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**NIS ENERGY INSTITUTIONAL
BASED SERVICES
DELIVERY ORDER NO 16
GEORGIA - FINAL REPORT**

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Delivery Order No 16**

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Energy and Infrastructure Division

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Background

The emergence of a democratic, prosperous and independent Georgia is in the United States' long-term interest. As a democracy with a market oriented economy, which also serves as the gateway to the Caucasus Region, Georgia has the potential to become a major stabilizing force in the Caucasus region.

Georgia had been a modest producer of oil (an estimated 3,500 barrels/day in 1993) and natural gas (1.4 billion cubic feet per year), but production fell off over the last several years due to the decline of existing fields and the lack of exploration and development of new fields. In 1993, the Georgian economy consumed some 16,000 barrels/day of oil and 128 billion cubic feet of natural gas, most of which was imported. The refinery at Batumi had significant production capacity (120,000 barrels/day capacity in 1993), but is now inoperative due to lack of feedstock and maintenance.

By the summer of 1996, the Country had begun to attract the interest of foreign investors in the exploration, refining and transportation sectors of the oil and gas industry. Specifically, Saknavtobi (a state budgetary entity) had entered into a number of production sharing agreements for exploration and production of oil and gas, two of which have now begun producing modest amounts of relatively high quality crude (3,500 bpd). Additionally, there are indications in one of the concession areas that there may be significant commercial quantities of very dry gas. This is of particular significance in light of Georgia's continuing dependence on the importation of fuel oil to power electricity generation at Gardabani. In the refining sector, certain arrangements were made with Saknavtobi for the importation of a small refinery, and preliminary studies are underway with GIOC for the development of an export refinery in Supsa to service northern Turkey and Armenia with refined products.

However, Georgia's importance in the region stems not from its own oil resources but from its location as a potential oil transit corridor. Through its boundaries and access to the Black Sea flow commerce and aid to neighboring Armenia and Azerbaijan. If Georgia competes successfully for oil or gas pipelines to transit the country from the Caspian Sea basin, the strategic importance of the country as a transportation corridor will increase to the benefit of Georgia and the entire Caucasus Region.

The economic transition underway in Georgia requires that the energy sector move toward adoption of market oriented systems required to support the broader economic transition. USAID has been actively working in the power sector of Georgia, in conjunction with the World Bank, to foster economic restructuring of this key sector. Beginning in 1995, the US Government's recognition of the important position of Georgia with regards to the transport of the oil produced from fields in the Caspian Sea region led to USAID providing short-term assistance to the Government of Georgia in the oil & gas sector.

In October, 1995, the Azerbaijan International Operating Company (AIOC) decided to use two routes to export so-called "early" oil from Azerbaijan, which includes production of about 240-280 million barrels total until 2010, with daily flows reaching about 90,000 barrels. One route (the "Russian" or "northern") goes from Baku to Grozny to Tikhoretsk to the Black Sea (Novorossiysk or Tuapse). The other route (the "Georgian" or "western") goes from Baku to Akstafa to Samgori (near Tbilisi) to Supsa on the Black Sea. Its total length is about 550 miles of which about 250 miles goes through Georgia, a sea port terminal in Georgia is being built as well. Total investment costs for this route were originally estimated at \$265 million and now have soared to almost \$600 million.

Under the terms of the Production Sharing Agreement ("PSA") with the State Oil Company of the Azerbaijan Republic ("SOCAR"), AIOC has agreed that the proposed development of Oil in the Caspian will be in two phases, a) the Early Oil phase, and b) a Full Field development phase. It is a condition of the PSA that each phase will only occur upon completion of arrangements for the operation of export routes to transport the production to international markets. These arrangements are now being made. This puts Georgia at the center of contention for the Main Export Pipeline.

The planning phase for the MEP has begun. Capital spending on the Full Field development export route will be an estimated \$2 billion. The World Bank provided Turkey with a \$15 million loan to study the feasibility and impact of the MEP transiting that country (and by extension, Georgia), and President Shevardnadze has instructed GIOC to form a working group with Turkey and Azerbaijan to insure that Georgia's interests are served. AIOC is now conducting a parallel study of the export route options for which Georgia's input is also being sought.

TASK A: Restructuring The Oil & Gas Sector And Assisting In The Development Of Appropriate National Government Energy Policies

Specific Goal/Objective

The goal of this task was to restructure the Oil & Gas Sector of Georgia into separate production transportation, refining, and distribution enterprises and shape its operating environment through the development of appropriate national government energy policies

Major Results

Overall, results of this task included the delivery of a plan for restructuring the Oil & Gas Sector in a manner that will improve the commercial provision of services

The sector has, in fact, been disaggregated, i.e., broken into constituent parts of exploration and production (Saknavtobi), refining (Batumi and the new refinery being built near Tbilisi), gas transportation and wholesale marketing (Saktransgazmretsvi), gas distribution (municipal governments and Interpak), petroleum product marketing (Saknavtoprodukti and a myriad of independent wholesalers and retailers) and international oil and gas transportation projects (GIGC and GIOC). Notably, liquid natural gas and petroleum product imports, exports and retail sales are free market activities. The Government, however, still controls most of the enterprises (as they are Treasury Enterprises under the umbrella of the Ministry of Fuel & Energy), most of the enterprises have not been set up as joint stock companies, and the actual ownership of most of the physical assets over which these enterprises exert some form of control has not been transferred to them by the Government. Recently, the Government has taken some small steps to privatize, via tenders and auctions, certain facilities and enterprises, but this has been done in a very opaque manner and by no means signals that the Government is prepared to proceed with the large scale privatization of this sector. In fact, the Government has stated that the sector is strategic and that it will not be privatized.

