relevant contract for capacity reserves.

(f) Currently Applicable Tariffs

As of the date of this report:

- The Low Voltage (LV) consumer step tariff for Tbilisi is 16 tetri/kWh and 13.8 tetri/kWh for the regions.
- For efficiency and social protection reasons a "step tariff" has been established.
- For sales at 6 – 10 kV and above, differential tariffs have been set.

(g) Tariff Stabilization

Regulation No 26 on Approval of the Preliminarily Determined Long-term Fixed Tariffs for the Purposes of Creating a Stable Investment Environment in Energy Sector of Georgia is a regulation of specific rather than general application and

endorses a pre-agreed mechanism for tariff revision or correction for Telasi.¹⁶ In similar cases, such practice may be subject to replication.

Chapter 10 **Network Access**

Access to transmission and distribution networks is governed by:

- the Electricity Law; and
- Market Rules.

In exchange for the tariff established by GNEWRC, a transmission or a distribution licensee is required to wheel within its network electricity that, under the Electricity Law, may be sold directly to customers. Upon application, the GNEWRC sets wheeling tariffs pursuant to its common tariff regulation.

Third parties wheeling electricity using the assets of other licensees are required to do so pursuant to a direct agreement with such licensee. Similarly, small capacity power plants should also enter into direct agreements with such licensees or plants. Wheeling of electricity cannot be denied by the owner of the corresponding transmission or distribution network, unless there restrictions are caused by the capacity of the network or are justified by the failure of the third party to pay the wheeling tariff.

PART THREE **RELEVANT RELATED LEGISLATION**

Much of the legal framework upon which a successful hydro power sector investment depends is not sector specific. This Part will examine the following related but discrete subjects:

- Environmental Law;
- Water Law;
- Land Use and Ownership;
- Taxes and Customs;
- Company Law;
- Investment and Promotion; and

¹⁶On September 24 2008 GNEWRC adopted Regulation No 26 on Approval of the Preliminarily Determined Long-term Fixed Tariffs for the Purposes of Creating a Stable Investment Environment in Energy Sector of Georgia. This regulation is based on the Resolution No 170 of August 6, 2008 of the GoG on Promotion of Investments in Energy Sector of Georgia and the Memorandum signed between GoG and RAO UES (shareholder of Telasi, Tbilisi Disco) in June 2007, under which guarantees for stable investment environment were provided by the Government of Georgia.

- Banking and Financial Regulation.

Chapter 1 **Environmental Law**

The rules governing environmental protection in Georgia are found both internationally and domestically. International norms are found in the Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters (“the Aarhus Convention”).¹⁷ The Aarhus Convention is the only international agreement that may have potential application in the development of Georgian hydropower resources. Because Georgia is a monist state, in the event of a conflict between a convention and Georgian domestic law, the convention shall control.

The domestic legal framework is comprised of:

- the Law *On Environmental Protection*; (“the Environmental Protection Law”);
- the Law *On Environmental Impact Permit* (“the EI Permit Law”)
- the Law *On Water* (“the Water Law”); and
- the Technical Regulation on Environmental Protection.¹⁸

(a) The Law on Environmental Protection

The Environmental Protection Law establishes a legal foundation for environmental protection in Georgia. It sets out the main principles of:

- environmental protection;
- the protection of human rights in the area of environmental protection;
- the state’s role in protecting the environment;
- the rational use of nature;
- state support for biodiversity, and
- the protection of the environment from adverse impact.

(b) The Law on Environmental Impact Permit

The EI Permit Law, a law that is complementary to the Environmental Protection Law, deals specifically with the process of obtaining an environmental impact permit.

¹⁷ Aarhus Convention was ratified by the Parliament of Georgia on February 11, 2000 under Resolution of the Parliament No 135.

¹⁸ Adopted under the Order No745 of the Ministry of Environmental Protection and Natural Resources on November 13, 2008.

Pursuant to the EI Permit Law, no HPP having a capacity greater than 2 MW may be sited, constructed or operated in the absence of an Environmental Impact Permit (“EI Permit”). This law establishes:

- a complete list of activities that are subject to mandatory expert review;
- a list of documents that must be submitted in order for a permit to be granted; and
- procedures for the issuance of a permit, the conduct of an environmental impact assessment and public participation and public hearings.

The issuance of an EI Permit is subject to the procedure known as an ecological examination. If construction of a hydropower facility requires an investor to propose technology different from previous technology used to generate the hydropower, the construction will require an ecological examination of the project, regardless of the size of HPP capacity (i.e., even if it is below 2 MW).

Because construction of an HPP over 2 MW also requires a construction permit under the Law of Georgia *On Control of Technical Hazard*,¹⁹ the EI Permit Law requires the Ministry of Environmental Protection and Natural Resources (“MEPNR”) to make the process of issuing an environmental impact permit a part of, and the foundation for, the issuance of a construction permit by the Technical and Construction Inspectorate. Therefore, upon the conclusion of an ecological examination, the report detailing such examination is delivered to the Technical and Construction Inspectorate in the form of an administrative legal act of MEPNR. Ultimately, the report will become a part of the construction permit.

The filing of an application for a construction permit is also conditioned on the observance of any requirement of the EI Permit Law, including:

- those related to public hearing (review) of an Environmental Impact Assessment Report;
- formal issuance of the results of the hearing; and
- observance of the terms of the EI report.

Chapter 2 **The Law on Water**

(a) Overview

The water resources management system in Georgia is governed principally by the Law On Licenses and Permits and the Water Law.

The state water resources of Georgia include rivers, lakes, natural and artificial reservoirs, canals, ponds, underground water, glaciers and wetlands. They are

¹⁹ Law of Georgia on *Control of Technical Hazard*, April 8, 2010, No 2911.

managed by National institutions, institutions of the Autonomous Republics (“AR”), and Units of Local Self-Governance. In general, the control, monitoring, management and protection of water resources are within the competence of the MENPR.²⁰ Although water management is highly centralized, Units of Local Self-Governance are responsible to supervise measures for water protection and rational use of water on their territories and to control water protection and water use. At the same time, AR authorities are responsible to protect water and to control of water use on their territories. Unfortunately, the competences of Units of Local Self-Governance and ARs in respect of water management are not clearly defined and in many instances, they overlap.

The legislative framework for the water sector is currently being revised. In addition, the MENPR is developing a new draft environmental code that is intended to replace existing sectorial environmental legislation. In the near future the GoG also intends to revise the nation’s principal water resources legislation.

The Water Law identifies the following categories of water:

- Category 1 – Bodies of Water that have Special Importance to the State: This category includes permanent snow covers and mountain tops; surface waters and bodies of water that have special scientific or aesthetic importance.
- Category 2 – Bodies of Water that are Important to the State: This category includes wetlands, surface water bodies and water fund lands situated in more than one administrative-territorial unit, trans-border bodies of water, territorial waters, bodies of water that are located within special economic zones, significantly sized bodies of ground water.
- Category 3 – Bodies of Water of Local Importance: This includes all bodies of water not defined under other Category 1 or Category 2.

It is unlawful to use a Body of Water of Special State Importance for hydro power development. A body of water of State Importance and a body of water of Local Importance may be so used, but they are subject to numerous environmental and safety standards. They are also subject to the MEPNR’s regulations and to regulations promulgated by the ministry’s territorial units, AR authorities and Units of Local Self-Governance.

The MEPNR has established a list of bodies of water that are characterized as being of Special Importance as well as a list for Waters of State Importance. Most of the nation’s major rivers (56) and 9 water reservoirs fall into the category of bodies of water of State Importance. A list of bodies of ground water either of State Importance or Local Importance has been adopted under a joint order of the Geology Department and the MEPNR.

²⁰ Not all types of water regulatory issues fall within its competence, however. For example, a license to use underground waters issued by the Ministry of Economic Development and issues of drinking water quality are controlled by the Ministry of Agriculture.

(b) Authorizations for Water Abstraction and Discharge

Regulatory clearances required for electricity generation do not include any licensing or permitting, either to abstract water or to discharge water.

