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**PLANNING FOR THE COMMERCIAL AND
LEGAL FUTURE OF THE OIL AND GAS
SECTORS OF GEORGIA**

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Final Report

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CHAPTER 1

INTRODUCTION

This report aims to provide detailed assistance to the Republic of Georgia in restructuring and commercializing its oil and gas industry — and organizations therein — according to international standards. To understand the relevance and application of the findings presented in this report, certain information from previous Hagler Bailly reports on the oil and gas sectors of Georgia, has been included.

1.1 THE TASKS

The objective of the commercial and legal assistance was to provide the following strategies:

- ▶ A plan for strengthening the commercial operation of all of the entities, with special emphasis on strengthening the cash flow in the entire oil and gas sector.
- ▶ 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.

1.2 COMMERCIAL FINDINGS

With respect to developing a plan for strengthening the commercial operation of all of the entities, with special emphasis on strengthening the cash flow through the entire Oil and Gas Sector, Hagler Bailly's report *A Brief Assessment of the Status of Commercialization in the Oil & Gas Sectors of Georgia* (Hagler Bailly, September 15, 1997) concluded that

“Not one of the oil and gas sector state-owned enterprises (SOEs) in Georgia operates according to western commercial norms. No recognizable accounting systems are used by any of them, yet, taken together, they constitute the largest economic activity in the country, with an estimated combined annual turnover exceeding \$200 million.

“Despite innumerable presidential decrees, laws, protocols, agreements, and public pronouncements over the past 5 years, no commercially effective operation has

emerged save those shadowy private oil distribution companies over which the State professes to have no control but yet subsidizes by permitting the use of its assets

“Starting with the Energy Law of 1994, coupled with the execution of the European Energy Charter, and followed by innumerable edicts in one form or another the State Owned Enterprises have failed to reform. Meanwhile the energy infrastructure has deteriorated to the point of collapse. Oil production has dropped to negligible levels (less than 150,000 mt/per annum), gas deliveries have fallen 83%, and storage facilities and delivery systems are so ill maintained as to threaten public safety.

“What is striking, when looking back over time is the total failure on the part of the executive branch of government (which controls the SOEs through the Ministry of Fuel & Energy) to take a leadership role in curing the situation.

“Recognition of this fact is important when trying to determine just how to effect real change.

1.3 LEGAL & REGULATORY FINDINGS

With respect to a plan for moving the *regulatory* environment forward in a manner that will improve the commercial provision of services for the Gas industry of Georgia, we refer the reader to the Hagler Bailly report, dated September 15, 1997 entitled *A Proposed Structure for an Independent Gas Regulatory Commission for Georgia and Suggested Tariff Setting Procedures*. This plan provides a blueprint for the establishment of a regulatory framework for the gas industry of Georgia.

With respect to a plan for moving the *legal* framework forwards toward the formal separation of policy, regulatory, and operational functions in a manner that will improve the commercial provision of services for the exploration and production of hydrocarbons in of Georgia, we refer to the Hagler Bailly draft for a Petroleum Law (yet to be enacted), a copy of which is attached to this report as a model for Georgian planners.

With respect to the Industry as a whole, referring to the observations made in Hagler Bailly's report on the privatization policies of the Government, we observed that

“The open issues are a) the transfer of the ownership of physical assets into the equity structure of companies, b) active supervision of the corporations' management and financial conditions until privatized to improve their sale potential and value, c)

the separation of Government regulatory functions and ownership through completion of the privatization of the remaining entities in the oil and gas sector and d) providing public disclosure of transactions. The most urgent need in ensuring a healthier future for the industry is to establish a regulatory regime to safeguard that the 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."

The Government of Georgia, however, appears to disregard this need, opting instead to retain control over the ownership of assets, and with little transparency in business practices.

1.4 COMMERCIALIZATION RECOMMENDATIONS

Commercialization demands a drastic change in the management culture of the state enterprises and, therefore, extensive re-training of personnel. We recommend that further assistance be directed to achieve the following:

- ▶ The immediate introduction of accounting, budgeting, costing, and credit and billing systems and procedures
- ▶ The simultaneous identification and training of qualified agents for change within each organization, and the 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, employees, and the public
- ▶ Annual audits of the SOEs, the results of which should be widely published
- ▶ A shifting of budgetary outlays for roads, environmental protection, etc., to the consumer through higher taxes on the consumption of petroleum products

1.5 LEGAL & REGULATORY RECOMMENDATIONS

A number of changes are needed in Georgia's legal and regulatory framework, including

- ▶ The creation of a cohesive Energy Policy for Georgia

- ▶ The abolition of Saknavtobi's role as an agent of the State in the contracting and administration of exploration and production contracts, and the adoption of a petroleum law which eliminates the current dual contracting/licensing regime
- ▶ The establishment of an enforcement agency within the Ministry of Fuel & Energy to ensure product quality and enforce public safety, the financing of this regulatory function to be achieved through the rigorous collection of taxes on the sale of oil products, particularly gasoline and diesel oil
- ▶ The enactment of an internationally credible Natural Gas Act to promote investment in, and provide a regulatory framework for the operation of the gas transmission and distribution industry, and concomitant establishment of an independent gas regulatory commission
- ▶ The prevention of unfair practices through the enactment of consumer protection legislation, the legislation will also include the setting of safety standards governing the generation, transmission, and distribution of energy, as well as the disposal of associated wastes

CHAPTER 2

COMMERCIALIZATION OF GEORGIA'S OIL & GAS SECTORS

2.1 INTRODUCTION

Georgia's incipient capital markets are similar in many ways to those of the United States in the early years of the Industrial Revolution when reports of earnings and asset values in accounting statements were unreliable, and share trading by insiders and manipulators often distorted market valuation and led to wild fluctuation. Despite the unprecedented number of business failures in the United States during the 1930s the mode of management operations remained largely the same until after World War II the marketing manager, or central planner, would project sales, the engineering and production staffs would determine what assets were necessary to meet these demands, and the finance manager was instructed to simply find the money to purchase the necessary plants, equipment, and inventories. The process was entirely production-driven.

This mode of operation is no longer prevalent in the United States. Today, financial decisions are recognized as the critical factor in corporate decision making with the financial manager directly responsible for the control over the process. This shift in emphasis has been the primary factor in the development of efficient markets, stability, and prosperity. It is this task of instituting an internationally acceptable, commercially effective financial management system that Georgia's oil and gas sectors now face.

2.2 COMMERCIAL STRUCTURE

Capital in a free economy is allocated through a pricing mechanism. Like the United States' former command economy, the Georgian oil and gas industry does not recognize capital as a factor of production (i.e., it has no cost). The successful transition to a free market will depend on how well the industry management learns modern financial techniques.

Not one of the state-owned Enterprises (SOEs) under the control of the Ministry of Fuel & Energy of Georgia is a true commercial organization. None could stand alone and function without the patronage of the state. The state preserves the monopoly position of each of the enterprises and, in so doing, ensures the further misallocation of capital and degradation of services, and stifles the economy by precluding competition.

With respect to corporate structure and management policies it is important to consider the stability of the enterprise's corporate structure the organization's management and financial credibility as it appears to outsiders the adequacy of financial disclosure and availability of audited financial statements, and the clarity of the ownership and definition of corporate income assets and liabilities

In the oil and gas enterprises of Georgia there is a failure to emphasize profitability Business-critical issues to improve economic performance were neither identified nor understood by management, and financial and management reports where they exist at all, are not formatted against financial objectives Furthermore, the value of financial information was not appreciated by senior or middle management, the most rudimentary definitions of ownership income assets and liabilities were not understood

2.3 NEXT STEPS

The current corporate structure makes accurate, profitability-based accounting and financial tracking impossible Accordingly the enterprises must support an aggressive re-training program directed at all levels of management to develop financial management skills, articulate a clear policy on the profitability objectives for the enterprises, establish a policy supporting the application of financial criteria for decision making, and establish a pay program to adequately compensate personnel within the SOEs

Wherever possible, these actions should be supported by assistance to revise the financial planning and budgetary processes to support the rate of return as a gauge of performance, and re-train *all* personnel

Once the state decides to truly separate itself from the control and ownership of the oil and gas sectors and allow free competition, several steps will have to be taken by each of the enterprises These steps are no more or less what any normal company must do in any competitive market, namely establishing internal procedures and systems, ensuring credibility through planning and transparency, identifying corporate assets and liability, and securing the appropriate equipment to maintain the new systems and practices If the SOEs fail to reform, they will be replaced by more competitive structures — capital will be properly allocated, and the public and the government will benefit accordingly

2.3.1 ESTABLISH INTERNAL PROCEDURES AND SYSTEMS

To achieve the transition to a commercial enterprise, the SOEs must be made familiar with the following business tools

- ▶ Planning for profit

- ▶ Budgeting process
- ▶ Projections of financial statements to future dates
- ▶ Preparation of cash budgets
- ▶ Management of working capital
- ▶ Management of fixed capital
- ▶ Planning the capital structure
- ▶ Formulation of corporate financial policies

Planning

Planning systems must be developed to adequately address the need for decentralization of management, new and revised activities, divestiture of non-core activities, planning for change performance improvement, and the implementation of new bidding and pricing regimes. The systems must also facilitate the transition to a market economy, and establish mechanisms for meeting "best industry performance standards," and coping with the macro-economic environment.

Business Practices

Business practices must be developed that are consistent with the objectives of security of supply, commercial and technical efficiency, and the promotion of self-financing.

Finance

A finance department must create financial reports that are consistent, prudent, and based on the notion of a "going concern," and prepared on an accrual basis according to internationally accepted standards. These reports must be substantive as opposed to formulaic, and material as opposed to merely detailed.

Accounts must be recorded on a consistent basis and consolidated across the organization. They must be restated to account for inflation, adequately disclose contingencies, use appropriate inventory valuation methods, and reflect the appropriate depreciation rates consistent with asset life. None of these standards is currently applied.

The Budget

A budget must be developed which permits the management of internal and external funds, in coordination with the relevant Ministries. Other requirements include the development of short-term cash flow forecasts, the creation of meaningful 'use of funds' statements, the application of project analysis methodology, the creation of reports to top management, liquidity management, the development of risk exposure policies, control over working capital, and the development of banking arrangements.

Internal Controls

Scheduling and control procedures, and a system of internal and external audits must be developed. To oversee these controls, the Georgian oil and gas industry must mandate the

creation of an audit committee and a corporate governance concept (i.e. a Supervisory Council that recognizes the organization's sphere of influence must be expanded to encompass shareholders, investors, competitors, regulators and customers)

Management Systems

Management systems must adequately provide for executive information, customer information, asset management, engineering resource and human resource management, business modeling, investment planning, and cost management.

Reward Systems

Industry must establish reward systems that comprise several key components: pay, benefits and bonuses, working conditions, and performance management, wherein achievement is quantified and measured against objectives.

Human Resource Development

Policies must be developed based on the principles of selection, promotion, and training and education.

Management Information Systems

MIS systems must be developed to adequately emphasize commercial over technical details, identify business-critical issues to improve economic performance, emulate best practices, report against key objectives, emphasize profits, establish priorities on relative values of information, and provide input to management for strategic planning.

Information Technology

These MIS systems must be strengthened by the adoption of IT hardware and software, the application of new accounting, maintenance, construction, and material management systems, and the overall integration of IT functions within organizations. Specifically, telecom circuits must be implemented, particularly as they relate to facilitating collections and settlements, and database management and customer information systems must be developed.