Deliverables Required by the Delivery Order

The contractually-required deliverables for this task include

- A brief assessment of national government energy policies and the status of restructuring in the Oil & Gas Sector

This deliverable was accomplished through the issuance of report entitled “An Assessment Of The Status Of Oil & Gas Sector Restructuring And Of Fuel Supply Subsector Reform/Restructuring Efforts in Georgia ”

- Through consultation with the GOG and existing Oil & Gas Sector entities a plan for moving the restructuring of the Oil & Gas Sector forward towards the ‘ unbundling ’ of the sector into separate production, refining, transportation, and distribution enterprises in a manner that will improve the commercial provision of services

This deliverable was accomplished through the issuance of “A Plan For The Restructuring and Privatization Of The Oil & Gas Sectors in Georgia ”

- Provide technical assistance to help the GOG to implement the restructuring plan, including the development of modified or new national energy policies, in concert with the activities carried out under the other three tasks

This deliverable was accomplished through the development of numerous working relationships between the consultant and various counter-parties in Georgia. These counter-parties included Saknavtobi, Saktransgazmretsvi, the Georgian International Gas Company, the Ministry of Environment and the Ministry of Fuel and Energy, the Ministry of State Property Management, the Ministry of Natural Resources and Environment, and the Parliamentary Committees on Economic Sectors and on Economic Reform. Hagler Bailly became the principal advisor to the Parliamentary Sub-Committee on Oil & Gas and, in that capacity, attempted to advise Parliament on the need for a more comprehensive Energy Policy.

- Report on an assessment of national government energy policies relevant to the Oil & Gas Sector and its fuel supply subsector

This deliverable was accomplished through the issuance of a report entitled “An Assessment Of The Status Of Oil & Gas Sector Restructuring And Of Fuel Supply Subsector Reform/Restructuring Efforts in Georgia,” and was also covered in the reports on “Opportunities for Private Sector Investment in the Oil & Gas Industry of Georgia” and “A Plan For The Restructuring and Privatization Of The Oil & Gas Sectors in Georgia ”

- An environmental assessment per USAID Environmental Procedures (22 CFR 216)

This deliverable was unnecessary due to the fact that no equipment was supplied to Georgia under this Delivery Order

Other Task Activities

Additional activities undertaken during this task are the following

- 1 Prepared briefings for Congressional delegations, Senate delegations, and senior USG and USAID personnel who were on fact-finding trips to the Caucasus
- 2 Prepared orientation materials for the new US Ambassador, the new DCM, and new USAID personnel on the Oil & Gas Sectors of Georgia
- 3 Prepared a report on the activities of Gazprom for USAID and the Embassy
- 4 Prepared draft letters for the Embassy on issues critical to the functioning of the oil & gas industry in Georgia, which text was used in communications with senior Georgian officials. The objective of these communications was to encourage openness, reorganization and reform in the sector.
- 5 Provided USAID with draft conditionalities for the supply of humanitarian gas
- 6 Prepared an analysis for USAID of Georgia's over-dependence on imported gas

TASK B. Legal/Regulatory Reform through the development of legislation and regulations regarding the structure of the Oil & Gas sector

Specific Goal/Objective

The primary objective of this task was to develop the necessary legislation and regulations to allow (i) for the establishment of an open and transparent regime for the exploration and production of the Country's natural resources (ii) for the definition of a national policy regarding the structure of the Oil & Gas sector and the approach to be taken relative to regulation and private sector participation, (iii) for the separation of the policy responsibilities of the government, the regulatory responsibilities of an independent body, and the commercial responsibilities of the companies themselves, and (iv) for the creation of a fair and transparent framework that will allow public and private investors to become involved in the Oil & Gas sector and to assert management control over the companies in order to increase economic efficiency and foster competition

Major Results

The primary result of this task was the drafting of an international acceptable Petroleum Law. Additionally intensive legal advice was given on all issues relating to policy and reform to Saknavtobi, Saktransgazmretsvi, the Georgian International Gas Company, the Ministry of Environment and the Ministry of Fuel and Energy, the Ministry of State Property Management, the Ministry of Natural Resources, and the Parliamentary Committees on Economic Sectors and Economic Reform. Significant training was also provided (see Task E)

As of the date of this writing, The latest draft of the Petroleum Law, as prepared by the Parliamentary Committee on Economic Sectors still fails in two key areas: a) it establishes Saknavtobi as the State Oil Company (thus failing to separate commercial and policy making functions), and b) it preserves the dual contracting/licensing regime which has stymied the Country's oil & gas sector development.

Other open legal issues are: a) the transfer of the ownership of physical assets from the State to the State Enterprises, b) the incorporation of those State Enterprises as Joint Stock Companies, c) the separation of Government regulatory functions and ownership through completion of the privatization of those, as yet to be formed, JSC's, and d) the development of a transparent privatization regime.

Another and most urgent need in ensuring a healthier future for the industry is to establish a regulatory regime to ensure that privatized entities behave in the interest of the public good and

serve the Country's needs in cases of emergencies. That regulatory regime must also ensure that the Government's role be focused on oversight of the activities by legal means and not through ownership. This is particularly true in the gas sector where there is a need to develop an Independent Gas Regulatory Commission.

Deliverables Required by the Delivery Order

The contractually-required deliverables for this task include

- A brief assessment of the legal and regulatory framework, including all government decrees, that guide the operation of the Oil & Gas Sector

This deliverable was accomplished through the issuance of a report entitled "An Assessment Of The Current Legal And Regulatory Framework Of The Oil & Gas Industry in Georgia." The subject was also expanded upon in the report "Opportunities For Private Sector Investment in the Oil & Gas Sectors of Georgia."

- Through consultation with the GOG and existing Oil & Gas Sector entities, a plan for moving the regulatory and legal framework forwards toward the formal separation of policy, regulatory, and operational functions in a manner that will improve the commercial provision of services

This deliverable was accomplished through the development of a Report entitled "Planning For The Commercial and Legal Future of The Oil & Gas Sectors Of Georgia."