(c) Fees for Water Use

The Law of Georgia *On Fees for Use of Natural Resources*²¹ establishes an obligation to pay fees as well as the level of fees payable for the use of water resources. For hydropower plants, the fee for 1 m³ of water constitutes 0.01% of the fees envisaged for the groups of bodies of water which are categorized as follows:

Groups of Water Bodies (including types of the water bodies)	Fee for 1m³ LARI
Group I (Caspian Basin Rivers, Lakes and Other Water Reservoirs)	0.01
Group II (Black Sea Basin Rivers, Lakes and other Water Reservoirs)	0.005
Group III (Black Sea water)	0.003

Fees are paid to the State Budget on a monthly basis, on or before the 15th day of the following month. The process of fee collection is administered by the Georgian Tax Authorities (except for the fees paid prior to acquiring a license/permit for which MEPNR is responsible). Violations are prosecuted under provisions of the Georgian Tax Code.

(d) Irrigational Reservoirs

The use of water found in irrigation reservoirs is governed by the Regulation on rules of Exploitation of Irrigation Reservoirs.²²

The Ministry of Economic Development of Georgia has established four state-controlled regional irrigation companies:

- (i) Alazani M: operating in the Kakheti Region;
- (ii) Sioni M: operating in the KvemoKartli Region;
- (iii) Mtkvari M, LLC: operating in the ShidaKartli; and
- (iv) Kolkheti M, LLC: operating in Western Georgia.

²¹ The Law of Georgia on *Fees for Use of Natural Resources*, December 29, 2004, No 946.

²² Regulation on Exploitation of Irrigation Reservoirs, Order 2-25 of the Ministry of Agriculture of Georgia of February 19, 2001.

The GoG has allocated charter capital to each of these companies. Another newly-established company, Hydrogeology LLC, is tasked with providing hydro-geological services and rehabilitating systems throughout the country.

Irrigation companies are required to provide rehabilitation services to the associations and individual users and to collect fees for the rendering of such services. HPPs that require water from the irrigation systems will be required to enter into direct contracts with the relevant irrigation company and to pay the relevant service fee. This fee, subject to negotiation, may be as high as ten per cent (10%) of the revenues collected from the sale of electricity.

(e) Land Improvement Associations

Land Improvement Associations have been established to improve water management and to provide land improvement services. These associations are public legal entities established by the Act of the Ministry of Agriculture of Georgia pursuant to an application by the founders of association.²³ In order to establish a Land Improvement Association it is necessary to have the written consent of not less than 51% of land owners on the territory covered by association services.

An association, governed by a board:

- receives water through irrigation systems;
- distributes water among land owners (members and non-members of the association) (primary water users);
- registers water use;
- receives service fees; and
- pays the fees to the water supply organizations.

There are two types of associations. The first is an Association of Water Users. This entity is created by the owners of the land in the systems zone. Natural and legal persons who generate electricity are required to agree to conditions of secondary use of the water from their reservoir as well as from the irrigation systems with the primary users of water. Primary water users are the members (land owners) of the association. Any other users are secondary users. The second type is Association of Drainage Users created by the owners of the land in the drainage system zone.

Activities of Land Improvement Associations are subject to the control of the Ministry of Agriculture of Georgia.²⁴

Chapter 3 **Land Use and Ownership**

²³The entire process is governed by the Law of Georgia on Land Amelioration.

²⁴Under the Order of the Minister of Agriculture No2-107 of April 21, 2005 on Form and Scope of Implementation of State Control over Activities of Amelioration Associations.

(a) General

In order to implement a hydropower investment, an investor will require property rights over the land on which the plant will be located. The acquisition of this property right is a precondition to receiving a construction permit.

The right of a natural person and a legal entity to own property is protected by the Constitution of Georgia. Under the constitution, the right to own, acquire, alienate and inherit property is universal and interference with such rights is prohibited. However, the Constitution also envisages exceptions to that rule and these exceptions are detailed in the Law of Georgia on the *Rules of Expropriation of Ownership for Urgent Public Necessity*²⁵.

Depending on the legal nature of the ownership of such land (state or private), case-specific procedures may be applicable.²⁶

A potential or actual investor will have to deal with private or public entities in the process of acquiring land rights. Such rights may comprise:

- ownership;
- long-term lease; the right to build; or
- any other form envisaged by the Civil Code of Georgia.

Under Georgian law, land rights include

- ownership;
- various types of usage rights, including:
 - lease;
 - tenancy;
 - servitude;
 - usufruct; and
 - the right to construct.

Rights to land can be obtained in different ways, including:

- privatization (i.e. gaining full ownership directly from the state or local government),
- purchase from private owners; and
- expropriation by the state under the eminent domain legislation.

²⁵ Law of Georgia on *Rules of Expropriation of Ownership for Urgent Public Necessity*, July 23, 1999, No2349.

²⁶The process of acquiring property rights is governed by the Law of Georgia on *State Property*, the Law of Georgia on *Local Self -governance* and Civil Code of Georgia together with secondary legislation enacted pursuant thereto.

(b) Types of Land Ownership

Land is divided into two categories:

- state (or local self-governance) owned land; and
- privately-owned land.

The legislation envisages certain restrictions in respect of transfer of various property rights to the state (or Units of Local Self Governance) properties. Obtaining property rights over privately-owned lands is not limited by law, but rather negotiations with the private owner.

In respect of state-owned land, however, there is a category of “*de facto* occupied land.”²⁷

Under the same law, with exceptions, state-owned land that is being lawfully used by a tenant may also be recognized as a property of the user or tenant.

(c) Functional Designation

Georgian law distinguishes between lands that are designated agricultural in nature and those that are not. The distinction is significant because the law forbids foreign ownership of agricultural lands. The designations also affect land use and the methods or procedures which can be used to acquire property rights where state ownership is involved. There are various methods and procedures that must be followed if an investor or potential investor seeks to acquire land use rights over agricultural or non-agricultural lands held by the State or by Units of Local Self Governance

Other than for agricultural land, these procedures do not apply to the acquisition of rights in privately-owned land, where generally speaking the matter is subject to negotiations and agreement by the private owner and the buyer. This is true, irrespective of the functional designation of the land.

(d) Agricultural Land

According to the statutory definition, agricultural land is land that has been registered with the *National Agency of Public Registry*, a legal entity of public law located at the Ministry of Justice of Georgia. Land qualifies for registration as an agricultural land plot if is used for production of crops and life-stock products, with or without the industrial and supplementary structures. The legislation further qualifies:

- a household’s (family’s) share of ownership in pasture;
- hay land and forest territories of the village or settlement; and
- such part of agricultural land which can be designated as a separate property.

²⁷This is found in the Law of Georgia on *Recognition of Property Rights over the Factually Occupied Land*.

Agricultural land can be either privately-owned or owned by the state (or by a Unit of Local Self Governance). A private owner can be either a citizen of Georgia or a household of Georgia, or a Georgia-registered legal person. However, the law establishes several restrictions on the right of a foreign natural or legal person to own agricultural land. Foreign citizens can own (in fee) an agricultural land parcel, provided such person has received the parcel as a legacy, or if such parcel was under its lawful possession while the person was a legal citizen of Georgia. There are no time limitations on agricultural land parcels held in ownership by a foreign legal person if such a parcel was received as a legacy.

If, however, agricultural land is acquired for ownership by foreign citizens or foreign legal persons in any other manner, such foreign owner will be required to transfer the land holding plots to a Georgian citizen, household, or to a Georgia-registered legal person within six months of acquisition. Failure to do so will result in confiscation of the holding by the state upon the payment of adequate compensation as determined by a court of competent jurisdiction.

Georgian law expressly prohibits the use of agricultural land for non-agricultural purposes. However, it is possible to change the functional designation of agricultural land to non-agricultural land. After such a change has been registered, the land can be lawfully used for non-agricultural purposes. Any change of functional designation results in the inapplicability of the ownership restrictions described above. The MEPNR is the state body responsible for confirming any change in designation. The law gives interested state bodies, Units of Local Self Governance and legal and natural persons the right to apply for a designation change. Requirements for the justification of a claim to change designation are also clearly established by law and vary according to the type of land ownership (state or private).

(e) Non-Agricultural Land

Non-agricultural land is registered and designated as such in the Public Registry. The designation is not affected by whether the land is held privately or by the state or a Unit of Local Self Governance. The right to hold full and unrestricted title over non-agricultural land in Georgia does not depend on nationality (citizenship) of the holder.

(f) Privatization of Land

As a general rule, ownership in a land parcel held by the state or a Unit of Local Self Governance (either agricultural or non-agricultural) may be transferred to a private person, provided that such person meets the relevant privatization requirements and provided that the transfer of ownership is accomplished pursuant to relevant legal procedures.