2.3.2 ENSURE MANAGEMENT AND FINANCIAL CREDIBILITY

Credibility is judged by a standard of apparent openness; Georgia's lingering culture of secrecy will impede the successful transition of the enterprises. Thus, as proper practices and systems are being implemented, industry management must receive training and exposure to western business culture and norms.

In particular, credibility is judged by evidence of the organization's ability to plan for profit. We saw no evidence whatsoever of an ability to plan for profit in the western commercial sense wherein every resource has a cost, and every asset must be thought of in terms of its contribution to the profitability of the enterprise. The time value of money is not understood. No attempt is

made to evaluate alternative investments based on their net present value. Thus, it is quite likely that capital continues to be misallocated.

Successful business planning is comprehensive and impacts every item on the balance sheet and profit-and-loss statement. Planning therefore becomes a preview of the financial statements as they will appear in the future. This is based on forecasting future economic conditions, sales, expected selling prices, future operating costs, production schedules, planning for working capital requirements and use, planning for capital expansion, planning for new financing and refinancing, planning for the effective use of funds from profits, and provisioning for contingencies.

There is no individual or department within the Georgian SOEs that is responsible for the profit planning function. Formal financial controls do not exist, nor are profitability goals articulated or promoted. Management must develop a system of formal controls, and top management must articulate a clear, specific profit objective. Day to day emphasis has to be put on profit improvement that will necessitate the interest and participation of the entire staff.

For the program to succeed, lower levels of management must be convinced that upper management is vitally interested in the comparison of financial results against this plan. For this reason, a formal program that ensures workers are paid for their labor must be created. Currently, in spite of significant cash flows within the enterprises, workers are routinely underpaid, and often go unpaid for months. This is not due to lack of money, it is because senior management appropriates the money for itself.

2.3.3 IDENTIFY CORPORATE ASSETS AND LIABILITIES

We observed that income, assets and liabilities were very difficult to identify. No inventories exist, and ownership is unclear. Loans fail to be recorded on the books, and there is no such thing as a contingent liability.

Any outsider trying to evaluate a business will face the issue of understanding its liabilities. Investors/financiers are apprehensive of undisclosed liabilities, and are often reluctant, as a result, to provide capital. This in turn translates into higher costs of capital and a demand for faster payback.

Considerable effort will be required to raise confidence in the commercial viability of the SOEs. Management, however, does not appreciate this fact. Accordingly, an effort should be made to incorporate concept and definitional training within the auditing process.

2.3.4 PROCURE EQUIPMENT

We noted several areas where assistance in the form of equipment provision was requested. It is our opinion that such assistance must be considered as the other reforms are adopted. In particular, SOEs will require IT hardware and software, gas meters maintenance construction and material management systems, telecom circuits, database management systems and customer information systems.

2.4 RECOMMENDATIONS

To achieve commercialization, the SOEs must be forced to compete. The sector must be opened up and every investor, foreign or Georgian, must be granted entry into the business without being tied to the State. This is, first and foremost, a question of political direction and must be ordered and enforced by the Executive Branch of the government. It is unlikely, however, that such steps will be taken freely, as certain entities currently benefit greatly from the alliance between the State and the enterprises. Change will have to be guided and closely monitored.

Corporate and management policies must be examined and revised. We recommend that the SOEs

- ▶ Mandate the adoption of a rate of return as the principle goal of the organization
- ▶ Revise the planning process to support the rate of return as a gauge of performance
- ▶ Re-train all management personnel
- ▶ Implement an effective pay program
- ▶ Collect and report financial data on a timely basis
- ▶ Develop proforma business plans
- ▶ Prepare audited financial statements/prospectuses and identify potential partners
- ▶ Support business development

2.4.1 MANDATE THE ADOPTION OF THE RATE OF RETURN AS THE GOAL OF THE ORGANIZATION

The impetus for change must come from the top. Senior management will have to mandate the adoption of an overall profit objective for the enterprise and require the incorporation of financial criteria in the decision-making process. Without such a decree, the organization as a commercial entity will lack direction.

The overall objective for the enterprise must be stated in terms of the rate of return on investment (the profit for the period divided by the value of the asset base). As discussed in Section 2.3.2, profit planning is the expression of an enterprise's methods for achieving profit objectives, and

follows immediately from the statement of the overall rate of return objective. The ensuing plan will therefore include all major steps necessary to attain the stipulated objective rate of return.

For purposes of profit planning, the rate of return calculation represents the end result of the enterprise's activities. This rate has two components: 1) earnings as a percent of sales, and 2) the turnover of investment. Earnings as a percent of sales represent the degree to which costs were contained when measured against sales. Turnover of investment measures the efficiency with which the capital employed in the operation is being used. A manager can look at this calculation for the enterprise as a whole or on a division-by-division basis. The utility of the calculation is the same no matter what the perspective. A manager can improve his return on investment by either reducing costs or working his investment harder, both of which are entirely within his/her control.

2.4.2 REVISE THE PLANNING PROCESS TO SUPPORT THE RATE OF RETURN AS A GAUGE OF PERFORMANCE

Outside financial consultants should be brought in and tasked with assembling a core group of staff who in turn will develop financial planning procedures consistent with the articulated rate of return objective. Because this process is both cyclic and continuous, as part of this comprehensive reformation of the planning process, an enterprise's internal financial management team must be strengthened in order to achieve the prosperity and, in fact, the survival of the enterprise. This strengthening will be achieved through the development of a complete financial and operational plan for all levels of the enterprise.

As stated above, the plan must be geared to an approved profit objective. The stipulated objective has to be further broken down into sub-objectives for the various units of the enterprise. Responsibility for the attainment of each sub-objective should be assigned to unit managers. Variances of actual performance against plan must be reported to top management, and, where possible, openly addressed. The budget for the ensuing years will be derived using the results of the financial planning process.

The planning process involves

- ▶ Setting a goal for the enterprise to achieve in a future period
- ▶ Forecasting economic conditions which will effect demand
- ▶ Forecasting demand and selling prices
- ▶ Determining how much demand can be satisfied from existing capacity
- ▶ Determining the required expansion of plant and equipment to meet increased demand
- ▶ Production costs at projected demand levels
- ▶ Projecting selling and administrative costs
- ▶ Projecting working capital required
- ▶ Projecting cash required for

- Working capital
- plant and equipment outlays
- administrative expenses
- ▶ Making profit estimates
- ▶ Determining finance requirements

Once the planning process has been completed, it is possible to develop budgets for the divisions and the enterprise as a whole. It is important that the financial plan precede the formulation of the budget. A comprehensive budget includes the following components:

- ▶ Sales budget
- ▶ Production budget
- ▶ Materials budget
- ▶ Labor budget
- ▶ Manufacturing expense budget
- ▶ Distribution cost budget
- ▶ Administration expense budget
- ▶ Plant and equipment budget

By definition, the budget should be prepared for the forthcoming year, broken down by months. The budget should be flexible enough to allow for changing circumstances, and the actual results should be compared to budgeted amounts for use as a management tool.

2.4.3 RE-TRAIN ALL MANAGEMENT PERSONNEL

Concomitant with the issuance of the profitability edict, the formulation of a strategic plan and the development of budgets, the Supervisory Council should instruct the General Director to create training programs to incorporate western business curricula. The objective is to develop a curriculum that supports the articulated profit goals of the enterprise. The curriculum must emphasize commercial over technical details, stress the notion of profit over production, and identify business-critical issues to improve the economic performance of the enterprise. The long-term objective should be the development of the training assets within the system.

Based on our observations, the concepts that need to be taught must include:

- ▶ Planning for profit
 - the concept of profit
 - measuring profit
- ▶ The cost of capital
 - the concept of the time value of money

- applications to decision making
- risk/timing and uncertainty

- ▶ The preparation of financial statements
 - financial planning
 - responsibility
 - reports

- ▶ Working capital management
 - definition
 - administration of current assets and current liabilities
 - sources of working capital
 - the cash budget
 - management of internal and external funds
 - short-term cash flow forecasts
 - controls and 'use of funds' statements
 - liquidity management

- ▶ Capital asset planning
 - definition of fixed capital assets
 - planning for capital expenditures
 - the capital budget
 - estimating investment profitability
 - depreciation in capital management

- ▶ Dealing with special problems
 - capital investment and cash flow management
 - methods for evaluating investment proposals
 - time adjusted methods
 - payback and payout
 - ranking
 - project analysis methodology
 - risk exposure policies
 - control procedures
 - Internal audits
 - external audits

- ▶ Operations
 - defining and meeting "best industry standards"
 - management information systems
 - customer information systems
 - engineering resource management techniques

- ❑ competitive market development skills
- ❑ inventory management
- ❑ IT and MIS integration
- ❑ human resource management

2 4 4 FORMULATE AN EFFECTIVE PAY POLICY

As discussed in Section 2 3 2, most employees of the oil and gas enterprises are egregiously underpaid. In order to motivate staff, payment must be guaranteed. Pay scales have to be adopted for each level of the enterprise, and a budget must be adopted to serve the goal of assuring prompt and adequate payment for labor.

2 4 5 RECORD AND REPORT FINANCIAL DATA ON A TIMELY BASIS

With the assistance of outside financial consultants, the core group of enterprise staff will establish and routinize procedures for the collection of financial data as a precursor to the development of financial statements and managerial reports. Shareholders, potential strategic partners, bankers, analysts, and management will use some or all of these statements and reports to decide how to allocate resources and structure deals. As the process becomes routine, enterprise personnel will develop their own financial expertise, making further involvement by outside consultants unnecessary.

2 4 6 PREPARE AUDITED FINANCIAL STATEMENTS/PROSPECTUSES AND SURVEY POTENTIAL PARTNERS

The regular preparation of audited financial statements is a prerequisite for financing. Without them, an enterprise will not be able to raise significant funds on a commercial basis. Where and when appropriate, a project prospectus should be developed for each particular endeavor marketed to investors. The prospectus will contain information about the enterprise's planned use of the funds, the investment risks, and payback mechanisms. The prospectus should also cover economic and legal issues affecting the enterprise or project into which the funds will be directed. Once an enterprise has completed these steps, it will be well-positioned to identify and approach potential partners, lenders, and investors.

2 4 7 DEVELOP PROFORMA BUSINESS PLANS

Before investment in an individual enterprise is possible, it must first be identified as an accountable unit. The two principle statements used to portray the effects of future circumstances are profit-and-loss forecasts and balance statements, referred to as *proforma*. The preparation of these proforma statements allows management and outsiders to track the flow of reinvested profits into current and fixed assets, adapt to and plan for seasonal variations in operations,

determine short- and long-term financing requirements, plan capital investments forecast cash balances and requirements and model the effects of different policies

The production of a reasonable proforma for each accountable unit will give these enterprises a valuable tool to use internally for decision making Furthermore these proforma business plans will be critical to attracting investors to new projects, investors and lenders want to understand the expected rate of return, and how their funds will be used Management needs to be convinced of the utility of a proforma, and versed in its preparation

2.4.8 SUPPORT BUSINESS DEVELOPMENT

A bridge between the newly commercialized enterprises and western companies needs must be created to augment the entire process of capital knowledge, and technology transfer One possible solution is to create a liaison function to act as a facilitator, assisting an oil or gas sector enterprise in locating appropriate suppliers of management expertise, capital and technology In order to correctly assess the value of potential products and services, the organization has to be assured that its requirements are communicated as widely as possible to the potential universe of qualified suppliers Moreover, the organization has to develop the skills to assess the value and terms and conditions of the offered product or service as well as develop bidding regimes and after sales support compliance policies

2.5 CONCLUSIONS

A comprehensive profit strategy articulated by top management will be the key to successful commercialization All of the recommendations require common initial preparatory work, the foundation for which is comprehensive training

CHAPTER 3

LEGAL AND REGULATORY REFORM OF GEORGIA'S OIL & GAS SECTORS

3 1 INTRODUCTION

Georgia is in the middle of a complex transition from a centralized economic system to a capitalist-style decentralized system. To accommodate this shift, it is necessary to establish some very basic principles with respect to petroleum operations, including the ownership of the mineral resources before and after production, the right to transfer ownership of those resources to others, the terms of such transfer, the conditions for disposal of the minerals produced, dispute resolution procedures, rights and obligations respecting land use and the facilities of commerce (e.g., roads, bridges, ports, telecommunications, etc.), uniform accounting practices and fiscal incentives and the conditions under which such incentives may be granted. Given the present circumstances in Georgia, new or amended legislation is necessary to provide a clear rational framework for dealing with these and other petroleum issues and to establish minimum legal principles which are significant to both the state and petroleum investors.