- Technical assistance to help the GOG to implement the regulatory and legal reform plan, in concert with the activities carried out under the other three tasks, including technical assistance to complete the drafting and encourage passage of specific energy sector laws that support sector restructuring and commercial energy development while safeguarding the environment. In particular, such legislation should provide for maximum possible private participation in the energy sector and would include recognition and protection of private property rights, creation of contracts between existing oil & gas enterprises (or successor companies) and their customers

This deliverable was accomplished through the drafting of and ensuing discussions about innumerable versions of a Petroleum Law, some drafted by Hagler Bailly, some drafted by various Georgian parties and critiqued by Hagler Bailly. Hagler Bailly tried but failed to introduce specific language into the drafts that would have mandated the separation of the commercial and policy making activities of the Ministry of Fuel and Energy and Saknavtobi.

- Report on the establishment, development and proposed organizational structure and

functions of an independent regulatory commission

This deliverable was accomplished through the issuance of a report entitled "A Proposed Structure For An Independent Gas Regulatory Commission For Georgia And Suggested Tariff Setting Procedures" This report was translated and given to the Parliamentary Committee on Economic Sectors, which had heretofore sponsored the legislation establishing the Electricity Commission It is expected that this report will eventually serve as the basis for establishment of a gas commission, whether separate from or part of the current Electricity Commission, is still to be determined

- Report on proposed tariff methodology

This deliverable was accomplished through the issuance of a report entitled "A Proposed Structure For An Independent Gas Regulatory Commission For Georgia And Suggested Tariff Setting Procedures" See preceding comments, above, re the establishment of an independent gas regulatory commission

- A recommended overall Restructuring Implementation Plan, including the linkages with other Tasks of this Delivery Order (in conjunction with Task A)

This deliverable was accomplished through the issuance of "A Plan For The Restructuring and Privatization of The Oil & Gas Industry in Georgia" - see Task A Also, please see "Planning For The Commercial and Legal Future of The Oil & Gas Sectors Of Georgia"

- A procurement list presenting limited critical commodities (e.g., equipment) that improve the performance of an Independent Oil & Gas Regulatory Commission

This deliverable was rendered moot since a Commission was not established during the period of this Delivery Order

- An environmental assessment per USAID Environmental Procedures (22 CFR 216)

This deliverable was unnecessary as no equipment was supplied pursuant to this delivery order

Other Task Activities

Several additional activities were undertaken as part of this project

- 1 Reviewed a proposed Law on Production Sharing at the request of the Georgian Oil Company (Saknavtobi)
- 2 Consulted with the GOG, Parliament and existing oil & gas sector entities with the aim of developing a plan for moving the regulatory and legal framework forwards toward the formal separation of policy, regulatory, and operational functions in a manner that will improve the commercial provision of services
- 3 Worked on an operational plan (including a transition period) for establishing a unified regulatory/legal strategy for accelerating restructuring as it relates to separation of policy, regulation and operations in the oil & gas sector In this connection, discussions have been were held between the implementer and the UK and EU Missions to Georgia
- 4 Worked with the Ministries of Fuel and Energy and Environment on resolving issues raised in the preparation of an Oil & Gas Law Hagler Bailly liaised with the Ministry of Fuel and Energy, the Industry Committee, and the Economic Reform and Policy Committee This cooperation was close and frequent Hagler Bailly not only assisted in drafting the Law but also explained in detail the workings of the new Law Further, the Working Group discussed the laws, regulations, procedures, forms of contracts, etc , used in other countries to explore and exploit oil and gas resources In short, Hagler Bailly did everything it could to familiarize the joint committees and the Ministry of Fuel and Energy with international industry practice, and to achieve the desired level of comfort they needed to analyze and digest that information
- 5 Worked with the Ministry of Fuel and Energy, the Ministry of Environment and the Parliament on the development of a Pipeline Law Hagler Bailly prepared a plan of action for coordination of activities of the Working Group and Parliament, and provided Parliament with a written opinion stating the reasons why a Pipeline Law was necessary Thereafter Hagler Bailly prepared an outline of a proposed Pipeline Law showing the principal sections and heads of articles Then, Hagler Bailly submitted a draft Law based on this outline Throughout this process Hagler Bailly consulted with the Working Group, at frequent intervals to discuss and explain the intricacies of the proposed Law Ultimately Parliament decided to defer consideration of a pipeline law due to opposition by AIOC

TASK C: Commercializing The Oil & Gas Sector

Specific Goal/Objective

The primary objective of this task was to strengthen the operation of these new Oil & Gas sector companies by introducing sound western commercial business practices as well as by mandating the adoption of open and transparent accounting systems

Major Results

The major impact of this project was to advance the state of knowledge regarding financial reporting and the introduction of International Accounting Standards (IAS) Under the aegis of Hagler Bailly, Carana completed a comprehensive review of Georgian accounting practices and developed a chart of account and an accounting manual for each of the major enterprises found in the oil & gas sector These charts of account, when implemented, will permit the enterprises to provide financial reports in accordance with IAS while simultaneously meeting local tax reporting requirements

Other activities under this task were varied and included reviewing current accounting standards in Oil & Gas Sector, recommending new accounting standards, reviewing current financial management practices and recommending appropriate financial management organization and procedures Additionally, assistance was provided on corporate governance, and seminars were held dealing with oil & gas accounting

Commercialization demands a drastic change in the management culture of the state enterprises, it therefore demands extensive re-training and sweeping changes of personnel What is required is that further assistance be directed to achieve the following

- The immediate introduction of accounting, budgeting, costing, and credit and billing systems
- The simultaneous identification and training of qualified agents for change within each organization and the wholesale replacement of those persons within the organization who fail to adapt
- The corporatization of the oil and gas enterprises and the immediate devolution of government ownership and control in favor of new management, outside investors, the remaining employees and the public
- The abolition of Saknavtoproducti through the sale of its assets to the private sector