(g) Land not subject to Privatization

Certain movable and immovable property having strategic importance for the state may not be privatized, including:

- mineral resources;
- water resources;
- territorial waters;
- continental shelf;
- state forest fund;
- air space;
- reservation;
- national park;
- natural monument;
- habitat/species management area;
- objects of historical, cultural and artistic value and buildings of cultural and artistic designation (unless respective conditions are complied with and unless the privatization is agreed with the Ministry of Culture, Protection of Monuments and Sports of Georgia);
- active or inactive religious buildings, their ruins and land parcels where these are located;
- historical and cultural state archives of special significance;
- state fund of cine-, photo- and phono-documents;
- archives and funds of the ministries and other institutions of Georgia and scientific-research institutions;
- museum collections and funds of special importance;
- properties of electricity sector dispatch; properties of legal persons of public law, where public schools, institutions of higher education and science are located; hydro-technical buildings, lighthouses, signal posts and waters of ports of special importance; main gas pipelines;
- automobile roads;
- facilities for air movement, management and control;
- take-off and landing tracks of special importance;
- frequency spectrum;
- position of Georgia on geostationary orbit;
- state pantheons;
- properties allocated to the Prosecutor's Office of Georgia and Ministries of Defense and Internal Affairs for deployment purposes.

Further, Georgian law specifically prohibits the transfer of the following types of state-owned agricultural land into private ownership:

- pastures, excluding pastures leased prior to July 2005 or pastures which lawfully form part of the state or privately owned buildings located on respective land;
- livestock trails;
- first tier of sanitary protection zones of water-supply objects;
- forest fund land, which is used for agricultural purposes;
- recreational land;
- land designated for historical, cultural, natural and cultural-religious monuments;

- land of protected territories; and
- agricultural lands transferred with usufruct right to institutions and legal persons of public law under budgetary financing;
- land plots adjacent to a number of rivers of Georgia on which construction of new sources of renewable energy is envisaged and coordinates X and Y of which are approved under the Order of the Ministry of Economy and Sustainable Development of Georgia.²⁸

Notwithstanding these prohibitions, Georgian law does authorize the GoG, upon a specific request lodged by the Ministry of Economic Development of Georgia, to permit privatization of:

- livestock trails;
- land within the first tier of sanitary protection zones of objects of water-supply;
- forest fund land;
- recreational land;
- land plots adjacent to a number of rivers of Georgia on which construction of new sources of renewable energy is envisaged and coordinates X and Y of which are approved under the Order of the Ministry of Economy and Sustainable Development of Georgia.

This authorization is applicable only for purposes of projects designated by the GoG to be “of high significance”. Under the State Promotion of Investments Law, hydropower plant investments qualify as an “investment of special importance”. This implies that such a project would fall under the definition of “project of high significance”. Thus, an investor may also be granted the right to privatize listed types of land parcels if they are needed for HPP construction. Finally, an investor may also take advantage of the provisions in Georgian law which allow the use of certain parcels of land to be recategorized.

Chapter 4 **Taxes and Customs**

(a) Overview

In the past few years, the GoG has simplified the tax structure in Georgia. In addition, applicable rates in the Tax Code and the Customs Code have been reduced. Further, several duty free zones have also been established. The new Tax Code (1 January 2005):

- reduced the number of taxes from 21 to 7 (excluding tariffs);

²⁸ Such rivers include: Enguri, Rioni, Kvirila, Mtkvari, Khrami, Tergi, Ksani, Aragvi, Supsa, Bakhvistskali, Khobi (Khobistskali), Tekhura, Tskhenistskali, Dzirula, Nenskra, Kintrishi, Jejori, Khanistskali, Gubazeuli, Faravani, Stori, Nakra, Kheleduli, Jonouli, Sakauri, Chakvistskali, Tsablarastskali, Samkuristskali, Magani, Pirikita Alazani, Avaniskhevi, Dumala, Cheleti, Chveshuri (Chashusi), Duruji, Chkhorotsku, Iori, Lebarde, Tsachkhuri, Bzholiskhevi, Chanistskali, Merisi (Akavreti), Shavi Tskali, Uraveli, Khumfreri, Kvirilistskali, Jutistskali (Juta), Snostskali, Khda (Khdistskali), Amali, Chkheri, Qesia, Mnaisistskali, Chorokhi and Acharistskali.

- introduced a flat personal income tax rate of 20%;
- removed social tax;
- reduced the VAT rate from 20% to 18%; and
- reduced the corporate tax rate.

The new Tax Code also increased excise tax rates on some products and broadened the tax base for VAT and profit taxes.

The tax on gambling business was abolished on 1 January 2006.

Also in 2006, a new Law on Customs Tariffs was enacted. Its purpose was to streamline the customs tariffs so that only three rates (12%, 5% and 0%) were in force.

In 2007, the Law on Customs Tariffs was abolished and merged with the Tax Code of Georgia. This further reduced customs fees in order to stimulate trade. As a result of these reforms, all imports, except for a small number of agricultural goods, construction materials and certain other goods, are subject to 0% customs tariffs. Georgia's weighted average import tariff is among the lowest in the world.

The GoG has also adopted measures to improve tax administration. Increasing tax revenues have allowed the GoG to pay off wage and pension arrears and to increase spending on infrastructure. The GoG expects that the Tax Code will continue to stimulate the economy, encourage faster economic growth, expand the Government's tax base, reduce tax evasion and thus increase revenues.

Pursuant to the revised Tax Code (1 January, 2009):

- withholding tax on interest income received from deposits placed with licensed institutions has been abolished;
- withholding tax on interest income received from debt securities admitted to trading on a local stock exchange with a free float exceeding 25% has been abolished;
- corporate profit or personal income tax on capital gains from securities admitted to trading on a local stock exchange with a free float²⁹ exceeding 25% has been abolished;
- withholding tax on dividend income from equities admitted to trading on a local stock exchange with a free float exceeding 25% has been abolished; and
- interest paid on state debt securities and income received from the sale of such securities is exempt from personal income tax or corporate profit tax, as applicable.

²⁹ Free float is defined as a share of the securities of any class issued by an issuer which does not belong to any of the following: a) 5% or larger share in the securities held by any person (including the issuer); b) securities held by the state or local governance bodies, legal persons of public law; c) securities which are in beneficial ownership of the Issuer's management body members and employees.

The personal income tax rate is 20% until 1 January 2011 and it is scheduled for further reductions to 18% through 1 January 2012. The tax on dividends is 5% until 1 January 2011 and it is intended to be further reduced on 1 January 2012. Interest received from licensed financial institutions is no longer taxed at the source and is not included in the gross income of the recipient unless it is also a licensed financial institution. If the recipient is a licensed financial institution, the interest is not taxed; it is however included in its gross income.

The Ministry of Finance (“MoF”) has plans to combine the tax and customs codes. This merger is part of the second phase of tax and customs reforms. It is intended to make it easier for a taxpayer to understand the duties and penalties in both cases. The government hopes that the combined code will make procedures and responsibilities clearer for both customs users and taxpayers. Among known changes are:

- abolition of the Customs Department and takeover of its functions by the Revenue Service;
- new procedures for rescheduling tax obligations without adverse consequences;
- clearly defined penalties for repeated violations by a taxpayer;
- allowing electronic communication between taxpayers and the tax authorities; and
- assigning legal force to the answers/interpretations received from the tax authorities in response to the questions posed by taxpayers.

(b) Profit Tax

Legal entities carrying out activities in Georgia are subject to a corporate profit tax. Georgian entities, meaning entities incorporated or managed in Georgia, pay corporate profit taxes on their worldwide income. In contrast, foreign entities pay corporate profit taxes only on Georgian-sourced income.

Taxable profit of Georgian entities, as well as that of foreign entities operating in Georgia through their permanent establishment, is equal to the difference between taxable income and tax-deductible expenses. The corporate tax and profit tax rates are flat and, starting from the 1st of January 2008, is 15%.

A permanent establishment is defined as any permanent location in Georgia and generally includes any entity or natural person through which a foreign entity conducts its business activities in Georgia. Domestic tax law and double tax treaties identify certain activities that do not result in a taxable permanent establishment.

Foreign entities earning Georgian-sourced income (including dividends, royalties and interest income) without a permanent establishment in Georgia are subject to withholding tax on this income at the source of payment (i.e. by the company paying income) at the rate of 4% or 10%.