3 2 INDUSTRY STRUCTURE

The oil and gas sector of Georgia is composed of companies wholly owned by the Government, in either a joint stock company form as is the Georgia International Oil Corporation (GIOC) and the Georgian International Gas Corporation (GIGC), or as state enterprises, i.e., departments of the Ministry of Fuel & Energy (MFE) such as Saknavtobi (Georgian Oil Co.), Saktransgazmretsvi (Georgian Gas Transmission Co.), Saknavtobprodukti (Georgian Oil Products Co.), Saktkhevadgasi (Georgian Liquid Gas Co.), and the Batumi Oil Refinery. Those that are an integral part of the MFE are considered to be part of the Treasury.

3 2 1 THE MINISTRY OF FUEL & ENERGY

The Ministry of Fuel & Energy was established on June 26, 1996, by Presidential Decree. The main functions of the Ministry are to 1) define and execute energy policy, 2) develop the electricity sector, including the construction and rehabilitation of hydro-electric and thermal-electric power plants, exploration, production, and processing of oil and gas, exploitation of coal and other renewable energy resources, and development of an energy transportation network, 3) reorganize and reform the fuel and energy sector, 4) establish an appropriate legislative framework for the fuel and energy sector, 5) establish policies for the efficient use of energy, 6)

create and promote an attractive environment for energy sector investments and 7) supervise electricity and fuel quality

Management of the Ministry

The Ministry of Fuel & Energy is governed by a Minister appointed by the President and approved by Parliament. The Minister has a First Deputy Minister and several Deputy Ministers who are responsible for different aspects of the Ministry's activities.

The administrative structure of the Ministry of Fuel & Energy comprises the Department for the Development of the Fuel and Energy Sector, the Department of Reforms, the Financial-Economic and Energy Balances Department, the Department for Coordinating Credits and Investments, the Foreign Relations Department, the Legal Department and Sub-Department for Parliamentary Relations, the Information and Novel Technologies Department, the Department of Energy Supervision, the Licensing Department, and the Technical Department.

Organizations Governed by the Ministry of Fuel & Energy

According to the Georgian Law entitled "On the Rules of Activity and Structure of Executive Power," the Ministry of Fuel & Energy governs the following state-owned enterprises:

- ▶ Treasury enterprise "Sakenergogeneration" (power generation)
- ▶ Treasury enterprise "Sakenergo" (power transmission)
- ▶ Treasury enterprise "Saknavtobi" (Georgian oil)
- ▶ State enterprise "Saktransgazmretsvi" (gas transmission)
- ▶ State enterprise "Saknavtobprodukti" (Georgian oil products)
- ▶ State Sub-Governmental Agency "Saknakhsiri" (Georgian coal)
- ▶ Joint Stock Company "Saktkhevadgasi" (Georgian liquid gas)
- ▶ Treasury enterprise "Scientific-Research Institute of Power Engineering"
- ▶ Treasury enterprise "Energokselproekti" (energy network design)
- ▶ Treasury enterprise "Energy Resources"
- ▶ Treasury enterprise "Satbobenergoinformatika" (fuel and energy information)
- ▶ Design research Institute "Hydroprojecti" (hydro design)
- ▶ Treasury enterprise "(Batumi) Oil Refinery Plant"

The Treasury Enterprise "Saknavtobi" (Georgian Oil)

Saknavtobi has functioned in various forms since 1930. Its current incarnation was established on January 17, 1996, pursuant to Decree No. 124. The Company's goals and objectives include 1) definition and execution of oil and gas industry development programs, 2) satisfaction of the country's demand for oil, oil products, natural gas, and oil imports, and 3) production, transportation, refining, and sales of oil through its structural units.

The organizational structure of Saknavtobi includes "Oil Constructions" Ltd providing construction and installation of facilities, "Oil and Gas Exploration" Ltd, providing exploration works, "Oil Service" Ltd, providing oil related service in the country, the department of oil and gas mining, the commercial center for oil and gas sales, and Georgian-foreign investor joint ventures

The enterprises accountable to "Saknavtobi" include

- ▶ "Navtobgeophisika" Ltd (petroleum geophysics)
- ▶ "Navtobsamecniero" Ltd (petroleum sciences)
- ▶ "Samtomashveli" Ltd (lifeguard/rescue team)
- ▶ "Menavtobe" Ltd (petroleum operator)
- ▶ Treasury enterprise "Komerციული Centრი" (commercial center)

The Treasury Enterprise, "Saktransgasmretsvi" (Gas Transportation)

This company was established by the Ministry of Fuel & Energy in Decree No 48 on November 11, 1996 and is a legal successor to the former department "Sakgas" (Georgian Gas) and of the Joint Stock Company "Transgas" (gas transportation) Its main activities are the supply of natural gas to industry and the population of Georgia, the transportation of natural gas through the main gas pipeline, natural gas purchases and sales, and construction, installation and maintenance of natural gas transportation facilities

At one time, 46 Georgian cities and 230 rural villages throughout the country consumed natural gas through a pipeline network which exceeded 10,000 km in length This network included a 2 300 km trunk line, thousands of gas distribution stations related equipment, and electrochemical protective stations Of this distribution system, only the main trunk line continues to function

The State Company "Saknavtobproducti" (Georgian Oil Products)

"Saknavtobproducti" was established on June 11, 1995, pursuant to Presidential Decree No 288 The company was established during the transitional period of the Georgian economy in order to exercise state economic policy on oil product distribution and to create state reserves of oil products The company holds controlling shares in 38 joint stock companies It operates 982 storage tanks, with a total capacity 436,375 m³ Each tank has railway access The company also controls the main oil product pipelines from the seaports of Georgia to the internal territories of the country and abroad Its facilities include the Khashuri site, with storage capacity of 76,000 m³ The main oil product pipeline has a diameter 530 mm and a length of 232 km, with a volume of 43 024 m³, and four reservoirs with a total volume of 4,000 m³ at the Batumi refinery

The Joint Stock Company, “Saktkhevadgas” (Georgian Liquid Gas)

“Saktkhevadgas” was established in 1995. Its function is to supply liquefied natural gas (LNG) for domestic consumption. Receipt, storage, and distribution of LNG is conducted at nine stations. The total capacity of all distribution units is 12,500 tons.

3.2.2 GOVERNMENT JOINT STOCK COMPANIES

The following two organizations are not part of the Ministry of Fuel & Energy. Nominally, the shares of these companies are held by the Ministry of State Property Management. In actuality, the shares have been “given back” to the companies, hence voting control lies with the Supervisory Council (the Board of Directors) of each company.

The Georgian International Gas Company

The Georgian International Gas Corporation (GIGC) was established on April 20, 1997, pursuant to Presidential Decree No. 206 and was given the authority to manage Georgia's gas network. It subsequently took over the operations of Saktransgazmretsvi, whose management now reports to GIGC. The Company was also given the authority to represent the state in all natural gas-related negotiations and agreements with third-party countries.

The Georgian International Oil Company

The Georgian International Oil Company (GIOC) was established by Presidential Decrees N477 and N178, dated November 11, 1995 and February 18, 1996 respectively, and chartered as a joint stock company, registered in the Tbilisi courts on February 21, 1996. The purpose of the company is to engage in the transport of “Early Oil” from the Caspian Sea through Georgia as part of a broader development of Caspian Sea oil by the Azerbaijan International Oil consortium (AIOC). AIOC has signed a thirty-year Pipeline Construction and Operating Agreement (PCOA) with GIOC under which GIOC will receive revenue from the operation of the pipeline. AIOC will invest \$150 million in the construction of the Georgian portion of the pipeline and associated terminal and will have the right to operate the line for the duration of the contract term, after which the pipeline will revert to Georgian control. At all times, the pipeline will remain the property of Georgia. Under the PCOA, GIOC will receive \$0.17/bbl of throughput, adjusted upwards quarterly by the US GDP Deflator. Every 8.5 years, GIOC will have the right to renegotiate the pipeline tariff.

A considerable amount of information has been gathered already by Hagler Bailly on the sector's operations during the past one and a half years. The information concerns the structure of the industry, the financial condition of the companies, the physical assets, markets, the import issues vs. domestic exploration and production, the presence of foreign firms in the field and the joint ventures undertaken with Georgian national firms, the depth of monopolistic practices, and other related issues. These studies have been submitted to USAID and are referenced in this report.

3 2 3 LEGAL FRAMEWORK

Georgia does not have a specific system of laws governing its petroleum sector. The existing legislation, the "Law on Entrails of the Earth" (generally known as the "Subsoil Law") is deficient in several respects. As written, it is more appropriate for hard rock mining than petroleum operations. For instance, the Subsoil Law permits only "licensing of minerals for development." Production sharing, service, or risk-type agreements are not permitted. Additionally, the licensee is not permitted to transfer any rights under the license (this has caused ARCO to postpone its off-shore exploration while it obtains rights under a license granted to JKC). Furthermore, the Law has no provisions for international arbitration.

Dual Contracting System

In Georgia, a petroleum investor must pass through a "dual contracting/licensing system" in order to secure the rights to mine and develop hydrocarbons. Under the current system, an investor must negotiate a contract with Saknavtobi, the national oil company, to acquire rights to oil and gas deposits. However, before the investor may exercise these rights, it must apply for and be granted a license by the Ministry of Environment and Natural Resources. The proceedings before this Ministry are in effect a second negotiation of the original agreement. The Ministry's view is that the entire contract is subject to renegotiation. Such a system is a large disincentive to investors.

The Role of Saknavtobi

The status of Saknavtobi is unclear at present. Is it at times an agency of the state with quasi-governmental duties and authority, in other respects it is a business entity with all the entitlements of commerce. This creates a system that is not transparent, and gives Saknavtobi an unfair competitive advantage over all investors, both domestic and foreign. Moreover, it obscures the boundary between the state and business in the areas of policy development.

Decree 277

Presidential Decree No. 277 further complicates the legislative climate. Through this decree, the Government of Georgia (GoG) has threatened to rescind oil companies' licenses if certain production levels are not achieved. These production levels were unilaterally imposed upon the license holders after they had entered into contracts with the state. The constitutionality of this decree has not been tested in the Georgian courts, but its existence alone may prove a political risk, and ultimately, a deterrent to investors.

The Draft Petroleum Law

Although Georgia does not have a petroleum law, that has not stopped the signing of contracts with and the granting of licenses to foreign investors. During the Soviet era, petroleum exploration, production, refining, and marketing efforts were conducted according to a central

plan imposed from Moscow. Following Georgian independence in 1991, the sector was controlled by Saknavtobi as a separate department of the Government. In 1994, Saknavtobi was placed under the nominal jurisdiction of the Ministry of Fuel & Energy, but it has continued to operate as an autonomous entity on an *ad hoc* basis. In 1996, the Georgian Parliament adopted the Natural Subsoil Law, following the pattern already established by Russia, Kazakhstan, and the other former Soviet republics.