Deliverables Required by the Delivery Order

The contractually-required deliverables for this task included

- A brief assessment of the status of the commercialization including corporatization of the production, refining, transportation, and distribution enterprises in the Oil & Gas Sector

This deliverable was accomplished through the issuance of a "A Brief Assessment of the Status of Commercialization in the Oil & Gas Industry in Georgia "

- Through consultation with the GOG and existing Oil & Gas Sector entities, a plan for strengthening the commercial operation of all of the entities, with special emphasis on strengthening the cash flow through the entire Oil & Gas Sector. The plan shall include corporatizing the entities to improve the commercial provision of services and prepare for private sector participation (i.e. with suitable charters, boards of directors, management control, and open accounts)

This deliverable was accomplished through the issuance of "Planning For The Commercial And Legal Future of The Oil & Gas Sectors Of Georgia "

- Technical assistance to help the GOG to implement selected elements of the commercialization plan, in concert with the activities carried out under the other three tasks, including

A) TA, long-term advisors, training, and limited commodities to develop and implement modern accounting and management information systems

This deliverable was accomplished through the presence, as resident advisor, of Mr Thomas J Sherwood who worked with the Georgian enterprises to develop commercial practices. Also, the contractor conducted a series of training seminars and workshops (see Task E)

B) The development of standard contracts for oil & gas product purchases, sales, etc

This deliverable was accomplished through the delivery to the Georgians of model contracts

- An environmental assessment per USAID Environmental Procedures (22 CFR 216)

This deliverable was not necessary as no equipment was supplied pursuant to this Delivery Order

- A procurement list presenting limited critical commodities (e.g., equipment) that improve the performance of Oil & Gas Sector entities (for Tasks B and C only)

This deliverable was not necessary as no equipment was supplied pursuant to this Delivery Order

Other Task Activities

Additional activities were undertaken during this task. They were

- Prepared and presented break-even analyses for Saknavtobi, demonstrating the methodology used for determining the take of the State and the take of the developer in a typical Production Sharing Contract

TASK D. Privatization/Private Sector Participation: to improve economic efficiency within the Oil & Gas sector by transferring asset ownership and management to the private sector

Specific Goal/Objective

The objective of this task was to improve economic efficiency within the Oil & Gas sector by transferring asset ownership and management to the private sector in ways that raise badly-needed capital investment and by introducing competition through the entry of private sector Oil & Gas developers

Major Results

The impact of this task was to inculcate the need for further privatization into the various bodies with which the contractor dealt, particularly the Ministry of State Property Management. Yet the Government remains ambivalent about its privatization plans, even though it has effectively “unbundled” the sector. As recently as May, 1998, the Government went on record that it would not, in the foreseeable future, privatize any of the oil and gas enterprises.

Government policy is further muddled by the fact that there is no coherent energy policy (though many drafts have been provided to the government of energy policies over the years) and the privatization policy as articulated is no more than a plan for the retention of assets. Any downturn in the world economy will surely reduce the Government’s chances of receiving a reasonable price for its assets.

The current process of privatization appears to be cumbersome and disjointed, and subject to reversals. This does not foster investor confidence, as Hagler Bailly repeatedly advised the Government. The Government must have the will to carry out the privatization according to a set policy and with steadfastness. If not, the influence of special interests will grow and will derail the process.

Deliverables Required by the Delivery Order

The contractually-specified deliverables for this task include

- A brief assessment of the status of the privatization and private sector participation in the production, refining, transportation, and distribution enterprises of the Oil & Gas Sector

This deliverable was accomplished through the issuance of a Report entitled "Opportunities For Private Participation In The Oil & Gas Sectors Of Georgia "

- Through consultation with the GOG and existing Oil & Gas Sector entities a plan for increasing private sector participation and private investment in the sector with special attention to increasing the economic efficiency of enterprises through private management and the introduction of competition through the creation of new private ventures

This deliverable was accomplished through the issuance of a report entitled "Privatization Policy Guidelines For The Oil And Gas Sector Of Georgia "

- Technical assistance to help the GOG to implement selected elements of the privatization plan, in concert with the activities carried out under the other three tasks, including

This deliverable was accomplished through the provision of the services of Mr Paul Teleki who worked extensively with the Ministry of State Property Management on the development of the aforementioned report

- TA for reviewing and evaluating the many proposals for oil & gas projects received by the GOG and on-the-job training to allow the GOG and its oil & gas enterprises to develop the capability to review such proposals on their own in the future

AID, in conjunction with US Embassy policy, decided that it was best that the contractor avoid all transactional related assistance This assistance was instead incorporated into the more generalized training agenda (see Task E) under which specific workshops were held wherein hypothetical examples were worked upon

- technical assistance for developing pre-loan packages for new private oil & gas investment projects and/or developing concessions or project proposals that would be used to solicit bids from the private sector

This assistance was incorporated into the more generalized training (see Task E) under which specific workshops were held wherein hypothetical examples were worked upon

- TA to promote the privatization of existing assets

This deliverable was accomplished through the issuance of Mr Teleki's report and his work with the Ministry of State Property Management

- TA to assist in the valuation of assets, if required, and the adoption of an auction method open to both foreign and domestic investors to privatize existing facilities

The Ministry of State Property Management declined assistance beyond the preparation of the plan prepared by Mr Teleki

- An environmental assessment per USAID Environmental Procedures (22 CFR 216)

This deliverable was not necessary as no equipment was supplied pursuant to DO 16

Other Task Activities

Several additional activities were undertaken as part of this task

- ▶ Hagler Bailly provided various of the State Enterprises with model contracts
- ▶ Hagler Bailly reviewed various corporate charters and bylaws proposed for state energy enterprises

Task E - Training/Study Tours in International Oil & Gas Practices

Specific Goal/Objective

The primary objective of this task was to improve the knowledge base of government and enterprise officials and thereby support the reform of the oil & gas sector and the negotiation of agreements for the development of oil & gas pipelines and for the development of domestic oil & gas resources