Certain relief on non-resident income withholding tax may be available through applicable double taxation treaties.

(c) Capital Gains

Georgia has no separate tax on capital gains. Capital gains of resident natural persons, as well as Georgian-source capital gains of non-resident natural persons arising from the sale of any asset (including securities), are taxable at the flat personal income tax rate of 12%. Although the income tax rate is a flat 20%, special tax concessions (which are enforced) serve to lower capital gains taxes to 12% until January 1, 2011.

The sale of tangible assets (including securities) held by an individual for more than two years is exempted from personal income tax.

Non-resident private persons are required to register as taxpayers in Georgia, file an income tax declaration and pay personal income tax on capital gains before the 1st of April of the year following the year in which the gain was generated.

Capital gains of Georgian entities, as well as Georgian-source capital gains of foreign entities, are taxable similarly to other taxable profit at the flat profit tax rate of 15%.

Foreign entities are required to register as taxpayers in Georgia before declaring and paying their Georgian tax liabilities. The deadline for declaring and paying corporate profit tax is the 1st of April of the year following the year in which the profit/gain was generated.

Certain relief on the taxation of capital gains may be available to both nonresident individuals and companies through double taxation treaties.

(d) Dividends

Until January 1, 2011, a 5% withholding tax is imposed on dividends paid to natural persons and foreign entities, subject to certain relief which may be available through applicable double taxation treaties. Dividends paid to Georgian entities or Georgian permanent establishments of foreign entities are not subject to withholding tax and are not included in taxable profit.

From January 1, 2011 until January 1 2012, dividends shall be subject to a 3% withholding tax. Thereafter, dividends paid to natural persons and foreign entities shall be taxed at 0% rate.

(e) Property Tax

Georgia applies a property tax at a flat rate of up to 1% on the annual average net balance sheet value of tangible and intangible non-current assets of Georgian entities and Georgian permanent establishments of foreign entities.

The property tax is a local tax. As such, its exact rate is determined by Units of Local Self Governance.

Notably, land and certain movable property (cars, yachts, etc.) are taxed based on specific rules set out by domestic tax law.

(f) Value Added Tax

The Tax Code of Georgia sets the value added tax at the rate of 18%. Taxable operations include supply (and import) of goods and services in Georgia. Certain business activities, such as, for instance, financial services, are exempt from VAT.

The Tax Code of Georgia establishes a mechanism to, on a monthly basis, offset input VAT (VAT on purchase and import) against output VAT (VAT on sale).

Companies are required to file a VAT declaration for the reporting month not later than 15 days after the end of the reporting month and offset input VAT against output VAT and transfer the difference to the state budget. Surplus VAT payments can be reclaimed or offset against future VAT payments or current tax liabilities pursuant to the special provisions of the Tax Code of Georgia.

VAT taxable transactions include:

- the supply of goods or services made in Georgia (including free supply);
- the supply of goods or services by a taxpayer to its employees with or without payment;
- deemed supply of goods at the moment of termination of VAT registration;
- the export of goods from Georgia; and
- the import of goods into Georgia.

When goods are temporarily imported into Georgia, VAT is paid at 3 % of the amount of VAT payable for each complete/incomplete month.

Transactions that are not subject to VAT taxation include:

- the supply of cash or land;
- the supply of assets when an entity is reorganized;
- the supply of assets contributed to the authorized (charter) capital of another entity; and
- the supply of all assets of an independently operating unit of a VAT taxpayer entity to another VAT taxpayer in a single transaction provided that both parties notify Georgian Tax Authorities within 15 days after the supply.

The place of supply is wherever the goods are actually supplied or where the transportation of goods commences in Georgia. Depending on the nature of the service, the place of supply is either:

- the place where the service is actually provided;
- the place where a service provider is registered; or
- the place where the benefits from the supply are received.

VAT registered taxpayers must issue VAT invoices to customers upon request, no later than the second day after a VAT taxable transaction is carried out irrespective of whether the customer is a taxpayer or not.

An enterprise can register voluntarily as a VAT taxpayer; however it must register if it:

- conducts economic activities and the total amount of VAT taxable transactions in any continuous period of 12 calendar months exceeds GEL 100,000; or
- produces and/or imports excisable goods for business purposes (except for production and/or import of motor vehicles); or
- intends to carry out a single VAT taxable supply or a set of VAT taxable supplies in one day with a total amount exceeding GEL 100,000 (registration must be done before the supply is made).

The VAT registration procedure is straightforward and can be accomplished within one working day.

VAT registration can be terminated:

- upon liquidation of a business;
- if the one time supply exceeding GEL 100,000 is not carried out; or
- if total taxable transactions excluding VAT during the last 12 months do not exceed GEL 100,000, provided the company has been registered for at least 2 years.

VAT is either 18% or 0%. Zero Rated Supplies include:

- exports, supplies of goods or services intended for the official use of foreign diplomatic and comparable representative offices;
- organized foreign tours into Georgia by tour operators and the supply of tourist packages to them; and
- international transportation of freight and passengers.

Until January 1, 2009 supply, transfer and delivery of electric power was qualified as zero rated supply.

The list of exempted items includes:

- financial and insurance services;
- privatization sales;
- the import and supply of goods and services under the Law of Georgia on *Oil and Gas*;

- the import and supply of certain medicines, educational services, medical services, transit, supplies of baby products, publications and mass media;
- the supply of goods and services within Free Industrial Zone; and
- the supply of goods and services to a VAT taxpayer in Free Warehouse.

With respect to the electricity sector, VAT exemption applies to the import of goods and/or construction-installation, renovation, rehabilitation, testing and/or geological exploration services financed by the favorable credits issued by the foreign states and/or international organizations under international agreements ratified by the Parliament of Georgia for the purposes of rehabilitation of the Georgian electricity sector.

VAT paid or payable (input VAT) can be credited against VAT or other taxes payable, or may be refunded, with some exceptions (e.g. VAT paid on purchases not intended for economic activity, or purchases for social, charitable, entertainment and representation purposes, etc.).

For paid VAT to be creditable, certain conditions apply, including:

- being registered VAT payer;
- presenting a valid VAT tax invoice for the purchase to GTA within 45 days from the end of the month to which the invoice corresponds;
- the goods and services purchased must be intended solely for economic activities; and
- the goods and services purchased must be intended solely for VAT taxable operations.

Cases where no VAT credit is allowed include cars (except for cars purchased by persons whose principal activity is the purchase/sale, lease or rent of cars), social, entertainment and representation expenses, goods and services intended for production of goods and services that are exempted from VAT, goods and services intended for non-economic activities.

A reverse charge VAT (“RCVAT”) mechanism applies when a supplier of VAT taxable services is non-resident and has no VAT registration in Georgia. The resident paying for the non-resident service must report and pay RCVAT. Paid RCVAT is creditable against VAT payable in the same manner as directly paid input VAT. Refunds of RCVAT are based on the same rules as usual VAT but the Report verifying the payment of RCVAT is used as the VAT tax invoice. A credit can only be made if a taxpayer is registered for VAT.

(g) Withholding Taxation and Double Taxation Treaties

Income earned by foreign companies and individuals from Georgian sources not having a Permanent Establishment (“PE”) in Georgia is subject to withholding tax at the source of payment.

Double taxation treaties may reduce the tax rates. In general, double taxation treaties provide relief from the payment of non-resident income withholding tax (such as on interest payments, for instance), as well as withholding tax on dividends and capital gains in Georgia when the non-resident has invested in the Georgian company in excess of a certain investment threshold, while taxing dividends and capital gains in other cases at lower tax rates compared to the statutory rates.

A resident payer of income is responsible:

- to withhold the tax from the income paid without taking into consideration associated expenses;
- to transfer the amount withheld to the state budget upon the payment to the foreign person; and
- to file the return not later than the 15th day of the month following the month in which the payment was made.

Currently Georgia has double taxation treaties with: Armenia, Azerbaijan, Belgium, Bulgaria, China, France, Germany, Greece, Iran, Italy, Kazakhstan, Latvia, Lithuania, the Netherlands, Romania, Turkmenistan, Ukraine, The United Kingdom, Uzbekistan, Poland, Austria, and Czech Republic.

Because double tax treaties vary from country to country, they must be analyzed in the light of the investor's specific circumstances.