In January 1997, the President decreed that the Ministry of Fuel & Energy be responsible for the drafting and submission of a Petroleum Law. In May 1997, President Shevardnadze decreed that a working group be established under the Ministry of Fuel and Energy, with participation by other interested government parties to draft a production sharing contract law, an oil and gas law, and a main pipeline law. In the initial stages of deliberations, the working group decided to limit its work to the creation of an oil and gas law. The results were disappointing, and discussions reached an impasse because of the conflicting roles of Saknavtobi, the Ministry of Fuel & Energy, and the Ministry of Environment.

In July 1997, Hagler Bailly prepared an initial working draft of a Petroleum Law designed to establish a legal framework for oil and gas exploration and production activities in Georgia. The objectives of this law were to (1) protect the legitimate interests of the Georgian state, (2) permit investors to receive a fair return on invested capital, and (3) establish one effective and efficient Competent Authority, unburdened by excessive bureaucracy and opaque rules and procedures.

In August 1997, after in-house review and revision, the Hagler Bailly team submitted its first draft petroleum law to parliamentary committee chairmen David Onoprishvili and Zurab Tskishvili, with a copy to Revaz Tevzadze, Chairman of Saknavtobi. Our draft attempted to resolve the dual contracting/licensing dilemma by removing the authority of both Saknavtobi and the Ministry of Environment, and placing it in the Ministry of Fuel & Energy. It further provided that the Subsoil Law would no longer be applicable to petroleum, and that oil and gas exploration and production operations would be governed exclusively by the new petroleum law.

At this point, the Hagler Bailly team, with support from the World Bank chief energy lawyer, proposed that an inter-ministerial body hold full responsibility for negotiating, signing, and implementing contracts for the exploration and production of petroleum in Georgia. This solution met with tentative approval at the working group stage, but the consensus soon unraveled.

The Subsoil Law prescribed a system of licensing of all underground resources, including petroleum, and gave the licensing authority to the Ministry of Environment and Natural Resources Protection. As a result, investors in oil and gas exploration and production in Georgia must negotiate a petroleum contract with Saknavtobi and a license with the Ministry of Environment, each entity considering itself to have full authority over all matters involving petroleum operations. This situation has emerged as the biggest obstacle to the adoption of an

internationally acceptable petroleum law as neither Saknavtobi nor the Ministry wish to relinquish power

In November 1997, most of the working group members and other key players attended a study tour in Britain, sponsored by the British Know-How Fund. A presentation was made by a British lawyer who was then invited by Zurab Tskitishvili to come to Georgia. The result was a new draft of the petroleum law, this time under the aegis of the Parliamentary Committee for Sectoral Economics. This latest draft, dated the 15th of June 1998, gives Saknavtobi a grant of anti-competitive, preferential authority to act for the state.

3.3 NEXT STEPS AND RECOMMENDATIONS

The purpose of privatization is to promote economic transformation. To develop a restructuring and privatization policy, it is therefore necessary to understand and monitor the Government of Georgia's policies on economic goals and the supporting legislation. The work must also reflect the status of Government's expenditures and services, its methods of promoting market opportunities, liberalizing commerce, and its means of disposal of state assets. The policy developed must also reflect the Georgian energy policy in regard to the level of its involvement through ownership, its role in dealing with emergencies and force majeure, import/export policies, and similar topics.

Thus, there are several issues that must be specifically addressed to ensure that the transition to a restructured, privatized market is successful. The following sections outline the key issues and provide, in detail, our recommendations and proposed response.

3.3.1 ADDRESS THE INEQUITY OF PRESIDENTIAL DECREE NO. 277

The problems with Decree No. 277 may be addressed in one of two ways: 1) a decision of the Georgia judicial system invalidating this decree and denying the President the power to issue such decrees in the future, or 2) new legislation expressly overturning Decree No. 277 and placing decrees of similar import beyond executive authority. Today, the Georgian judicial system is weak and immature. It is doubtful that such a decision by the courts, if it came at all, would be enforced. New legislative action is the only option available to resolve this issue.

3.3.2 ESTABLISH A PETROLEUM LAW ACCORDING TO INTERNATIONAL STANDARDS

Following the repeal of Decree No. 277, the Georgian Parliament must adopt an internationally credible petroleum law. Properly done, this will have the effect of improving the provision of services in the exploration and production of hydrocarbons in Georgia, and will position Saknavtobi for reorganization and eventual privatization. The Hagler Bailly oil and gas team has proposed a draft petroleum law which would remove Saknavtobi from all government or state

functions, limiting it to commercial functions. The proposal also calls for the restructuring of Saknavtobi, with the goal of eventual privatization.

Once the petroleum law is adopted, assistance should be provided to the Ministry of Fuel & Energy – or to the government body assuming the Ministry's responsibilities under the petroleum law – to draft appropriate regulations for the conduct of petroleum operations.

Finally, legislation must be drafted that allows for provisions to restructure the state enterprises, prescribe the creation of joint stock companies, and assign to the new companies the discrete businesses of the existing enterprises.

Assessment of Current Draft

The Hagler Bailly team is now studying the June 15th draft with a view toward preparing recommendations that will lead to an internationally acceptable petroleum law. The Committee's Chairman, Zurab Tskitishvili, believes that this draft separates the policy making functions of the State from commercial activities of Saknavtobi and creates a single-step licensing process. After a preliminary read, however, the draft appears to do the opposite.

The subject draft fails in both main areas:

- ▶ *The draft perpetuates a dual licensing/contracting regime.* In the areas of petroleum exploration and production, a major flaw in the existing legal regime in Georgia is the necessity for the investor to first negotiate a contract with Saknavtobi, and then again with the Ministry of Environment to obtain a license. While this draft maintains the separate contracting and licensing regime, it purports to place both functions under the same entity, a newly created Competent Body. However, the Competent Body is allowed to delegate "certain operational or commercial tasks of state management" to Saknavtobi. Those certain tasks are to be contained in a resolution of the Competent Body after passage of the law, and can reasonably be expected to include negotiating and administering petroleum contracts.
- ▶ *The draft ensures that Saknavtobi acts for the state.* This draft makes Saknavtobi the national oil company, and authorizes it to act on behalf of and for the state. Hagler Bailly recommended that Saknavtobi's functions in negotiating, drafting, and administering contracts be given to a strictly governmental entity, and that its remaining interests, commercial in nature, be restructured and eventually privatized. Not only does the June 15th draft keep Saknavtobi in its former position, but it legally sanctions its informal hegemony in petroleum matters.

Other aspects of the draft that raise additional concern. Some of the more disconcerting provisions of this latest draft include:

- ▶ Article 9 1 of the draft requires that Saknavtobi be transformed into a joint stock company within six months but not be privatized Article 9 12 of the draft provides that the state may (but is not required to) dispose of 49% of its shares in Saknavtobi to private investors after three years, and the state may (but is not required to) offer all of its shares in Saknavtobi to private investors after six years

Article 9 12 requires the issuance of shares to private investors only by tender or auction Nothing is mentioned about a subscription price at that juncture The initial capitalization will, pursuant to Article 9 9, be divided into 10,000 shares at a par value to be determined and stipulated in the law The whole issue of adequate compensation for the state is side-stepped

- ▶ The law in Article 8 1 (x1) allows the Competent Body to delegate to Saknavtobi until the state ceases to be a 100% shareholder "certain operational or commercial tasks of State management" Those tasks "shall include the representation of the State on the management organ of Production Sharing Agreements and disposal of all of the State's share of Oil and Gas produced in Georgia" It is important to note, however, that the Competent Body does not control Saknavtobi's Board of Directors according to Article 9 11 (2) At the time the law comes into effect, the Chairman of Saknavtobi becomes the Chairman of the Board and may appoint the other members, subject to the President's approval After the full offering of shares the Board is appointed in accordance with the rules and regulations of the privatized company

The law could pave the way for certain individuals (possibly former high government officials) to create important positions for themselves in the Georgian petroleum sector The rights granted in Article 9 8 1 would allow Saknavtobi, without the approval of the Competent Body or any other entity, to create powerful positions by establishing branches, entering into contracts with financial institutions, and purchasing or selling shares in other companies, engaging in general commercial activities of any kind, both inside and outside of Georgia, and entering into cooperation and partnership agreements with third parties in Georgia and abroad

Although this report is critical of the latest draft petroleum law, continuing discussions with the Georgians have resulted in a much better understanding of the problems that remain Once our analysis is completed, we will prepare our own "final" draft, which will incorporate the acceptable features of the current draft

As an example of a model law, Hagler Bailly's original draft is included (see Appendix)

Recommendations

The Subsoil Law clearly grants all mineral rights, including oil and gas licensing rights, to the Ministry of Environment and Natural Resources The source of Saknavtobi's authority to

contractually encumber or otherwise dispose of any such mineral rights is unclear. Although we have requested it, we have yet to receive a copy of a law, regulation, or decree granting Saknavtobi the rights and powers it claims. Without new or amended legislation which clarifies this matter, the dual contracting system will remain.

The scope of authority of the Competent Authority must be determined. These matters require political decisions by the GoG and Parliament. The concept of a single-step process, or "one-stop shop," has been generally accepted by Georgian politicians. Still being disputed is the determination of the entity responsible for the oversight of the program. Saknavtobi is clearly attempting to position itself as both a quasi-governmental agency and a business enterprise. It wants to command the prerogatives and powers of government while also enjoying the entitlements of commerce. Consultations with the GoG, probably at a high level, could help resolve this issue. However, institutional leverage will more effectively solve this problem.

Additionally, there is a danger. The way the draft law is written, certain individuals could secure control over Saknavtobi and transfer the nation's petroleum wealth to themselves, providing inadequate compensation to the State. It could be possible for individuals to purchase Saknavtobi with little or no investment on their part. Furthermore, once Saknavtobi is privatized, these private parties will be in a position to determine the national energy policy. There is nothing in this law or in any other Georgian laws which require that the stockholders of Saknavtobi be Georgian citizens. Foreign entities could effectively dictate the future development of Georgian petroleum reserves.

Finally, the interested parties in Georgia do not have the same motivation to approve an internationally acceptable petroleum law as they did for the passage of the Electricity Law. For this reason, we recommend that the major institutions in Georgia (e.g., the World Bank) take an active role. Also, to achieve acceptable legal reform of the Georgian petroleum sector, a "carrot" such as humanitarian gas, must be offered. Assuming that such leverage can be found in a timely fashion, there is strong likelihood that Hagler Bailly's draft Petroleum Law will achieve the necessary objectives, as defined above, and meet international industry standards.

3.3.3 DEVELOP A FORMAL ENERGY POLICY

The Government has been developing a national *energy policy* lead by the Scientific-Consulting Council of the Ministry of Fuel & Energy. The latest draft in English (March 24, 1997) outlines the necessary instruments to be in place, namely: a legislative-regulatory framework, tax and price-setting policy, regulatory framework for natural monopolies, energy efficiency policy, energy export/import policy, regional development policy, and the role of the Government in decision making.

The Government has developed legislation for the privatization process exemplified by the Law on Privatization of State-Owned Enterprises, the Law on Underlying Principles and Policies to

Define the Procedure for How State Enterprises may be Transformed into Public Stock Companies, the Law about the Competitive Sale of State-Owned Property and issued a decree (in April, 1993) on Special Investment Foundations for Privatization. These laws together with the Law on Foreign Investments, will have to be harmonized. They are often vague and contradictory.