Major Results

The most important element of this task was to conduct an assessment of the training needs of the Georgian Oil & Gas Enterprises, and to hold a series of seminars (seven in number) aimed at improving the knowledge base of management in the sector

Deliverables Required by the Delivery Order

The contractually-specified deliverables for this task include

- Prepare a needs assessment, not to exceed twenty pages in length, of the oil & gas enterprises and government bodies involved in the legal, regulatory and commercial reform of the sector, with special emphasis on the teams involved in negotiating the Main Oil Export Pipeline and the Russia-Turkey Gas Pipeline projects Through consultations with the GOG, the World Bank, and other donors, develop a coordinated training/study tour program based on the needs assessment, with priority attention to the needs of the negotiating teams

This deliverable was accomplished through the issuance of “A Needs Assessment Of The Training Requirements Of The Oil & Gas Sector Of Georgia” and subsequent meetings between the contractor and the World Bank, EBRD, GIOC, GIGC and the Ministries of Fuel & Energy and Natural Resources & Environment

- Training subjects should include topics such as the following
 - 1 pipeline transport economics,
 - 2 international contract negotiation skills,
 - 3 environmental impact assessment,
 - 4 legal principles of trans-country pipeline construction and operation,
 - 5 principles of oil & gas accounting, general accounting, and auditing,

- 6 project financing, and
- 7 oil & gas administrative law

This deliverable was accomplished through the conduct of all seven of the above seminars, usually of four days duration each

- Provide technical assistance to help the GOG to implement the training program in concert with the activities carried out under the other four tasks

This deliverable was accomplished through the multitude of meetings which were held with all the SOE's Ministries and parliamentary committees

Other Task Activities

None The task commenced in March 1998, and was limited in scope

Summary

Overall, this delivery order attempted to contribute to the state of reform in the energy sector. Hagler Bailly's assistance in the oil & gas sectors was predicated on and driven by US support for the development of an East-West Energy Corridor. The US has consistently and firmly endorsed the Baku-Ceyhan route through Georgia as one of the multiple export routes that will bring Caspian energy resources to the world markets and Hagler Bailly played a vital role in Georgia in this regard.

It was the objective of this delivery order to support and enhance the sovereignty, stability and independence of Georgia. This independence, however, was and still is being undermined by certain practices in the energy sector of Georgia, which if uncorrected, threaten the viability of Georgia as an independent country. Hagler Bailly's role has been that of an advisor, and, as such, it cannot force change. We wish, therefore, to draw the reader's attention to the situation as we see it as of the end of this contract period (9/30/98).

Georgian mentality about cheap energy acquired during the Soviet era, devoid of concepts of supply, demand and markets, still rules even though supplies of primary energy have been interrupted for non-payment. The demand for fuel (mainly gas) for electricity generation cannot be met as the State and its enterprises are unable to pay (though not necessarily always for lack of available funds) and barter deals with neighboring countries are now rejected. State Enterprises, operating as departments of the Ministry of Fuel and Energy, act as market regulators in collusion with their own commercial interests. Conservation is an unpracticed concept. Consumers manage to consume electric power, however sporadically provided, often without paying for it, leaving the power generation companies without means. Employees of State enterprises are seldom paid. Domestic reserves of gas remain undeveloped because the interest of the State (the people) has been suborned by the private interests of government officials. The infrastructure ranges from antiquated to defunct. Working facilities, such as natural gas pipeline, operate with technical losses of 22% (when gas arrives at all). Probably not more than 10% of all petroleum product imports are taxed.

Against this background, the Government announced its plans for the future of the oil and gas industry. Presidential Decree 776 (Dec 29, 1997), "General Privatization Plan for Separate Branches of the Georgian National Economy (1998 - 2000)" states that the government intends to hold onto this sector, likely for fear of losing control and income. Finally, Presidential Decree 277, which Hagler Bailly has lobbied against, permits the Minister of Fuel and Energy to unilaterally abrogate any contract entered into by the State.

All of the foregoing deficiencies work against Georgia's viability as an independent country and mandate further technical assistance to the energy sector of Georgia. The consequences of failing to reform the sector will be an increased reliance on the importation of Russian gas, the

subordination of the gas distribution and electrical generation sectors to Gazprom (as in Armenia), and the concomitant loss of economic and then political sovereignty

The Future

There are two recommendations that Hagler Bailly would make at this juncture. The first pertains to the method for accelerating the pace of reform in the sector, the second pertains to the development of Georgia's capacity to serve as the linchpin in the East-West Energy Corridor.

Accelerating Reform

We would argue that meaningful reform in the Oil & Gas Sector of Georgia will only occur when foreign assistance and multilateral lending institutions make mandatory as a condition precedent to the provision of further assistance or loans, the immediate adoption of western accounting and management reporting systems, and, using that handle, force commercial discipline upon the system.

We believe that the World Bank, the European Bank for Reconstruction and Development, the various international donor agencies, all are in an excellent position to make and enforce meaningful conditionalities *prior to the provision* of loans or technical assistance. Specifically, all external fund and assistance providers should require that these SOE's adopt basic accounting and budgeting regimes.

Without these management systems, all further discussion of commercialization or privatization is meaningless, all further provision of technical assistance is of dubious value, loans will not be repaid, and a culture of dependency will be created which will jeopardize the establishment of a market economy in Georgia.

The East-West Energy Corridor

The unfinished work in Georgia, is, by definition, driven by the US policy for the support of the East-West Energy. This process is driven by the increasing need to meet the challenges posed by developments in the Caspian as a whole and Georgia's ability to cope with those challenges.

As articulated by Jan Kalicki, US support for pipeline routes is predicated on a positive answer to each of the following four questions:

- 1 Does the proposal promote the independence, sovereignty, and prosperity of the Caspian states as well as their democratic and free market development?
- 2 Does the proposal promote regional cooperation and conflict resolution?