(h) Withholding Tax on Interest

A 7.5% withholding tax is imposed on interest payments made by Georgian entities or Georgian Permanent Establishments of foreign entities, provided that the source of interest income is in Georgia. Interest paid on loans from resident banks is not subject to withholding tax. Relief on withholding tax on interest income may be available through applicable double taxation treaties. Interest tax rate are 5% from January 1 2010 to January 1 2011. Thereafter it shall constitute 0%.

(i) Thin Capitalization Rules

For the purposes of the Georgian Tax Code thin capitalization means a debt to equity ratio (leverage) that exceeds 3/1. In the event of thin capitalization, interest expense is not deducted from its gross income. This however does not restrict the right to deduct the payment of interest on the debt prior to reaching the established thin capitalization level.

Thin capitalization rules do not apply to Financial Institutions, enterprises with the gross income under 200,000 GEL, if the interest expense does not exceed 20% of the gross revenue remaining after deductions envisaged by the Georgian Tax Code. For sole proprietors, if the thin capitalization rules will not apply if the Tax Authorities are not able to prove that the debt of such persons is three times greater than the market price of the assets owned by such person.

For the purposes of thin capitalization rule, “debt” includes any debt obligation on which interest is paid except for the loan received from a state or international financial institution (the list of which is established by the GoG).

For the purposes of thin capitalization rule, “equity” means:

- for the purposes of Georgian enterprises the difference between assets and liabilities deducted with the obligations of the shareholders towards the enterprise, which constitute asset of such enterprise; and
- for the purposes of foreign enterprises or permanent establishment of a non-resident, the difference between the assets and liabilities. Thin capitalization is established based on the average annual proportion according to the rules adopted by the Minister of Finance.

(j) Loss Carry-over

Losses can be carried forward for up to five years. Further, losses generated in 2010 and after can be carried forward for up to 10 years (subject to the filing of a relevant application). However, the statute of limitations for a ten-year carry forward period is 11 years. A ten-year carry forward period can be changed to a five-year carry forward period. A loss cannot be carried forward if it is generated by an international financial company, international company or Free Warehouse Company. No carry back is allowed.

(k) Customs Duties

The Customs Code of Georgia (“CCG”) regulates Georgia’s customs procedures. The CCG defines various customs regimes under which goods are brought in or taken out of the customs territory of Georgia. The most frequently used customs regimes are *import*, *export*, *temporary import* and *transit*. Taxpayers of customs duties are persons who cross the customs border of Georgia holding the goods. Where imported goods are subject to customs duties, the importer or the importer’s authorized representative is responsible for the payment of any customs duties due at the time the goods are released by customs for free circulation within the territory of Georgia.

Goods that enter the customs territory of Georgia from a foreign country are referred to as “foreign goods”. In order to import foreign goods, importer must:

- lodge a customs declaration for the goods;
- submit invoices and make the goods available for inspection by customs;
- pay any import duties owed;
- submit a license or certificate in order to check the compliance of goods with the regulations in the area of safety, health, economy and environment upon the import of goods.

Once all these conditions have been satisfied and customs clearance procedures completed, the foreign goods will be regarded as “Georgian goods”. They may then

be transported, stored or offered for sale, without being subject to any further customs formalities.

Customs duties include taxes and fees payable upon bringing goods in or taking them out of the customs territory of Georgia, and for some special goods a license fee is payable.

Taxes include:

- customs tax;
- VAT (payable on imported goods by both VAT registered and non-VAT registered persons) and
- excise tax

Fees include customs fees. License fees are identified in the Law on License and Permit Fees³⁰ and in the Law on Licenses and Permits. Customs tax and customs fee are discussed below.

(I) Customs Tax (Tariff)

Customs tax, governed by the Tax Code of Georgia since 2007, is based on either customs value or per physical unit of goods. The rate applicable to the customs value of the goods is fixed at 0%, 5% or 12%, depending on the classification of the goods. Most goods fall into the 0% rate. Most food products and construction materials fall under the 5% or 12% tax rates.

The Customs tax is imposed as an *ad valorem* duty, which means that the tax is calculated as a percentage of the customs value of the goods, determined according to the rules contained in CCG and the customs secondary legislation. As a general rule, GCA collect customs tax on the CIF (cost, insurance and freight) value of the imported goods. For this purpose, the general rule is that the customs value will be the price actually paid or payable for the goods when sold for export to Georgia. This is commonly known as a “transaction value”.

However, a number of additions must be made to the price paid or payable if those elements have not already been included in the selling price. Those elements include:

- transportation costs;
- commissions and brokerage;
- loading and handling charges;
- warehousing charges;
- royalties and license fees related to the goods being valued;
- insurance charges; and
- other similar charges incurred with respect to the goods before their customs clearance.

³⁰ Law on License and Permit Fees, August 12, 2003, No2937

Provided that certain costs are shown separately from the price actually paid or payable, the following shall not be included in the customs value:

- charges for the transport of goods from the customs;
- buying commissions;
- charges for the right to reproduce imported goods in Georgia; and
- other similar charges.

When the transaction value of the goods imported cannot be used, the importer must rely on alternative methods such as the transaction value of identical goods or the transaction value of similar goods.

The sequence of the methods employed in Georgia comply with the requirements of the World Trade Organization (WTO) Customs Valuation Agreement, which Georgia, as a WTO member, must apply.

(m) Goods Exempt from Customs Tax (Tariff)

The list of goods that are exempt from customs tax includes the import of:

- goods exported, re-exported and goods in transit through Georgia from a foreign country;
- goods produced in a Free Industrial Zone;
- goods defined by the grant agreements;
- goods for diplomatic purposes;
- child and diabetic food products;
- fuel, polish and other materials for international flights and shipment;
- goods identified by the Law of Georgia on *Oil and Gas*; and
- goods under 5-50 kilogram and with the value GEL 300-7,500 depending upon:
 - the type of goods;
 - the means of transportation (international post, airplane, etc.); and
 - the period the goods remained outside of Georgia.

No exemptions are specifically provided for the equipment or other goods related to construction of hydropower plants.

(n) Customs Fees

Customs fees are payable at the time of declaration of the goods to customs and are due on import, export, or transit of goods into, out of, or through Georgian customs territory, as well as upon the registration of temporarily imported transportation means.

The rates of customs fees are as follows:

- the fee for customs procedures (except for temporary import):
 - EUR 5.00 per customs declaration, if the value of the declaration does not exceed GEL 3,000; and
 - EUR 60.00 per customs declaration, if the value of the declaration exceeds GEL 3,000.
- the fee for customs procedures related to temporary import:
 - GEL 0.01 for each kilogram of goods up to 10,000 kilograms, and GEL 0.03 for each kilogram in excess; and
 - GEL 0.025 for each kilogram of goods imported for exhibition purposes.

(o) Property Tax

- **Tax Payers:** Individuals and legal entities owning or leasing property in Georgia are subject to property tax. Property tax is a local tax. Local authorities set the tax rates within the limits established by Tax Code of Georgia.
- **Taxable Assets:** Georgian enterprises and individual entrepreneurs are subject to property tax on fixed assets, non-assembled equipment, unfinished capital investments and intangible assets listed on their balance sheet. Foreign enterprises are subject to property tax on the same type of assets located in Georgia. Organizations (not for profit entities) are subject to property tax on the same type of assets used in economic (profit oriented) activities.
- **Tax Rates:** The annual property tax rate for enterprises, organizations and individual entrepreneurs should not exceed 1% of the average annual balance-sheet value of the taxable assets (excluding land). Annual property tax rate for agricultural land varies according to the administrative unit and the land quality. The base tax rate per 1 hectare varies from GEL 2 to GEL 57. The tax is further adjusted by a territorial coefficient of 50% to 150%. The base tax rate payable on non-agricultural land is GEL 0.24 per 1 square meter, which is further adjusted by the territorial coefficient not exceeding 1.5.
- **Tax Exemptions:** Certain types of assets are exempted from property tax, including:
 - roads;
 - communications and electronic transmission wires;
 - land plots used for railway transportation, property of an organization not used for economic activities, property and land used for activities defined by the *Law On Oil and Gas*; and
 - agricultural land plots not exceeding 5 hectares in the ownership of an individual as of 1 March 2004.

All types of assets including land situated on the territory of a Free Industrial Zone are exempted from property tax.

No exemption is envisaged specifically for property related to hydropower generation.