A privatization decree is currently being drafted by the GoG whereby both Saknavtobi and Saktransgazmretsvi would be established as joint stock companies, and the latter's control would be transferred to GIGC. Following this step, shares in Saktransgazmretsvi and Saktkhevdgasi would be offered to investors competitively, contingent upon the investors' willingness to rehabilitate the industry, shares not sold would be auctioned off. In the case of Saknavtobi 51% would be "temporarily" held by the state after restructuring, and the remaining shares would be sold competitively (on the condition that the buyers make further investments).

If a sensible Petroleum Law, and perhaps a Gas Distribution Law, are enacted, at least the beginnings of a legal and regulatory framework would in place.

3 3 4 ESTABLISH REGULATORY MECHANISM

Assuming that an internationally acceptable petroleum law is enacted, an essential component of a successful petroleum administrative regime is regulation. In contrast to the law, which is adopted by the Parliament, regulations are promulgated by the government body with responsibility for petroleum exploration and production matters.

These regulations must be issued in accordance with the provisions of the law. So long as they do not conflict with the petroleum law, the regulations should not be subject to prior legislative scrutiny. This allows the maximum flexibility for timely response to any developments to which the Parliament could not react quickly enough. Of course, Parliament has final authority and it may, by changing legislative policy, require changes in the regulations.

Recommendations

The regulations should follow the format of the petroleum law, and should address the following issues:

Petroleum licensing This assumes that the inappropriate licensing provisions of the Subsoil Law will no longer be applicable to petroleum exploration and production operations under the new petroleum law. Instead, licensing would be an administrative function in which no discretion is exercised by the licensing office.

Contract area The regulations can determine — if not already defined by the law — the maximum and minimum sizes of blocks to be offered for petroleum operations, and their location and orientation.

Bid tenders The regulations should specify the form to be used in bid tenders and the contents of a "bid package" to be furnished to prospective bidders. The bid package will normally require the payment of a fee designed to reimburse the state for the cost of making the information available, and for conducting the bid tender. In addition, prospective bidders may be required to purchase geological and geophysical data, well logs, and other data concerning the bid area.

Direct negotiations The regulations should define those circumstances in which bid tenders would not be necessary or desirable and should specify the information regarding technical and financial competence that a prospective investor would be required to submit.

Petroleum operations The regulations should address specific requirements to be met by the investor in carrying out petroleum operations, including the submission of an annual work program and budget, timing and approval, procedures for furnishing of geological, geophysical data, well logs, and other technical data, procedures for giving notice of drilling wells, their location and projected depth, procedures for abandonment of wells, and procedures for relinquishments.

Once we have reviewed the substance of the petroleum law that will be adopted, we propose to shift at least part of our efforts to the drafting of accompanying regulations. Prior to this effort, we propose to conduct training sessions for the Georgian government officials and employees who will be responsible for implementing the regulations, as well as one-on-one meetings to determine what issues are considered the most important.

3.3.5 ESTABLISH A REGULATORY COMMISSION

Recently, several Georgian municipal gas companies and other state-owned natural gas facilities have been sold or otherwise transferred to private entities. Few of the details of these transactions have been made public, and it is difficult to understand exactly which assets were transferred to whom and under what conditions. The absence of transparency in these proceedings, coupled with the lack of regulation of natural gas distribution activities, opens the sector to possible consumer abuse. Furthermore, the want of a definite legal framework for gas sales likely impedes the development of natural gas fields and markets. An unknown (but seemingly significant) quantity of associated gas is flared. This allegedly is due to lack of a market for the gas. Other natural gas prospects, which supposedly exist, are not being explored.

Recommendations

As a result, several preliminary issues then must be resolved. These include

- ▶ *The regulation of pipelines* At a minimum, the rates charged by consumers of local natural gas distribution systems should be regulated by a commission independent of the government. The same reasoning would also lead to the regulation of rates and/or tariffs of the pipelines that transport gas from the main pipelines to the local distribution systems.

- ▶ *The use of the existing electric energy commission to regulate the natural gas sector* It would appear preferable to avoid placing new and unfamiliar responsibilities on a body that is still learning how to do its primary job. However, this may be the most expedient way to introduce a regulatory mechanism.
- ▶ *The creation of a new regulatory framework* There are several possibilities to establish a new framework. A Pipeline Law (which may or may not exclude transit pipelines) may be drafted to regulate the rates, prices, and conditions of carriage of both oil and natural gas over "common carrier" pipelines, and to establish a regulatory body. A Natural Gas Act could be created to promote investment in, and provide a regulatory framework for the operation of the industry involved in natural gas transmission, transit and distribution. Finally, such a framework and regulatory body could be included in the Petroleum Law (this is not recommended).

We believe that the operations of natural gas distribution companies in Georgia should be examined with a view to establishing a legislative/regulatory scheme to oversee these activities.

While there has been discussion in Georgia concerning the creation of an independent commission to regulate the *entire* petroleum sector, we believe that this is neither a realistic nor desirable goal, and we advise that such a broad-ranging commission be discouraged. The regulation of the petroleum sector (in areas other than oil and gas transport) is best handled by an appropriate government entity, either a ministry or a department or branch thereof. Gas and oil pipelines, on the other hand, have elements that are very similar to the electric power sector, making them ideal candidates for regulation by a body that is to some extent insulated from political pressures.

The Government of Georgia should, therefore, adopt a policy to promote private investment in the country's gas industry, to ensure a reliable supply of gas, nondiscrimination (third party access) for domestic gas producers, transparency of tariff setting and fairness in pricing, safety, and equity among consumers. This policy should be formulated by the Ministry of Fuel & Energy, the implementation of the policy should then be carried out by an independent body functioning as the Georgian Gas Commission. The Commission should act to protect the public interest in the rates and services of gas distribution companies, and should be charged to establish a comprehensive and adequate regulatory system for public utilities to assure rates, operations, and services that are just and reasonable to the consumers and to the utilities.

Gas distribution companies are, by definition, monopolies in the areas they serve. As a result, the normal forces of competition that regulate prices in a free enterprise society do not operate effectively. Consequently, the Commission should regulate distribution company rates, operations, and services as a substitute for competition.

3 4 CONCLUSIONS

Although a cohesive legal and policy framework for the oil and gas industry is not in place in Georgia, steps are being taken to enact some legislation for the sectors' operations and for the related public service industry. The Petroleum Law, once revised, should abolish Saknavtobi's role as an agent of the State in the contracting and administration of exploration and production contracts, and eliminate the current dual contracting/licensing current regime. At the same time, effort must be made to establish an enforcement agency within the Ministry of Fuel & Energy to ensure product quality and enforce public safety.

Once the Law has been adopted, accompanying regulations must be drafted, and comprehensive training sessions held for those officials and employees who will be responsible for implementing the regulations.

In Georgia, as in many other countries at the beginning of the restructuring process, the Government believes in control of strategic assets by majority ownership. In the petroleum sector, these policies guided issuance of Decree No. 248 (Enterprises under Georgian Gas, 1995) and Decree No. 228 (Georgian Oil Products Holding, 1995). A total of 304 companies were classified as strategic in 1996.

CHAPTER 4 THE PATH FORWARD

4.1 LEGAL AGENDA

4.1.1 Drafting Future Legislation

Legislation specific to the oil and gas sector must be created with the specific goals of

- ▶ Ensuring that anti-monopolistic practices in the petroleum industry are kept in check including the segment known as “natural monopolies”
- ▶ Preventing collusion in creating unnecessary mergers, acquisitions anti-trust legislation
- ▶ Preventing unfair business practices, ensuring quality of service through consumer protection legislation
- ▶ Safety measures regarding the transportation and distribution of petroleum and petroleum products, and disposing of wastes
- ▶ Introduction of international standards and certification in equipment manufacturing, use and maintenance procedures
- ▶ Elimination of regulatory risk before privatization
- ▶ Elimination of “sweetheart” deals which cripple newly-privatized enterprises
- ▶ Requiring not only the adoption but also the diligent application of internationally acceptable accounting practices, resulting in full transparency

4.1.2 Training

Intensive training is necessary. These sessions should be targeted at managers, lawyers, accountants and others who would be involved in the organization and corporatization of the joint stock companies spun off from or replacing the various commercial interests of the state enterprises. These would include such topics as

- ▶ Legal aspects of company organization
- ▶ Drafting of company charters and by-laws
- ▶ International accounting standards
- ▶ Finance
- ▶ Developing seminars covering oil & gas and related transportation issues

In planning the training sessions, Hagler Bailly would draw upon its experience in developing and presenting a series of seminars covering oil and gas topics and related transportation issues, including follow-up interviews with seminar attendees in order to determine their perception of the value of the seminars and to collect information on issues of interest to Georgians for use in future seminars. From prior follow-up interviews we have concluded that there is a continuing lack of understanding on the part of many Ministry and government personnel of basic oil and gas contracts and negotiating practices generally prevailing in the international petroleum business. We recommend that this training for government/agency personnel be continued especially for individuals at the operational level. Subject matter, whether taught in seminar form or through regular classes should be more detailed and narrowly focused than heretofore.

APPENDIX

GEORGIA PETROLEUM LAW

SECTION I GENERAL PROVISIONS

Article 1 The Sphere of Application of the Law

- 1 1 This Law provides for the regulation of the activities of legal entities and individuals in the exploration, production, gathering, treating, and processing of Petroleum and Petroleum Products from, on, or under, the territory which is under the jurisdiction of Georgia, including its Black Sea shelf and special economic zone, and for the establishment of an independent regulatory authority whose responsibility will be the setting of natural gas transmission tariffs. This Law is intended to promote the development of the petroleum sector in Georgia on the basis of the principles of a market economy.
- 1 2 The objectives of this Law are to
- a Provide the legal basis for the development of the petroleum sector in Georgia,
 - b Encourage domestic and foreign investment participation in the rehabilitation and development of the petroleum sector in Georgia, and,
 - c Provide a legal basis for the regulation of pipelines for the transmission of natural gas in, from and through Georgian territory, including the setting of tariffs which accurately reflect the cost of efficient production, transportation, and distribution of and natural gas.
- 1 3 The purposes of this Law are to
- ▶ Assign responsibility for elaboration and implementation of State Energy Policy in the petroleum sector to the Ministry of Fuel and Energy, and relieve the Ministry of Fuel and Energy from commercial, entrepreneurial and operational responsibilities in the petroleum sector. The main directions of the petroleum policy shall be determined by the Parliament of Georgia.

- ▶ Determine the basic principles of regulation for the exploration production gathering, treating and processing of Petroleum and Petroleum Products and provide a legal basis for the establishment of an independent regulatory body
- ▶ Promote efficiency in the exploration, production, gathering, processing and treating of Petroleum and Petroleum Products and,
- ▶ Promote competition in Georgia's petroleum markets

This law shall supersede the Georgian law "On Subsoil Mineral Rights" and Presidential Decree Number 277 insofar as the same relate to the exploration, production, gathering processing, transportation and treating of Petroleum and Petroleum Products, and such law and decree shall from the date of adoption of this Law have no further force or effect with regard to Petroleum and Petroleum Products. If there are any conflicts between a provision of this Law and a provision of the law "On Subsoil Mineral Rights," or Decree Number 277 then the provision of this Law shall prevail and the provision of the law "On Subsoil Mineral Rights" or Decree Number 277 shall be null and void.