- 3 Does it increase and diversify the sources of world energy at a time when global energy demand is reaching unprecedented levels?
- 4 Does it support the commercial pursuits of U S companies which are some of the most advanced technologically and environmentally in the world?

In every case, Georgia is the one country for which the answer is resoundingly "yes" Moreover, Georgia is one country through which USAID can work to promote these goals Yet this will not be an easy task

The challenges for Georgia loom large The construction of a pipeline, particularly a large scale oil or gas pipeline crossing multiple boundaries, is a complicated process with many potential points at which the process could breakdown there is the negotiation to aggregate volumes among shippers, as well as negotiations with the potential transit states over route selection, the creation of an ownership structure involving the companies and transit states, the acquisition of financing, the lining up of rights-of-way, and many other steps that need to be accomplished before construction can begin The challenge for Georgia will be to comprehend and react positively, and not to miscalculate (as did the Turks in the Early Oil Pipeline negotiations)

Simultaneously, the back drop to the challenges in Georgia is the fact that the East-West Energy Corridor strategy is under pressure from the oil companies which increasingly are looking for alternative shipping routes as oil volumes increase and prices fall Georgia soon will be unable to handle any more crude shipments across its territory, yet the Country's policy making body (the President's Commission on Oil & Gas) is incapable of dealing with this problem Hence, Iran will increasingly feature prominently as a solution for the oil companies

Georgia is actively engaged in discussions with several countries and has recently sent representatives to Turkmenistan and Kazakstan to assess the opportunities for the further development of Georgia as a transit country Georgia is the choke point on the East-West Energy Corridor, and its infrastructure is inadequate, as are its laws and level of expertise needed to meet the challenges and opportunities with which it is being confronted Yet Georgia is the common factor in all the companies' and countries' respective equations on how to move oil - at least for the moment, and Georgia is also the one country in the region to which USAID assistance can be readily provided

The recommendation then, is to provide assistance to the MEP Committee (otherwise known as the President's Commission on Oil & Gas) to deal, not just with AIOC, but with the development of an East West Energy Corridor strategy in a Caspian wide context This assistance would be designed to encourage the Georgians to engage the Kazaks Turkmenis Azeris and Turks on oil and gas transport issues

Specifically, Georgia would be helped to develop

- Possible routes for transportation of Caspian Oil
- Investment information and economic analyses concerning those routes
- Tariff mechanisms for the transit of oil and gas
- International legal regulations for the construction and operation of export pipelines
- Guarantees necessary to provide for the security of pipeline operations
- Expertise on coping with environmental disasters
- Information on the expected volumes and timing of the flow of oil through Georgia from third countries

This is the task begun in December of 1995, it is this task that is as yet unfinished. The assistance being proposed is consistent with the US policy objectives in the region, and is a logical extension of Hagler Bailly's earlier work in Georgia.

Exhibit 1
Summary of Quarterly Deliverables and Events
Associated with Project Tasks

Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
<p>Task A Restructuring</p>	<p>1Q/97 3Q/98 Consulted with the GOG Parliament and existing oil & gas sector entities with the aim of developing a plan for moving the restructuring of the oil & gas sector forward towards the unbundling of the sector into separate production refining transportation and distribution enterprises</p> <p>Secured an instruction from President Shevardnadze directing the Ministry of Fuel & Energy to cooperate with the newly formed Parliamentary Subcommittee on Oil & Gas and informing the Ministry of the role that Hagler Bailly Consulting (HBC) will have with respect to the Subcommittee s activities</p> <p>Negotiated and obtained the commitment of the Minister of Fuel & Energy to seek passage of a Petroleum Law</p> <p>HBC appointed as Parliamentary agent for Oil & Gas Sector Reform</p>	<ul style="list-style-type: none"> • Workplan Submitted to USAID March 17 1997 • Assessment Of The Status Of Oil & Gas Sector Restructuring Start Date March 3 1997 Finish Date April 30 1997 Report Submitted May 15 1997 • Assessment Of Fuel Supply Subsector Reform/Restructuring Efforts Start Date March 3 1997 Finish Date April 30 1997 Report Submitted May 15 1997 • Oil & Gas Sector Transition Analysis Policy Recommendations And Ongoing Consultation To The Government Of Georgia Start Date May 16 1997 Finish date September 30 1998 Progress Reports weekly throughout the period • A Plan For the Restructuring of the Oil & Gas Sectors of Georgia Start Date January 1 1998 Finish Date May 30 1998 Delivery Date August 1998 • Quarterly and Monthly Status Reports ➤ Final Draft Report September 1998 ➤ Final Report October 26 1998 	<p>Term Worked with the Ministry of Fuel & Energy and with the Georgian International Gas Company (GIGC) to respectively transfer the commercial functions of Saktransgazmretsvi (a department of the Ministry) to GIGC (established as a corporation under the aegis of the Ministry of State Property Management) These were the first significant assets to be transferred out from under the control of the Ministry of Fuel and Energy</p> <p>Worked with the Ministry of Fuel & Energy and with the Parliamentary Subcommittee on Oil & Gas (to which HBC was an integral assistance provider and of which HBC was a member) reviewing drafts of proposed Petroleum legislation</p> <p>Maintained a dialogue with the Oil Workers Union of Georgia to assess their needs and determine how they could play a role in the restructuring of the Oil & Gas Sector in Georgia</p>

Exhibit 2
Summary of Quarterly Deliverables and Events
Associated with Project Tasks

Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
<p>Task B Legal & Regulatory Reform</p>	<p>1Q/97 3Q/97 Reviewed the proposed Law on Production Sharing at the request of the Georgian Oil Company (Saknavtobi)</p> <p>Consulted with the GOG Parliament and existing oil & gas sector entities with the aim of developing a plan for moving the regulatory and legal framework forwards toward the formal separation of policy regulatory and operational functions in a manner that will improve the commercial provision of services</p> <p>Prepared an operational plan (including a transition period) for establishing a unified regulatory/legal strategy for accelerating restructuring as it relates to separation of policy regulation and operations in the oil & gas sector In this connection discussions were held between the implementer and the UK and EU Missions to Georgia</p> <p>Researched the development of a petroleum law draft and methods by which to achieve passage of the legislation</p> <p>Researched a suitable Georgian structure and appropriate legislation for an Independent Gas Regulatory Commission</p> <p>4Q/97 1Q/98 Continued work on the draft Petroleum Law submitted HBC's final draft to the Working Committee and continued to provide advice to the Ministry of Fuel & Energy and the Ministry of Environment on the issues that have now been raised regarding which Ministry will become the Competent Authority and why it is necessary to end the double regime of contracting and licensing</p>	<ul style="list-style-type: none"> • Workplan Submitted to USAID March 17 1997 • 2Q/97 Assessment Of Current Legal And Regulatory Framework Of The Oil & Gas Sector Start Date March 3 1997 Finish Date April 30 1997 Report Submitted May 15 1997 • Preparation Of An Operational Plan (Including A Transition Period) For Establishing A Unified Regulatory/Legal Strategy For Accelerating Restructuring As It Relates To Separation Of Policy Regulation And Operations In The Oil & Gas Sector Start Date March 3 1997 Finish Date July 31 1998 Report Submitted August 15 1998 • Development Of A Petroleum Law Draft And Participation In The Process Of Ministry/Parliament Review/Finalization Start Date March 3 1997 Finish Date September 30 1998 Draft Petroleum Law Submitted to Parliament October 1 1998 • Development Of A Proposed Structure Of An Independent Gas Regulatory Commission Including Scope Of Oversight Functions And Responsibilities Organizational Structure Articulation Of Key Policies Including Rules For Market Operations Recommended Accounting Practices And Operational Budgets Start Date March 3 1997 Finish Date August 31 1997 Report Submittal September 15 1997 • Development Of A Law Establishing An Independent Gas Regulatory Commission Draft And Participation In The Process Of Ministry/Parliament Review/Finalization Start Date March 3 1997 Finish Date Titled 	<p>2Q97 2Q98 We convinced the Georgians that the proposed Law on Production Sharing should be scrapped and instead incorporated into a broader Petroleum Law</p> <p>We translated the law of Oil & Gas drafted by the Georgian Oil Company Saknavtobi together with the Parliamentary Commission on Natural Resources We prepared comments on said draft showing its deficiencies</p> <p>Completed a draft Petroleum Law and submitted it to the Ministry of Fuel & Energy</p> <p>Presented a week long seminar in Tbilisi on Oil & Gas contracting and international petroleum law regimens which was well attended and received by employees of Saknavtobi Saktransgazmretsvi the Ministry of Fuel & Energy and the Ministry of Environment</p> <p>3Q98 The entire drafting process for the petroleum law was thrown into disarray The Georgians are now insisting on redrafting the law yet again to accommodate the advice rendered by the UK Know How Fund advisor (who was paid for by a commercial enterprise already engaged in the sector) Thus the draft of the law which was to have been presented to Parliament prior to the end of the Spring Session has been delayed till the Fall Moreover there is no assurance that the draft when presented will look anything like an acceptable international version of a petroleum law Finally it should be noted that the Georgians are now in violation of the World Bank conditionalities for the SACII credit in so far as they have failed to have a</p>

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Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
	<p>Conferred with TACIS consultants who are continuing their work in support of the European Union's aid program to the Ministry of Fuel & Energy and discussed at length the draft versions of the Petroleum Law</p> <p>Conferred with W T Onorato Chief Energy Counsel for the World Bank which is also interested in oil and gas legislation in Georgia. Have agreed to keep him informed as to the progress of our effort. Mr Onorato will also visit the team in Tbilisi in October</p> <p>Continued consultations with the GOG Parliament and existing oil & gas sector entities with the aim of developing a plan for moving the regulatory and legal framework forwards toward the formal separation of policy regulatory and operational functions in a manner that will improve the commercial provision of gas services</p> <p>Continued the preparation of an operational plan (including a transition period) for establishing a unified regulatory/legal strategy for accelerating restructuring as it relates to separation of policy regulation and operations in the oil & gas sector. In this connection discussions are continuing between the implementer and the UK and EU Missions to Georgia</p> <p>Continued research into the development of a petroleum law draft and methods by which to achieve passage of the legislation</p> <p>Continued research into a suitable Georgian structure and appropriate legislation for an Independent Gas Regulatory Commission</p> <p>2Q/98 3Q/98 Continued our work with the Ministries of Fuel and Energy and Environment on resolving issues raised in the preparation of an Oil & Gas Law</p>	<p>Delayed outside term of Contract</p> <ul style="list-style-type: none"> • In Country Workshops/Training Seminars On Rules Tariff Methodologies Processes And Procedures Of An Independent Gas Regulatory Commission Start Date July 1 1997 Finish Date September 30 1998 Subject Matter changed See Task E • Regulatory Study Tour To The United States Tentative Start Date Fall 1997 Tentative Completion Date Fall 1997 Indefinitely Delayed No Law on Establishing A Commission • Preparation Of Tariff Methodology Start Date July 1 1997 Finish Date September 1 1997 Report Submittal September 15 1997 • Monthly Reports and Quarterly Reports • Other Reports As May Be Required By USAID From Time To Time Weekly Status Reports • Draft Task Report September 1998 • Final Report October 26 1998 	<p>version of the petroleum law before Parliament in the requisite time frame</p> <p>It is the opinion of HaglerBailly that the issue is now a political one and that for an internationally acceptable version of a petroleum law to surface it will take intercession by the World Bank and perhaps the tying of an acceptable version's adoption to the provision of future humanitarian fuel supplies. No other solution appears feasible at this time</p>