(p) Tax Free Regimes in Georgia

Specialized tax rates and procedures have been adopted for three types of Tax-Free Regimes. These include:

- Free-Industrial Zones (FIZs);
- Free Warehouse Enterprise; and
- Entities designated as being “International Finance Companies”.

These innovations are intended to establish new international financial institutions within the country, to attract inward investments and to encourage economic growth and sustainable development. The introduction of free warehouses and international enterprises into the tax and legal systems is intended to encourage the trade-transit function within Georgia.

(i) Free Industrial Zones

Free Industrial Zone (“FIZ”) legislation was introduced in Georgia in 2007 for the purpose of encouraging foreign investments, stimulating exports and developing Georgia’s international trade-transit activities. A favorable tax and customs framework for FIZ is intended to provide incentives for international firms to develop their production bases within such zones.

As of date, there are three FIZs in Georgia³¹ which entitle FIZ-incorporated International Companies³² to operate in a tax-free environment. In Free Industrial Zones firms can:

- process, produce and export goods with minimal tax burden;
- export goods free of trade barriers to global markets; and
- export more than 7,200 types of goods under GSP+ terms to the EU.³³

FIZ International Companies enjoy following tax exemptions and benefits:

³¹ Kutaisi FIZ, Poti FIZ and Tbilisi FIZ.

³² Status of an FIZ International Company is granted under an established procedure and may be removed if applicable restrictions are not observed. Such restrictions among others include: a) supply of the goods to entities outside FIZ on the Georgian territory; b) supply within FIZ territory, but to non FIZ companies; c) procuring services from Georgian incorporated entities (with few exceptions).

³³ Georgia benefits from the EU's Generalized System of Preferences (GSP). Under the previous GSP Regulation covering the period from 1 January 2006 to 31 December 2008, Georgia qualified for the special incentive arrangement for sustainable development and good governance, GSP+ (provisional application as from 1 July 2005), offering it a particularly advantageous access to the EU market. Georgia continues to benefit from the GSP+ also under the current GSP Regulation for 2009-2011.

- no property tax applies;
- no VAT applies to goods produced in other country imported into the FIZ;
- no VAT applies to the transactions carried out among FIZ incorporated entities;
- the supply of goods and services among enterprises of FIZ are VAT exempt;
- no customs duty applies to goods produced in other countries imported into the FIZ;
- only VAT shall apply to the goods produced in the FIZ under the free disposal Customs regime, regardless of the quantity of the goods;
- the export of goods produced in the FIZ within Georgian territory is free from Customs duty;
- no foreign exchange controls, trade barriers of quotas;
- no restrictions on capital repatriation;
- profit gained by an international enterprise from an activity carried out in FIZ is exempt from profit tax;
- employees of the entities incorporated in FIZ pay income taxes independently as FIZ incorporated entities are not considered as tax agents in relation to the salaries paid and are not obliged to withhold income tax at the source of payment.

(ii) Free Warehouse Enterprise

Due to its geographic location, one of Georgia's goals is to facilitate the *shortest and fastest transit route* between Europe and Central Asia. This goal is supported by the legislation which enables incorporation of Free Warehouse Enterprises ("FWE"). A FWE is intended to be an integral part of an international transit company and to benefit from exemptions from profit tax applied to income received from re-exporting goods from an independent warehouse via a FWE. The VAT rate on the supply of goods by a FWE to a VAT taxpayer is 0%.

The registration process for an FWE is simple and the status is granted by the tax authorities. The status of a FWE can be effectively used by international cargo companies, regional large network distributors and any other stakeholders wishing to transport goods from Central Asia to global economic markets or vice versa in the fastest and least costly manner.

(ii) International Financial Company

Georgian tax legislation offers incorporation of an International Financial Company ("IFC"). An IFC is defined as an entity whose revenues received from financial operations implemented or financial services provided in Georgia do not exceed 10% of its gross revenues. An IFC is not required to obtain a license from the National Bank of Georgia.

Activities of IFCs are exempt from taxes (i.e., it operates under a Tax-free Regime). Furthermore, an IFC enjoys exemptions from profit tax applied to:

- profits received from financial services provided by an IFC;

- gains from the sale of securities issued by an IFC;
- dividends paid by an IFC.

Businesses involved in the following or similar activities can effectively use the status and privileges of an IFC:

- wealth management;
- asset management;
- financial intermediation activities; and
- other similar activities.

Comparative Table of Tax Exemptions

Tax	FIZ International Company	Free Warehouse	International Financial Company
Corporate Income Tax	0%	0%	0%
Value Added Tax	0%	0%	0%
Customs Tariff	0%	up to 1%	up to 1%
Property Tax	0%	0%	0,5 or 12%
Personal Income Tax	20%	20%	20%
Net Operating Losses (years)			
Carry Back	0	0	0
Carry Forward	0	0	0

(q) Resolution of Tax Disputes

Georgian legislation provides for two levels of appeal in respect of a decision by a Georgian Tax Authorities. An appellant may file an appeal with the tax authorities or with a court of competent jurisdiction. Decisions of the tax authorities may be appealed by the tax payer if:

- the tax authorities refuse to satisfy a legitimate request; or
- a taxpayer does not agree with the tax charges imposed by the tax authorities.

In the event that a tax authority refuses to accede to a legitimate request, the aggrieved party has 20 calendar days to appeal the matter either to the Ministry of Finance or to the court.

If no reply is received within 15 calendar days, the appeal is considered rejected. If a tax payer appeals to the Ministry of Finance, the dispute may be resolved in the first instance by the GTA but may be raised to the Ministry's Dispute Resolution Board.

In either case, both sides reserve the right to appeal at any time to a court of competent jurisdiction.

If a taxpayer elects to file an appeal with the court, it must do so within the same deadlines established for appeal to the MoF. Failure to observe statutory limitation will result in rejection of the appeal.

Where a taxpayer appeals against a demand for tax payment, within 20 calendar days from receipt of the notice, the taxpayer must provide evidence that taxpayer has:

- secured a bank guarantee for the amount in dispute; or
- placed money on bank deposit; or
- a policy of financial risks insurance for the amount; or
- placed taxpayer's own property under the right of tax lien/hypothecation; and
- the total value of guarantees must be equal to or more than the amount of tax in dispute.

If a taxpayer does not deliver the above-described guarantees, or if the dispute is not resolved in taxpayer's favor, the Georgian Tax Authorities are authorized, after a 10 day period, to use enforcement measures for the amount of disputed tax liabilities without a Court order.

These measures include:

- Seizure of bank accounts;
- Seizure of any kind of property.

If a tax dispute is resolved in a taxpayer's favor, the taxpayer's secured guarantees will be annulled, any seizures by the tax administration will be removed and tax liens/hypothecations will also be annulled. If a decision is issued against a taxpayer, disputed taxes and resulting sanctions will be assessed from the date that the disputed tax liabilities arose.

Chapter 15 **Company Law**

(a) Overview

Georgian company law authorizes the following six types of business entities:

- **An Individual Entrepreneur ("IE"):** A natural person engaged in entrepreneurial activities. IE is not a legal entity under Georgian law. An IE is personally liable to creditors.

- **A General Partnership (“GP”):** A legal entity where two or more persons carry out entrepreneurial activities jointly under a single entity name. Partners are jointly liable to creditors with all their property. The liability of a partner is not limited.
- **A Limited Partnership (“LP”):** A legal entity where two or more persons carry out entrepreneurial activities under a single entity name. The liability of some partners to creditors is limited to a certain warranty amount, while the liability of the other partners (i.e. full partners) is unlimited. Partners of an LP can be both legal entities and individuals. Partners with limited liability are not permitted to participate in the management of an LP.
- **A Limited Liability Company (“LLC”):** A legal entity whose liability to creditors is limited to its property. Partners (founders) are not liable for company liabilities. Capital of a LLC can be specified in any amount. A partners’ meeting must be held to consider the annual results and other issues. An LLC can be founded by one person, which can be a natural or legal, resident or non-resident person.
- **A Joint Stock Company (“JSC”):** A legal entity having a charter and capital divided into shares with equal nominal value. A JSC’s liability to creditors is limited only by its property. Shareholders are not liable for the company’s liabilities. Capital of a JSC can be specified in any amount. A JSC is entitled to issue ordinary and preferred shares if the company charter does not provide otherwise. An annual shareholders’ meeting must be held within two months after the preparation of the balance sheet to consider the annual results and other issues if the company charter does not provide otherwise. A shareholders’ meeting is not needed if decisions are made by a shareholder who owns more than 75% of the capital of the company. Registration of shareholders requires an independent registrar if the number of shareholders exceeds 50. Under the law, shares are not material (dematerialized) and are represented in the form of registry entries maintained by an internal or independent licensed registrar.
- **A Cooperative (“Co-op”):** is a legal entity where its members carry out entrepreneurial activity mostly in agricultural or labor sectors. It is more oriented to satisfy the interests of its members, rather than to get profits. A partners’ meeting must be held at least once a year to consider the annual results and other issues.
- **A Branch Office (“BO”):** is the structural sub-unit of a business entity and is not a separate legal entity. Agency of public registry must register the BO of any foreign business entity upon submission of all Reports required by law.