It is recognized that, prior to the entry of this Law, certain contracts relating to Petroleum Operations have been entered into between entities acting on behalf of the State, and certain Parties. To the extent that such contracts were entered into before the adoption of this Law then the validity of such prior licenses and other contracts, in accordance with their provisions, is hereby confirmed and such contracts shall be and remain in full force and effect. Where any such contracts refer to the subsequent adoption of a Production Sharing Law, this Law shall be considered to be the Production Sharing Law referred to. The parties holding rights under such contracts may expressly elect to subject such contracts to the provisions of this Law by written notice to the Ministry not less than 30 days after adoption of this Law. Following such notice such party and the Ministry shall agree upon those changes in the contract which are necessary to bring it into compliance with the provisions of this law. Notwithstanding the foregoing, any such contract which is not made subject to all of the provisions of this Law shall nevertheless be subject to this Law to the extent that it is not in conflict with such contract or does not increase the economic burdens of such party under such contract.

Article 2 Definitions

For the purposes of this Law, certain words and phrases have the following meanings:

- ▶ **Law** means this Petroleum Law
- ▶ **Petroleum** means Crude Oil and Natural Gas [to be defined separately] as well as components derived therefrom or produced therewith

- ▶ **Petroleum Products** means components derived from the processing treatment or refining of Petroleum
- ▶ **Petroleum Operations** means all activities related to the exploration or exploitation of Petroleum
- ▶ **Petroleum Agreement** means any contractual document entered into in accordance with the provisions of this Law between the Ministry and a Contractor for the purposes of conducting Petroleum Operations within Georgia
- ▶ **Ministry** means the Ministry of Fuel and Energy of Georgia
- ▶ **Contractor** means any Person entering into a Petroleum Agreement with the Ministry
- ▶ **Person** includes both physical and juridical persons
- ▶ **Contract Area** means the area delineated and defined by geographical coordinates described in a Petroleum Agreement wherein a Contractor is authorized to conduct Petroleum Operations
- ▶ **Minimum Work Program** means the obligatory Exploration Operations which the Contractor is obligated to conduct in the Contract Area
- ▶ **Commercial Discovery** means a discovery of Petroleum of sufficient quality and quantity which, after consideration of all relevant data, including but not limited to, market conditions existing, would in the opinion of the Contractor justify the investment of technical and economic resources necessary to exploit such discovery
- ▶ **Exploration Operations** means all activities conducted by a Contractor within the Contract Area during the Exploration Period of the Petroleum Agreement to prospect for and evaluate accumulations of Petroleum, including but not limited to the conduct of geological and geophysical studies, and the drilling and testing of wells
- ▶ **Production Operations** means all activities conducted by a Contractor, either within or without the Contract Area, during the Production Period of the Petroleum Agreement, for the exploitation of a Commercial Discovery, including but not limited to the drilling and testing of wells, laying of pipe, construction or placement of equipment and other facilities, and all other activities necessary or convenient to lift, save, gather, store, treat, process, transport, or distribute Petroleum
- ▶ **State** means the Georgian State

- ▶ **Government** means the Ministers appointed by the President of Georgia
- ▶ **President** means the President of Georgia
- ▶ **Commission** means the Georgian Natural Gas Regulatory Commission created by this Law
- ▶ **Pipeline** means any line or system of pipes, including pumping stations, pressure reducing stations, and all other facilities in connection therewith, used or useful in the transportation of Petroleum or Petroleum Products
- ▶ **Plan of Development** means the program developed by the Contractor for the orderly and efficient exploitation of a Commercial Discovery on the Contract Area
- ▶ **Pipeline Owner** means any Person who owns or controls an interest in a Pipeline

Article 3 Ownership of Petroleum

- 3 1 Petroleum in its natural state within or under the territory of Georgia is the exclusive property of the State and is protected by the State
- 3 2 Matters involving the ownership, exploration, exploitation and disposition of the Petroleum resources of the State shall be under the jurisdiction of the Ministry, pursuant to the provisions of this Law
- 3 3 Petroleum lifted to the surface can be either State and/or private property, in accordance with the provisions of the relevant Petroleum Agreement
- 3 4 Petroleum returned or re-injected into the subsurface for storage or pressure maintenance shall be considered the same as Petroleum lifted to the surface and its ownership shall be defined through the Petroleum Agreement
- 3 5 Contractor shall have the right to take its share of Petroleum in kind and dispose of such share freely and separately, either within or without the Republic of Georgia, subject to the provisions of this Law and the Petroleum Agreement

SECTION II. RIGHTS AND RESPONSIBILITIES OF THE GOVERNMENT AND THE MINISTRY IN THE SPHERE OF EXPLOITATION OF PETROLEUM

Article 4 Rights and Responsibilities of the Government

The Government, within the Petroleum sector and in relation to the conduct of Petroleum Operations

- 1 defines the strategy and sets the order of priority for the exploitation of Petroleum resources and the rates of production therefrom,
- 2 is responsible for the protection of the public health and welfare, safe labor conditions and the natural environment in the conduct of Petroleum Operations,
- 3 organizes statistical reports on Petroleum reserves
- 4 sets restrictions for the conduct of Petroleum Operations in certain areas with the purpose of saving holy sites, historical and cultural monuments and the like, being important for the safeguard and development of the traditional values and culture of the Georgian people,
- 5 exercises other powers granted to it by the Laws and the acts of the President of Georgia

Article 5 Rights and Responsibilities of the Ministry of Fuel and Energy

The Ministry of Fuel and Energy (the Ministry) is responsible for implementing the Petroleum policies established by the Government The Ministry

- ▶ Sets uniform rules and regulations for the exploration and exploitation of Petroleum resources in accordance with the provisions of this Law as well as accepted standards of international practice for the conduct of Petroleum Operations
- ▶ In accordance with the provisions of this Law, negotiates and enters into Petroleum Agreements, and administers such agreements and oversees the conduct of Petroleum Operations thereunder, to ensure the Contractor's compliance with the provisions of such Petroleum Agreement and Georgian law
- ▶ Where appropriate, prepares bid tenders in accordance with the provisions of this Law, and publishes terms, conditions, and procedures for holding such tenders

- ▶ Prepares model form Petroleum Agreements for inclusion in bid tender documents and distribution to interested Persons
- ▶ Suspends and revokes Petroleum Agreements in accordance with the provisions of this Law
- ▶ Submits annual reports to the Government on the implementation of the Petroleum Agreements
- ▶ Exercises other powers attributed to it by the Government and the acts of the President
- ▶ The Ministry may require as a condition to the granting of a Petroleum Agreement that the Contractor submit a bank guarantee, an irrevocable letter of credit, the guarantee of its parent company, or other effective form of security to ensure the performance by the Contractor of its minimum work obligations and/or minimum expenditure obligations under the Petroleum Agreement
- ▶ The Ministry shall perform its functions hereunder in accordance with this Law and the national interests of Georgia

All commercial or entrepreneurial interests of the Ministry within the petroleum sector including but not limited to property owned or controlled by Saknavtobi (complete list) are hereby transferred to the Minister of State Property. The President shall within 60 days after adoption of this Law submit for the approval of Parliament a plan for the corporatization, commercialization and eventual privatization of such entities. For so long as the State owns any interests in such entities, they shall make audited financial reports periodically (not less often than annually) to the Ministry of Finance, all in accordance with internationally accepted accounting standards.

Article 6 Georgian Natural Gas Regulatory Commission

The Georgian Natural Gas Regulatory Commission is established as a permanent independent body with the status of a legal entity of public justice and is not subordinated in any way in its activity to any other Government or private agency or institution.

The Legal basis for the Commission's activities is the Georgian Constitution, International Treaties, this Law, the Charter of the Commission, and other existing laws.

The Charter of the Commission shall be elaborated and approved by the Commission, with the approval of the President.

The main functions of the Commission are to set and regulate wholesale tariffs for natural gas transmission.

Transmission tariffs shall protect natural gas shippers against monopolistic prices while providing Pipeline Owners an opportunity to recover their costs of providing transmission service, including prudently incurred fuel operating and maintenance costs the principal and interest costs of money borrowed for prudent investments and working capital and a just and reasonable profit on invested equity sufficient to attract financing for capital improvements and new construction

6 1 The costs of operation of the Commission shall be met through a special tax on the sale of natural gas

SECTION III. PETROLEUM OPERATIONS

Article 7 Petroleum Agreements

7 1 Petroleum Operations may be conducted in Georgia only pursuant to a Petroleum Agreement entered into between the Ministry, acting on behalf of the State and the Contractor

7 2 In entering into Petroleum Contracts, the Ministry shall give preference where feasible to competitive bids Nevertheless, if the Ministry determines that there does not exist sufficient interest on the part of potential Contractors in a particular tract of land or that an opportunity for significant investment may be lost by delay the Minister may, with the approval of the President, negotiate directly with a potential Contractor without seeking bids

7 3 The provisions of a Petroleum Agreement shall conform to the provisions of this law

7 4 Bid tenders, where used, may be open or with a short list of bidders Tender conditions shall be published or delivered to the potential bidders not later than ninety (90) days prior to the tender date A tender shall consist of two (2) parts an application to qualify and a bidding proposal All tenders shall be submitted in the Georgian language, or in the English language accompanied by a Georgian translation

7 5 Persons interested in qualifying for a tender are entitled to obtain the necessary information regarding the procedures and conditions for tender from the Ministry

7 6 Notice of a tender shall be published by the Ministry Any such notice must contain, at a minimum, the following

- ▶ the time and place of the tender as well as the deadlines for submission of applications,

- ▶ the principal terms of the tender,
- ▶ the principal conditions for qualification of the bidder,
- ▶ the location and descriptions of the Contract Area offered
- ▶ fiscal incentives offered,
- ▶ acceptable fiscal terms (which may include but are not limited to rental payments bonuses, production sharing percentages or royalties and taxes) the price of the package of geological information, and tender participation fees,
- ▶ such other information as the Ministry may determine to be necessary or convenient

7 7 An application to participate in a tender must contain the following

- ▶ applicant's name, applicant's address, nationality (for legal entities), or citizenship (for physical persons),
- ▶ information on the owners and the managers of applicants who will represent the applicant when executing the Contract,
- ▶ information concerning the technical, managerial, institutional and financial capacities of the applicant,
- ▶ fiscal proposals,
- ▶ any exceptions to the provisions of the Model Contract, if included with the bid documents

7 8 The Ministry shall form a commission of experts for the evaluation of the technical, financial, and organizational capabilities of the applicants and the fiscal proposals submitted

7 9 The winner of the tender shall be determined by comparison of the bids with regard to the following criteria

- ▶ the fiscal proposals,
- ▶ the commencement date of the operations and the work implementation pace,

- ▶ the Minimum Work Program offered by the applicant in terms of the level of geological and geophysical operations and exploratory drilling proposed
- ▶ compliance with the requirements for the protection of the natural environment and the subterranean resources and the safe conduct of operations,
- ▶ the estimated revenues for the State as determined by the commission of experts through the use of an appropriate computer model making such assumptions as they shall deem appropriate,
- ▶ any exceptions to the provisions of the model contract if included with the bid documents

7 10 Petroleum Agreements may take any appropriate form, including but not limited to

- ▶ Production sharing agreements, whereby Petroleum produced will be divided between the State and the Contractor
- ▶ Concession agreements, providing for payment of a royalty on petroleum produced,
- ▶ Joint venture agreements between private investors and entities wholly or partially owned or controlled by the State,
- ▶ Service contracts, providing for the performance of Petroleum Operations for a fixed or determined fee,
- ▶ Other contractual arrangements which may be agreed upon by the Minister and the Contractor, in conformity with the provisions of this Law

7 11 The term of a Petroleum Agreement may not exceed 37 years, determined as follows