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Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
	Worked with the Ministry of Fuel and Energy the Ministry of Environment and the Parliament on the development of a Pipeline Law		

**Exhibit 3
Summary of Quarterly Deliverables and Events
Associated with Project Tasks**

Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
<p>Task C Commercialization</p>		<ul style="list-style-type: none"> • Workplan was submitted to USAID on March 31 1997 • Assessment Of The Status Of Commercialization In The Oil & Gas Sector Start Date May 16 1997 Finish Date August 15 1997 Report Submitted August 31 1997 • Provide On Going Technical Assistance For Introducing Modern Management Information Systems Business Plans And Sample Contracts For Assisting In Commercialization Implementation Start Date September 1 1997 Finish date September 30 1998 Progress Reports weekly throughout period • Identification Of Required Equipment For Assistance In Commercialization Implementation Start Date September 1 1997 Finish Date September 30 1998 Preparation of justification documents As required • On Going Advise To The GOG On Implementing The Commercialization Plan Start Date September 1 1997 Finish Date September 30 1998 Progress Reports every three months throughout period • Quarterly and Monthly Status Reports • Other Reports As May Be Required By USAID From Time To Time ➤ Final Draft Report September 1998 ➤ Final Report October 26 1998 	

**Exhibit 4
Summary of Quarterly Deliverables and Events
Associated with Project Tasks**

Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
<p>Task D Privatization</p>	<p>2Q/97 None Task commences in September 1997</p> <p>3Q/97 Began an Assessment of the Opportunities For Private Sector Participation In The Oil & Gas Sectors of Georgia</p> <p>4Q/97 Completed an Assessment of the Opportunities For Private Sector Participation In The Oil & Gas Sectors of Georgia</p> <p>1Q/98 Continued our research into and review of the Privatization Process which review will be presented in the form of a recommended blueprint for the Ministry of State Property Management for the transfer of control over the oil & gas companies to private hands</p> <p>2Q/98 Delivery of Privatization Policy Guideline for the Oil & Gas Sector of Georgia</p> <p>Completed our research into and review of the Privatization Process which review was presented to USAID and upon their approval will be presented in the form recommended blueprint for the Ministry of State Property Management for the transfer of control over the oil and gas companies to private hands</p>	<ul style="list-style-type: none"> • Workplan was submitted to USAID on March 31 1997 • An Assessment Of Possibilities For Expanding Private Participation In The Oil & Gas Sector Start Date September 1 1997 Finish Date October 31 1997 Report Submitted November 15 1997 • Oil & Gas Sector Privatization Policy Recommendations And Ongoing Consultation To The Government Of Georgia Start Date November 16 1997 Finish date September 30 1998 Progress Reports weekly throughout period • Quarterly and Monthly Status Reports • Other Reports As May Be Required By USAID From Time To Time ▶ Final Draft Report September 1998 ▶ Final Report October 26 1998 	<p>4Q/97 Pursuant to the visit of Mr Rem Vyakhirev Chairman of Gazprom to Georgia on December 18th the Russian Georgian Joint Venture SAKRUSGASMRG ISVI was established</p> <p>This move was expected and is consistent with Gazprom's agenda see HBC's June 15th Assessment Report It is further expected that this move will have major long term implications for the development of the energy sector in Georgia</p> <p>How this will effect the reform the commercialization and the privatization of the energy system of Georgia will depend on how fast and how far the Russians assert their interests</p> <p>2Q/98 The Government is ambivalent about its privatization plans It announces it has no intention of privatizing the Oil & Gas sectors which it views as Strategic</p> <p>3Q/98 The Russian company Interpak (aka Intergas) takes over 7 municipal gas companies and the management control of Saktransgazmretsvi</p>

**Exhibit 5
Summary of Quarterly Deliverables and Events
Associated with Project Tasks**

Task	Quarterly Events	Quarterly Deliverables/Outputs	Other Highlights
<p>Task E Training</p>	<p>2Q/98 Conducted a needs assessment of the oil & gas enterprises and government bodies involved in the legal regulatory and commercial reform of the sector with special emphasis on the teams involved in negotiating the Main Oil Export Pipeline and the Russia Turkey Gas Pipeline projects</p> <p>Conducted seminars on Oil & Gas Accounting International Negotiation Skills and Oil & Gas Project Finance</p> <p>3Q/98 Conducted seminars on Pipeline Transport Economics Environmental Impact Assessments Legal Principles of TransCountry Pipelines and Project Finance and Oil & Gas Administrative Law</p>	<ul style="list-style-type: none"> • Prepare a needs assessment of the oil & gas enterprises and government bodies involved in the legal regulatory and commercial reform of the sector Through consultations with the GOG the World Bank and other donors develop a coordinated training/study tour program <p>This deliverable was accomplished through the issuance of A Needs Assessment Of The Training Requirements Of The Oil & Gas Sector Of Georgia and subsequent meetings between the contractor and the World Bank LBRD GIOC GIGC and the Ministries of Fuel & Energy and Natural Resources & Environment</p> <ul style="list-style-type: none"> • Training subjects on the following <ul style="list-style-type: none"> a) pipeline transport economics b) international contract negotiation skills c) environmental impact assessment d) legal principles of transcountry pipeline construction and operation e) principles of oil & gas accounting general accounting and auditing f) project financing and g) administrative law <p>This deliverable was accomplished by conducting all of the aforementioned seminars/workshops and extensive pre and post seminar interviews</p> <ul style="list-style-type: none"> • Provide technical assistance to help the GOG to implement the training program in concert with the activities carried out under the other four subtasks <p>This task was accomplished through meetings with al th</p>	

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Task	Quarterly Events	Quarterly Deliverables/Outputs Ministries SOE s and Parliamentary Committees	Other Highlights
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