(b) Registration

Georgian law makes registration of a commercial entity mandatory. The registration system has undergone major reforms. Whereas formerly registration was conducted

by the Georgian Tax Authorities, since January 1, 2010 registration of commercial entities is the task of the National Agency of the Public Registry under the Ministry of Justice of Georgia. An entity is considered registered from the moment that it is entered into the *Registry of Enterprises and Non-entrepreneurial (non-commercial) Legal Entities* (“the Public Registry”). Registration of an enterprise automatically covers state as well as tax registration. A decision on registration of an entity enters into effect at the moment it is published on the Public Registry’s the web-site (www.napr.gov.ge).

(c) Application

Registration is accomplished by way of an application filed with the Public Registry. The application should be filed either by a person authorized to represent the enterprise or by an attorney who presents a duly executed power of attorney.

(d) Charter

An application for the registration of an enterprise should include a charter signed by all founding partners of the enterprise. The charter is a constituent report (agreement between the partners) that must be notarized and must include the following information:

- the name of the company;
- the legal form of the company;
- the legal address of the company;
- the names, addresses and personal numbers of the founding partners;
- if the founder is a legal entity, its name, legal address, legal form, date of registration, identification number and data on representative;
- the governing body, rules of adopting decisions and in case of limited liability company, data on share participation of the partners;
- any limitations applicable to the representative powers of director of the company; and
- in case of limited partner, which partner has limited liability.

(e) Charter Capital

Georgian company law no longer requires a minimum amount of charter capital as a precondition for registration of companies with limited liability (JSC and LLC). As a result, no preliminary or temporary bank account or an report verifying availability of the funds is required. Capital contributions of the partners or shareholders of the enterprise are recognized and tax free.

(f) Protocol Nominating Director of the Company

The protocol must be signed and notarized.

(g) Signature Card

A signature card is a sample of the signature of a person authorized to represent the company (usually the director). Signature samples are performed and attested before the notary or witnessed by the officials of the Public Registry.

(h) Letter Confirming Legal Address

In order to register, an enterprise should provide a legal address of the company. Address should be confirmed by the letter issued by the factual owner of the property located at the address indicated. Since the Public Registry manages the registration of immovable property, ownership is thoroughly inspected. If a discrepancy is found, the applicant will be required to cure such discrepancy within a stated time period.

(i) Identification Number

Pursuant to relevant legislation, a unique identification number is assigned to each commercial entity and branch of a foreign enterprise. Since the registration process is common to state and tax registration, the number assigned to an entity is both the number of registration and the tax identification number which normally appears on the corporate seal.

(j) General Power of Attorney

Georgian company law recognizes a general power of attorney, pursuant to which a person can be assigned with the powers similar to those enjoyed by the director of the company. A general power of attorney must be registered with the Public Registry.

(k) Foreign Founders and Directors

There are no restrictions on the foreign ownership of companies in Georgia or their involvement in management and representation of the companies. Foreign individuals present the information and reports which are identical to those required to be submitted by Georgian citizens. The Ministry of Justice of Georgia issues rules on establishing equivalence of information and reports as required.

(l) Timeframe for Registration

Normal (unforced) registration takes only one business day. Registration may also be carried out on the same day, subject to payment of higher fee for acceleration of the process (200 LARI).

(m) Fees

The registration fee for any enterprise envisaged by the Law on Entrepreneurs (except for a sole proprietor) is a flat fee of 100 LARI payable at the Public Registry office.

(n) Expenses Associated with Registration of an Enterprise

Other expenses associated with registration of an enterprise include statutorily set notary fees (governed by the Law on Tariffs for Notary Services³⁴) and translation and certification fees, if required. If a local company is established by a foreign enterprise, the corporate reports of such enterprise must be furnished in a certified form,³⁵ and translated and certified by local notary. Corporate Reports may include relevant protocols, excerpts, charter and certificate of good standing or equivalent reports, depending on the jurisdiction of the founding enterprise.

(o) Changes to the Registration Data

If any data that requires registration is altered or amended, corresponding changes should be made to the information filed with the Public Registry. In the absence of such filings and registrations, the changes have no legal force. The company director is responsible to make required changes to the registration data. This does not, however, restrict partners or members of supervisory board from registering such changes.

(p) Entrepreneurial Excerpts

Effective January 1, 2010 an excerpt from the Public Registry has the equivalent effect as a certificate of tax registration. Rules on the issuing of excerpts are governed by secondary legislation and issued by way of an order by the Ministry of Justice. Procedurally, an excerpt is issued on the following day from the submission of an application and payment of non-refundable fee in the amount of GEL15. Same-day excerpts may be issued subject to payment of GEL50.

(q) Publicity and Authenticity of the Public Registry Data

Any data stored or registered in the Public Registry is available for public access in the form of company excerpt, unless such information has been labeled as confidential by the relevant enterprise pursuant to the rules prescribed by law.³⁶ Generally, such data is available in electronic form at the official web-site of the Public Registry (www.napr.gov.ge). Further, it is possible to generate electronic copies of the excerpts accessible on the official web-site of the Public Registry.

³⁴ On average these expenses do not exceed GEL150-200 and could be considerably less.

³⁵ Georgia is a party to the Hague Convention Abolishing the Requirement of Legalization for Foreign Public Documents and respectively notarized documents no longer require lengthy and inconvenient legalization procedures.

³⁶ Such rules are prescribed by the General Administrative Code of Georgia (June 25, 1999, No 2181).

These electronic excerpts have legal force assigned to them by law³⁷ and are accepted by the relevant authorities, notaries and private persons as authentic.

(r) Company Stamp

A company stamp or seal is not mandatory for the purpose of registration of commercial entities. State bodies are not allowed to issue a normative act requiring that a report from a commercial entity be stamped or sealed.

(s) Audited Financial Statements

Auditing of financial statements of Georgian business entities is not obligatory except for banks, insurance companies, companies whose stock is accepted for trade on the stock exchange, and some other businesses. Most foreign investors are established as Limited Liability Companies, Joint Stock Companies or Branch Offices to do business in Georgia.

(t) Status of the Branch Office

The Electricity Law provides that a licensee must be either a sole proprietor or a commercial entity established under the company law of Georgia. This implies that only a Georgia incorporated commercial entity can hold a license. Although there is no limit on which form should be selected, most licensees select a form comprising limited liability such as an LLC or a JSC.

Chapter 16 **Investor/Investment Promotion and Protection**

(a) General

Investment promotion and protection is governed by the Law of Georgia *On State Promotion of Investments*. This legislation is intended to promote investments by refining procedures for investment placement and entrepreneurial activities and by creating additional legal protections. The Law applies to any investments (local or foreign) within the territory of Georgia, regardless of the legal form of the investing entity.

The Law also provides additional support to promote “investments of special importance”. The term “investment of special importance” is applied to any investment:

- with a total volume exceeding GEL 8 Million; or

³⁷ Order of the Ministry of Justice of Georgia of December 31, 2010, No 241 on Approval of the Instruction on Registration of Entrepreneurial and non-Entrepreneurial (non-commercial) Legal Persons.

- that significantly impacts development of the country's economy and infrastructure.

The status of an *investment of special importance* is granted only by the GoG. The GoG may also assign such status to an investment above 2 Million GEL if the investment is made in a mountainous region or if it affects development of local economy or infrastructure.

(b) Investors' Rights

Under the Law of Georgia *On State Promotion of Investments*, an investor is entitled:

- to request issuance of any license or permit (including a preliminary license or permit) through the National Investment Agency of Georgia ("the Agency") (see section (c) below);
- to request the purchase of property and implementation of all related procedures through the Agency;
- to request any information related to the issuance of a license or permit (including a preliminary license or permit) and the acquisition of property or the implementation of an investment; and
- to enjoy the guarantees provided under Georgian legislation.