- 1 If the Petroleum Agreement is for the performance of Exploration and Production Operations, the term thereof shall be divided into an Exploration Period which shall not exceed 7 years, and a Production Period which shall not exceed 30 years
- 2 During the Exploration Period the Contractor shall undertake to perform a minimum work program, and to expend on such program a minimum amount of money Such work program and expenditure obligations may be divided into one or more phases within the Exploration Period If Contractor fails to meet such work or expenditure obligations, its rights under the Petroleum Contract shall be

extinguished and it shall become liable for the value of the work not performed and/or the money not spent

3 If the Contractor does not make a Commercial Discovery of Petroleum within the Exploration Period, its rights under the Petroleum Agreement shall be extinguished, provided that if at the end of the Exploration Period the Contractor is in the process of actually drilling or testing a well, the Exploration Period shall be extended for the time necessary (but not to exceed six months) to enable Contractor to complete and test such well and to determine whether a Commercial Discovery has been achieved

4 If the Petroleum Agreement is for the conduct of Production Operations only the term thereof shall not exceed 20 years

5 Notwithstanding the provisions of Paragraphs 1, 2, 3 and 4 of this Article 7 11, if not later than six months prior to the end of the Production Period, or the term of the Petroleum Agreement for the conduct of Production Operations only, the Contractor reasonably believes as a result of reservoir studies that if a Field or Fields discovered are capable of continuing commercial production beyond the end of such term, the Contractor shall give the Ministry written notice of that fact, together with full information concerning reserves estimates and production forecasts Thereafter Contractor shall have the preferential right to negotiate with the Ministry for an extension of the term of the Petroleum Agreement, under such conditions as the parties may agree in writing If the parties are unable to reach agreement by the end of such term (or such extension, not to exceed six months as the parties may agree in writing), then the Minister shall be free to enter into a new Petroleum Contract or Contracts with a third party or parties, covering the Contract Area

Article 8 Rights of the Contractor

8 1 The Contractor has the following rights

- 1 To explore and exploit the Contract Area to the exclusion of all other Persons
- 2 To have access to the lands needed, either within or without the Contract Area, for the conduct of Petroleum Operations within the boundaries of the Contract Area as provided for in the Petroleum Agreement,
- 3 To conduct within the boundaries of the Contract Area all the Petroleum Operations provided for by the Petroleum Agreement,

- 4 To use subject to the provisions of Article 10 sources of surface and underground waters as necessary for conduct of the Petroleum Operations
- 5 Subject to the provisions of Article 12 10 hereof to dispose freely of the quantities of Petroleum to which it is entitled including the right to export such Petroleum without payment of export fees duties or other taxes,
- 6 To have equal right of access, upon payment of applicable fees and tariffs and subject to applicable statutes and regulations as well as existing rights of third parties, to pipelines, harbors, docks and other State owned installations in the event Contractor determines that their use is necessary or convenient for the conduct of Petroleum Operations In the event of partial or complete privatization of any such facilities, the owners thereof shall undertake to give the same equal right of access as prescribed herein
- 7 To lay its own pipelines and construct other installations for the transportation of its Petroleum and Petroleum Products to the stations of separation processing and treatment, to the lifting terminals, and to the national system of transportation, in compliance with the regulations in force,
- 8 To build roads, bridges, and railways which Contractor determines are necessary or convenient for the conduct of Petroleum Operations and for the transportation of the Petroleum and Petroleum Products, in accordance with statutes and regulations in effect,
- 9 To carry out the Petroleum Operations provided in the Petroleum Agreement through the use of subcontractors
- 10 To obtain from the Ministry, such data as the Ministry may have or control concerning the Contract Area, and to keep and use such data, as well as data obtained from its own operations, for the entire duration of the Petroleum Agreement

Article 9 Obligations of Contractors

- 9 1 The Contractor under a Petroleum Contract has the following obligations
 - 1 To comply with the provisions of this Law, the Petroleum Agreement, and the Regulations issued by the Ministry pursuant hereto,
 - 2 To prepare, in accordance with the provisions of the Petroleum Agreement, all technical and economic documentation necessary for the performance of the

Minimum Work Program or the Plan of Development, as the case may be, and to submit the same for review by the Ministry,

- 3 To obtain, prepare, and keep up to date, and to submit on the scheduled dates all data, information, and documentation required by the Ministry concerning the Petroleum Operations performed with respect to the Contract Area
- 4 To keep confidential the data obtained from the Ministry and the data acquired through its Petroleum Operations, and not disseminate such data without the approval of the Ministry, provided that the Contractor may reveal such data where and to the extent required by the government of a State of which it is a national or pursuant to the rules of a stock exchange on which the shares of the Contractor or the parent company of Contractor are traded, or to employees agents affiliates, subcontractors, attorneys, or potential assignees or lenders of the Contractor, provided that any such Person undertakes in writing to keep such data confidential
- 5 To associate with the Contractors of adjacent blocks upon the request of the Ministry, in case the operations which were carried out show the hydrodynamic continuity of the deposit in such adjacent block, in order to ensure the efficient productivity of the reserves,
- 6 To utilize Georgian labor, equipment, and materials in the conduct of Petroleum Operations, provided such labor, equipment and materials are competitive in terms of quality, quantity, timely availability and cost, according to the best international petroleum industry standards, with that which is offered in the international marketplace
- 7 Promptly following the termination of the Petroleum Agreement by any of the ways provided under Article 18 or 19, to relinquish to the Ministry the Contract Area,

Article 10 Land Use

- 10 1 The Contractor may use as much of the Contract Area as may be reasonably necessary to carry out Exploration or Production Operations , taking into account prudent international industry standards and the particular technical and physical conditions present Prior to the commencement of a particular activity required under the Minimum Work Program or pursuant to the Plan of Development, as the case may be, Contractor shall designate, in writing, to the Ministry those plots of land which Contractor determines to be reasonably necessary for the particular activity intended The Ministry shall notify the Contractor, in writing, within thirty (30) days of receipt of Contractor's designation, of any objection

the Ministry has to the particular plots designated by Contractor or of the proposed use of such land. Thereafter Contractor shall enter into discussions with the Ministry to resolve such objections. If the objection is not resolved, the matter may be submitted for resolution in accordance with the provisions of Article 24 of this Law.

10.2 After the commencement of Petroleum Operations, any changes in Contractor's use of the land shall be reviewed by the Ministry.

10.3 If Contractor's right to the use of land conflicts with the rights of any other Person in possession, then Contractor may enter into a private agreement to compensate such Person for the loss of the use of such land. Any such private agreement shall be at the expense of the Contractor.

10.4 If Contractor is unable to reach agreement with such Person for the compensation of such Person for the loss of the use of such land, the Ministry shall at the request of Contractor institute legal proceedings against such Person in a Georgian court of competent jurisdiction to require the use of such land by Contractor. The court shall determine the fair market value of the loss the use of such land. The amount so determined together with the cost of the legal proceedings, shall be borne by Contractor.

Article 11 Exploration and Production Operations

11.1 Upon the coming into effect of the Petroleum Agreement, Contractor shall proceed to implement the Minimum Work Program during the term of the Exploration Period, in accordance with prudent international industry standards.

11.2 If a Commercial Discovery of Petroleum is located on the Contract Area, then the Contractor shall have the exclusive right to conduct Production Operations to exploit such Commercial Discovery pursuant to a Plan of Development during the term of the Production Period, in accordance with the provisions of the Petroleum Agreement.

Article 12 Taxes and Other Payments

12.1 Contractor shall be liable for the following taxes and payments in respect of Petroleum Operations:

12.1.1 Tax on the net profit of the Contractor from the sale of its share of Petroleum produced under the Petroleum Agreement after payment of costs of production, at the rate established by the laws of Georgia in effect on the date of signing the Petroleum Agreement. Such tax shall not be payable in respect of production received by Contractor for recovery of exploration and development costs.

- 12 1 2 A rental fee for use of the land included within the Contract Area of the Land equivalent of US\$ per hectare during the Exploration Period and US \$ per hectare during the Production Period
- 12 2 The Petroleum Agreement may provide for a signature bonus to be paid upon the signing of such agreement, and for one or more production bonuses to be paid upon achievement of levels of production specified in the Petroleum Agreement
- 12 3 The Petroleum Agreement may provide for the payment of a royalty on Petroleum determined as an agreed percentage of the gross production obtained and saved from the Contract Area. The State may take all or a part of its Petroleum royalty in money or in Petroleum, in accordance with the provisions of the Petroleum Agreement
- 12 4 The payment of taxes and royalties provided for by this Law does not exempt the Contractor from the payment of other fiscal obligations of general application established by statute, to the extent that any such obligations are applicable to the Contractor
- 12 5 Contractor shall pay to the appropriate State funds, in the amounts and in the manner prescribed by law, taxes for social and medical insurance of Contractor's staff who are citizens of Georgia
- 12 6 Subject to approval by the Government the Ministry may agree to grant fiscal incentives to as follows
- 1 exemption from the payment of profit tax as allowed by Georgian law, but for a period not to exceed ___ years from the date of Commercial Discovery,
 - 2 fixing of the profit tax at the rates provided by statute in effect on the date of entry of the Petroleum Agreement for the entire term of the Petroleum Agreement,
 - 3 exemption from payment of customs fees or duties for imports on the property and equipment of the Contractor or its subcontractors, used for the conduct of Petroleum Operations,
 - 4 exemption from payment of customs fees or duties for imported household and personal goods required by the expatriate personnel of the Contractor, its affiliated companies and foreign subcontractors, working in the conduct of Petroleum Operations, provided that if any such property is sold or otherwise disposed of in Georgia, the customs fees or duties attributable to such property shall be paid to the appropriate authorities

- 5 exemption from payment of export fees or duties for the export of Contractor's share of Petroleum and the property, equipment, and goods imported by Contractor, or its subcontractors and its or their expatriate personnel under subparagraphs 3 and 4 of this Article 12
 - 6 exemption from payment of Value Added Tax for sales of Petroleum within Georgia, as well as Petroleum exported from Georgia
 - 7 protection from adverse economic impact on Contractor as the result of new or increased taxes or other laws or regulations of Georgia, by revision of the fiscal provisions of the Petroleum Agreement or otherwise
- 12.7 Contractors shall have the right to receive and retain abroad the proceeds derived from the sale of their share of Petroleum exported from Georgia subject to the timely payment of their obligations to the State
- 12.8 The State shall have the preemptive right to purchase Contractor's share of Petroleum or Petroleum Products. All such purchases by the State shall be paid for in freely convertible currencies, at the world market price then prevailing and shall be upon adequate notice as set out in the Petroleum Agreement or without notice in cases of national emergency. The proceeds derived from such sale of Petroleum or Petroleum Products may be remitted abroad without restriction and free of banking commissions or other charges, subject to timely payment of Contractor's obligations to the State
- 12.9 If the sale of Contractor's share of Petroleum takes place in Georgia, Contractor has the right to convert the Lari amounts thus obtained into freely convertible foreign currency, and to dispose freely such foreign currency amounts, which may be remitted abroad without restriction, after the payment of Contractor's obligations towards the State

Article 13 Transfer of Rights and Liabilities

- 13.1 Any transfer of rights or liabilities under a Petroleum Agreement to another Person shall be subject to the approval of the Ministry, which approval shall not unreasonably be withheld. The proposed transferee shall possess financial resources and technical capabilities sufficient to enable such Person to meet the requirements and accept all liabilities provided under the Petroleum Agreement. The Contractor shall make written request to the Ministry to approve the proposed transfer, giving full particulars of the technical and financial competence of the proposed transferee. The Ministry shall notify Contractor in writing, within thirty (30) days after receipt of such request, of its approval or refusal of such request, and in case of refusal, its reasons therefor.