Georgian administrative bodies cooperate with the Agency to ensure investors' rights that are guaranteed by the Law on *State Promotion of Investments*.

(c) National Investment Agency of Georgia

The Agency is the only governmental body responsible for investment promotion and facilitation in Georgia. It is designed to act under the "one-stop-shop" principle. It was established in 2002 as a permanent independent legal entity of public law for the purposes of implementation, coordination and monitoring of financing of production-investment programs. The Agency is established under the authority of the Ministry of Economic Development of Georgia.

By law, the Agency is a designated representative of the GoG in matters dealing with the state promotion of investments. The Agency is entitled to represent an investor in its relationship with the administrative authorities and other persons (the actual scope of representation is covered by a corresponding agreement). However, the investor is also free to have a direct relationship with the administrative authorities. Under such an agreement, the Agency may assist the investor to obtain all the licenses and permits, necessary to conduct an investment activity as well as to discharge other representative activities. With the exception of *investments of special importance* which are exempt from such fees, the Agency is remunerated by the investor for discharging its tasks.

In order to acquire the status of an *investment of special importance*, an investor submits an investment proposal to the relevant Ministry, together with a detailed

investment plan. The plan is studied by a Ministry and a decision on granting the status of an *investment of special importance* is adopted by the GoG not later than one month after the filing of the application. Upon the grant of the status of an *investment of special importance*, the GoG and the investor conclude an agreement defining investment terms. At this stage, the parties may agree to modify the investment plan. The terms of the final agreement are made public.

In order to ensure the investor's fulfillment of its obligations under the agreement, the investor will be required to provide a deposit guarantee in the amount of 2% of the investment or a bank guarantee of a corresponding amount.

The Agency acts as a permanent monitor of the placement of special importance investments and reports thereon to the GoG. Any decisions on subsequent measures of support are taken on the basis of such reports.

HPPs of 100 MW and over are considered investments of special importance and potential investors are able to contact the MoE directly with proposed investment plans if they identify sites that they want to develop, whether or not the MoE has already identified such site. HPPs under 100 MW are covered by the regime described in Chapter 4.

Chapter 17 **Banking and Financial Regulation**

(a) Georgian Banking Sector

Georgia has a two-tiered banking system. The National Bank of Georgia ("NBG") acts as a central bank, regulating banking activities, issuing licenses and supervising all commercial banks. The National Bank of Georgia is independent from legislative and executive authorities, within the limits of the rights granted under the Organic Law of Georgia on *The National Bank of Georgia*.

In past years the NBG has consolidated the banking sector and instituted reforms comprising increasingly stringent reporting and minimum capital requirements. The NBG's basic priorities are price and exchange rate stability. The NBG's strategy focuses on:

- streamlining some of the more cumbersome regulations and harmonizing them with Basel principles;
- consolidating NBG's functions and independence;
- refining the payments system;
- introducing measures to develop capital markets, including for government securities; and
- facilitating the entry into the Georgian market by foreign banks.

The strategy seeks to stimulate foreign direct and portfolio investments by liberalizing capital flow and the tax system. NBG also supports the implementation of

modern risk management systems and corporate governance structures in local banks.

The Georgian banking system comprises 20 banking institutions, of which 18 are resident banks and two are the branches of non-resident banks. The foreign capital operating banking institutions comprise over 90% of the aggregate authorized capital of commercial banks. The share of foreign investments in the authorized capital of the banking system has increased in the recent years and includes investments by international financial and banking institutions (“IFIs”) such as EBRD, IFC, KfW, DEG, HSBC and Societe Generale. The Herfindahl-Hirschman Index is at the top of its moderate concentration limit, and this implies that the sector is dominated by several large banks. The GoG has no stake in any bank.

(b) Financing Opportunities

The Georgian financial market is dominated by the banking sector. However, due to the stringent regulation, capital adequacy requirements and limitations on single exposures (see below), the availability of financial resources from local commercial banks for large capital-intensive projects, like HPPs, is limited.

Some of the IFIs provide credit (on-lending) facilities for target areas like hydro power development (see below).

(c) Risk concentrations and bank’s limitations to single exposures

Although NBG regulation is considered to be prudent and sound, some regulations inhibit financial sector expansion. These include a 200% risk weighting for all foreign currency loans and capital adequacy requirements which limit the availability of lending resources.

Current minimum regulatory requirements set by NBG for commercial banks reflect the limitations to the bank’s exposures:

1	CR1 (Tier I capital ratio)	≥ 8% of Risk Weighted Assets
2	CR2 (Regulatory capital ratio)	≥ 12% of Risk Weighted Assets
3	LR1 (Ratio of one insider)	≤ 5% of Regulatory Capital
4	LR2 (Ratio of all insiders)	≤ 25% of Regulatory Capital
5	LR3 (Ratio of one outsider)	≤ 15% of Regulatory Capital
6	LR4 (Ratio of interrelated borrowers)	≤ 25% of Regulatory Capital
7	LR5 (Ratio of large loans)	≤ 200% of Regulatory Capital
8	LR6 (Ratio of unsecured loans)	≤ 25% of Loan Portfolio
9	LiqR (Average liquidity ratio)	≥ 20% of Average Liabilities
10	IR1 (Equity investment ratio)	≤ 50% of Share Capital
11	IR2 (Property investment ratio)	≤ 70% of Share Capital
12	PL1 (Unsecured loan ratio)	≤ 20% of Regulatory Capital
13	PL2 (Total open currency position limit)	≤ 20% of Regulatory Capital

(d) IFI On-Lending through Local Banks

The energy sector is a strategic sector of Georgia which is also high on the agenda of IFIs and donor organizations. From time to time, in collaboration with the local banking system, IFIs establish on-lending facilities for the energy projects, particularly with the focus on the development of Georgian hydropower sector. In particular, the German donor, GTz is taking a lead in providing these kinds of on-lending services.

(e) Secured financing

Any financing procured through the local banking system normally involves secured lending. Unsecured lending through Georgian banks is quite limited. Further, commercial banks normally require a high level of collateralization. More specifically, once the market price of an asset is established, banks take into account market price volatility and liquidity, when deducting value from the asset.

Loans are normally secured by immovable property, business assets, vehicles or shares/stocks in the business/enterprise. Charges on such assets can be registered. In order to secure a loan with registrable assets, an interested party enters into a hypothecation or pledge agreement with a lender. This agreement is registered with the Public Registry³⁸ (or, in the case of vehicles, with the Service Agency of the Ministry of Internal Affairs of Georgia) and such charge is reflected in the registry of the respective asset. Any third party transaction in relation to such asset will be restricted in accordance with Georgian law. Several charges may be registered for a single asset with corresponding priorities and weights. An underlying collateral asset may be sold, subject to the charge following such sale. This will be the case unless the original obligation is fully covered.

A lender may not levy against collateral in the absence of a legal adjudication or arbitration process. For swiftness, commercial banks normally elect arbitration, which from the enforcement perspective, is more costly. In the event of asset liquidation, by way of an enforcement proceeding (usually by way of a judgment by default or otherwise or by way of a bankruptcy proceeding) the lender conducts an auction which is intended to reflect the asset's market price. Where the asset is not sold on the first auction, subsequent auctions usually result in a lower sales price. Once a claim is satisfied by the proceeds of the asset sale, the balance is returned to the asset owner.

(f) Bank Guarantees

Obtaining a bank guarantee from a local commercial bank involves procedures identical to those involved in secured financing. Processes are lengthy, but entail

³⁸ Georgian law and the institution of security (collateral) registration have been substantially reformed to enable cheap and swift process of registration of charges. Registration facilities are modernized and consumer friendly. Banks also provide internal notarization/registration services.

less regulatory limitations, as bank guarantees are considered off-balance sheet transactions.

(g) Currency restrictions

No currency restrictions apply to currency operations in Georgia. The Tbilisi Interbank Currency Exchange was abolished in 2009 and today, commercial banks are engaged in daily foreign exchange operations by way of real time trading through Bloomberg terminals. As a result, exchange rates experience intra-day fluctuations. No hedging instruments are currently available in Georgia to reduce foreign exchange risks.

USAID Hydropower Investment Promotion Project (USAID-HIPP)

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