- 13 2 The Contractor shall be entitled to transfer its rights and obligations under the Petroleum Agreement in whole or in part to an Affiliate without the approval of the Ministry. However, no such transfer to an Affiliate shall be effective unless and until Contractor gives written notice of such transfer to the Ministry together with the transferee's written undertaking to be bound by all of the terms and conditions of the Petroleum Agreement. In the case of a transfer to an Affiliate, the transferring Party shall remain primarily liable for such Affiliate's failure to perform fully the obligations of Contractor under the Petroleum Agreement.

Article 14 Petroleum Agreements

- 14 1 The Petroleum Agreement shall be signed by the representatives of the Ministry and the Contractor. The Ministry shall develop model Petroleum Agreements which shall include such terms and conditions as are usually and customarily acceptable in the international petroleum industry.
- 14 2 All Petroleum Agreements shall include, at a minimum, the following provisions:
- a Financial terms including cost recovery, production sharing or royalties and bonuses as may be appropriate,
 - b Ownership rights on Petroleum produced,
 - c Minimum Work Programs,
 - d Duration of the Petroleum Agreement, and the Exploration Period and Production Period, if applicable,
 - e Requirement of periodic reduction of the Contract Area during the Exploration Period,
 - f Rights and liabilities of parties,
 - g Right of ownership of geological, geophysical, well and other data, confidentiality thereof,
 - h Enforcement of Petroleum Agreement conditions,
 - i Conditions for the early termination of Petroleum Agreement,
 - j Force Majeure,
 - k Settlement of disputes,
 - l insurance,
 - m Accounting and auditing procedures,
 - n Provisions for giving preference to Georgian personnel and subcontractors, provided that they have the requisite skills, and for training of Georgian personnel in the latest technologies, and
 - o Provisions for giving preference to Georgian equipment, material and supplies, provided that they are competitive with those available abroad in terms of quality, price and timely delivery.

- 14 3 Other provisions may be added to the Petroleum Agreement by agreement of the Parties provided that they are not in conflict with the provisions of this Law or existing legislation
- 14 5 Issues regarding recruitment, payment incentives insurance labor protection and the like shall be resolved in accordance with relevant legislation of Georgia and shall be provided for in labor agreements
- 14 6 The Petroleum Agreement shall be in effect during its entire term and may be altered only in if agreed in writing by the Contractor and the Ministry

Article 15 Ownership of Moveable Property

- 15 1 All property which is acquired by Contractor for use in the conduct of Petroleum Operations shall become the property of the State immediately upon its acquisition or importation into Georgia, provided that the Contractor shall have the exclusive right to use such property during the term of the Petroleum Agreement and the Contractor shall be responsible for the proper maintenance and up-keep and shall have the risk of loss of such property
- 15 2 Article 15 1 shall not apply to moveable property which is leased by Contractor or is property of a sub-contractor of Contractor , nor shall Article 15 2 apply to automobiles, furniture and household effects imported by Contractor's and its sub-contractor s employees
- 15 3 The State shall guarantee the protection of Contractor s property, and all other rights, obtained and exercised in accordance with the Petroleum Agreement

Article 16 Relinquishment of the Contract Area

- 16 1 During the Exploration Period of the Petroleum Agreement, Contractor shall relinquish parcels of the Contract Area from the Petroleum Agreement in accordance with the schedule provided in the Petroleum Agreement, and at the end of the Exploration Period shall relinquish the remainder of the Contract Area with the exception of the lands included within a Production Area or Areas The Contractor shall restore the surface of the parcels so relinquished to its original condition as nearly as reasonably practical Parcels so relinquished shall insofar as practical be in such size and shape as will enable them to be efficiently explored under a new Petroleum Contract or Contracts Insofar as possible, any such parcel shall be in the shape of a rectangle with sides bearing north-south and east-west, with the longer sides being no more than twice the length of the shorter sides

- 16 2 Relinquishment by the Contractor of all or any part of the Contractor Area shall not result in a reduction of the Minimum Work Program

Article 17 Commercial Discovery and Plan of Development

- 17 1 The Contractor shall ensure that all Production Operations are conducted in accordance with an approved technological scheme and in accordance with prudent international industry customs and standards Upon the discovery of a Petroleum deposit the Contractor shall immediately inform the Ministry of such discovery and shall promptly thereafter undertake the appraisal of such discovery in accordance with good international petroleum practice Following the completion of such appraisal Contractor shall notify the Ministry whether it considers such discovery to be a Commercial Discovery If The Contractor determines that the discovery is a Commercial Discovery, Contractor shall within ninety (90) days after giving such notice submit to the Ministry a Plan of Development therefor
- 17 2 The Plan of Development shall be based on prudent international industry standards and on Contractor's best expertise and judgment for the orderly exploitation of the Commercial Discovery No Production Operations shall be conducted without the approval by the Ministry of the Plan of Development, which Plan shall include provisions for the safe handling of uncontrolled wells If The Ministry fails or refuses to approve such Plan within 90 days after its submittal, the matter may be submitted to arbitration pursuant to Article 24 of this Law

SECTION IV TERMINATION, RELINQUISHMENT, SUSPENSION AND REVOCATION OF PETROLEUM AGREEMENTS, OFFICIAL LANGUAGE, AND SAFETY AND ENVIRONMENT

Article 18 Termination of Petroleum Agreements

- 18 1 The Petroleum Agreement shall terminate
- 1 Upon expiration of the term for which it was granted,
 - 2 Upon relinquishment by the Contractor of the Petroleum Agreement, as provided in Article 18,
 - 3 Upon revocation of the Petroleum Agreement by the Ministry, as provided in Article 21

Article 19 Relinquishment of Petroleum Agreements

- 19 1 The Contractor may relinquish the Petroleum Agreement at any time upon written notice to the Ministry, provided that

- a If at the time of such notice Contractor has not fully performed the Minimum Work Program or expended the full amount of the Minimum Expenditure Obligation Contractor shall tender to the Ministry the value of the work remaining to be done, and/or the unexpended Minimum Expenditure Obligation in accordance with the provisions of the Petroleum Agreement
- b Contractor shall also tender to the Ministry any other sums owing to the State or the Ministry under the provisions of the Petroleum Agreement
- c Contractor shall remain liable for any other unperformed obligations under the Petroleum Agreement, including but not limited to the obligation to restore lands not longer used for Petroleum Operations to a useable condition

Article 20 Suspension of Petroleum Agreements

- 20 1 The Ministry may suspend a Petroleum Agreement if the Contractor
 - 1 does not fulfill the Minimum Work Program or the Plan of Development within the time provided in the Petroleum Agreement,
 - 2 conducts Exploration or Production Operations not provided for in the Petroleum Agreement,
 - 3 conducts Production Operations which are not included in a Plan of Development, without the approval of the Ministry
 - 4 in the course of its activities, systematically violates the legislation of Georgia on the protection of mineral resources, environment, or safety
- 20 2 Ministry may not suspend a Petroleum Agreement until it has notified the Contractor in writing, stating the specific reasons for suspending the Petroleum Agreement, and setting a reasonable period of time (but not less than thirty (30) days) for Contractor to effect a cure, failing which the suspension shall take effect
- 20 3 Upon the cure or elimination of the reasons causing the suspension, the Petroleum Agreement shall be immediately restored in full force and effect The Ministry shall notify Contractor, in writing, that the Petroleum Agreement has been restored
- 20 4 Contractor may submit the matter of suspension and the grounds therefor to arbitration as provided in Article 24 hereof, and shall be entitled to continue operations under the Petroleum Agreement until such time as the arbitration tribunal shall have entered an award confirming such suspension

Article 21 Revocation of Petroleum Agreements

- 21 1 The Ministry may revoke the Petroleum Agreement if the Contractor
- 1 fails or refuses to cure or eliminate the reasons causing the suspension of the Petroleum Agreement
 - 2 does not abide by a decision of judicial court or arbitration with respect to disputes under the Petroleum Agreement,
 - 3 becomes subject to a legal process of liquidation for insolvency
 - 4 intentionally provides the Ministry with false data and information as to its Petroleum Operations or willfully violates the confidentiality requirements set forth in the Petroleum Agreement,
 - 5 does not abide by a provision of the Petroleum Agreement, which, if violated will give rise to the revocation of the Petroleum Agreement,
 - 6 willfully and unreasonably jeopardizes by the manner in which it conducts its Petroleum Operations the possibility of the future exploitation of the deposit, or willfully violates the norms regarding the protection and the reasonable production of the deposits, or the norms regarding the protection of the environment
- 21 2 Revocation of the Petroleum Agreement for any of the reasons stipulated in Article 21 1 shall be effective sixty (60) days from the date the Contractor was notified of such decision by the Ministry
- 21 3 Within the time limit provided in Article 21 2, the Contractor may appeal the decree revoking the Petroleum Agreement to the appropriate court of law or arbitration tribunal, as the case may be, as provided in Article 24, In such case, the revocation of the Petroleum Agreement shall be suspended pending a final decision of such court or arbitration tribunal

Article 22 Official Language

- 22 1 All business, financial, legal, scientific, technical, office, and other communications regardless of the means used, regarding Petroleum Operations shall be in the Georgian or English language, as provided in the Petroleum Agreement All signs, notes, inscriptions, information advertisements, and other notices posted on or near Petroleum facilities, together with all inscriptions or the titles of enterprises, organizations and establishments related to Petroleum Operations shall be in English and Georgian Petroleum Contracts shall be written in both the Georgian and English languages

Article 23 Safety and Environment

- 23 1 Contractors shall in the conduct of Petroleum Operations be subject to the Law of Georgia on Environmental Permits and the Law of Georgia on State Ecological Examination adopted on October 15, 1996

- 23 2 The Ministry shall, from time to time, issue such regulations and make such inspections as may be necessary to ensure that all Petroleum Operations are being conducted with due regard for the safety and well being of the people and the environment of Georgia
- 23 3 Representatives of the Ministry shall be permitted entry to the Contract Area at reasonable times and upon reasonable notice, to ensure compliance with this Article
- 23 4 Contractors shall be financially responsible for injury disease, or death of people or loss or destruction of property or damage to the environment caused or occasioned by or resulting from their or their employees or subcontractors' negligence in the conduct of their activities The Ministry is authorized to bring legal action in any court of competent jurisdiction to seek compensation for all such claims
- 23 5 Contractors are obliged to take immediate actions in all cases of emergency so as to prevent death of people or to mitigate damages to property or the environment The appropriate authority shall be notified as soon as possible after the occurrence of any such emergency Any cost or expense incurred by the State, or any subdivision of the State in its attempts to prevent or mitigate a situation for which Contractor is financially responsible shall be reimbursed by the Contractor

SECTION V SETTLEMENT OF DISPUTES AND ENFORCEMENT OF LAW

Article 24 Settlement of Disputes

- 24 1 Any dispute arising out of the application of this Law, or out of the signing or interpretation of any Petroleum Agreement, or out of any Petroleum Operations conducted pursuant to such a Petroleum Agreement shall be settled in accordance with the laws of the State of Georgia, provided however, that in any case where one of the parties to the dispute is a foreign Person, the Petroleum Agreement may provide for the settlement of disputes by international arbitration, including the waiver on behalf of the State of its sovereign immunity

Article 25 Effective Date of this Law

- 26 1 The present Law shall become valid on the date of its publication
- 26 2 All existing laws and decrees of Georgia which conflict in any manner with the provisions of this Law are hereby repealed to the extent of such conflict