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**ASSESSMENT OF THE LEGAL AND REGULATORY
FRAMEWORK OF THE GEORGIA POWER SECTOR**

**Georgia Power Sector Reform
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Final Report

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Background

Under the Soviets, Georgian electric facilities served as part of the South Caucasus power system, consisting of Georgia, Armenia, and Azerbaijan, in which all facilities were synchronized and centrally dispatched from Tblisi. With the collapse of the Soviet Union and independence for Georgia, the Georgian system emerged as a vertically integrated, State-owned monopoly, operating for the most part in electrical isolation from neighboring systems. For a variety of reasons (principally lack of funds, as management proved unable to operate in a commercially viable manner), the system eventually failed to provide Georgians with sufficient or reliable electricity supplies. In that context, USAID decided to provide the Government of Georgia with technical assistance to reform the power sector. That assistance began in late 1995.

Reform in the Georgian electric sector has made great strides in recent years. The Government of Georgia (GoG) has unbundled, commercialized, and corporatized the former vertically integrated monopoly. The government has commenced privatizing the sector. These changes have been made possible by sweeping modifications in the legal and regulatory framework of the Georgian electric sector, made possible for the most part by the reform programs sponsored by USAID.

We here present a brief assessment of the legal and regulatory framework in Georgia, including the identification of legislation, decrees, and regulations that govern the operation of the power sector. We also identify appropriate further steps to continue the reform process.

1. The Operational Structure of the Power Sector.

Status

Presidential Decree No. 437, "On Restructuring of the Power Sector," adopted on 4 July, 1996, ordered the unbundling of the vertically integrated electric monopoly. Pursuant to the Decree, the government: created Joint Stock Companies for generation enterprises, and transferred generating assets to those companies; transformed the transmission and dispatch subsectors of the state enterprise into a single unit called Sakenergo, which remained a state enterprise not subject to privatization in the near term; and created Joint Stock Companies for distribution enterprises, to which distribution assets were then transferred. The state continues to own the

distribution companies, although GoG has transferred operational control of the distribution enterprises to the municipalities that the enterprises serve

In 1998, the Ministry of Fuel and Energy ordered one additional structural change: the separation of Sakenergo's dispatch and transmission functions into separate enterprises. With that alteration, the operational structure of enterprises within the sector remains as it was after the restructuring ordered by Decree No. 437.

Issues

GoG has completed the unbundling ordered by Decree No. 437, and, so far as individual enterprises are concerned, little remains to be done by way of reform. We see only three issues pending in the current context:

1. Although the status of the sector is satisfactory so far as the organization of individual enterprises is concerned, the commercial relationships between and among individual enterprises, and between individual enterprises and the electric system as a whole, remain problematic. These commercial relationships are deeply flawed, particularly for generators, who currently receive little, if any, revenue.
2. Currently, Sakenergogeneratsia, a remnant of the state-owned monopoly, acts as a management company for many generation facilities. This structure probably imposes undue and unnecessary costs on the sector.
3. The sheer number of individual distribution companies (in excess of 65) makes the prospects for privatization confusing. Some grouping of these enterprises is appropriate.

Recommendations

1. The new wholesale electric market, scheduled to commence operating during 1999, will restate and restructure the commercial relationships among all participants in the electric sector. Our specific recommendations regarding formation and development of the market appear in the restructuring assessment, dated December, 1998.
2. As GoG privatizes individual generating projects, Sakenergogeneratsia's role will diminish naturally. Eventually, the enterprise should simply cease to function, as all of the projects for which it is currently responsible are sold.
3. Hagler Bailly and others have proposed a number of plans to group distribution companies for the purpose of packaging them for privatization. We discuss these proposals in the privatization assessment, dated December, 1998.

2. The Electricity Law of 1997.

Status

Perhaps the most important development (thus far) in the electric sector in the post-Soviet period has been the enactment of the Electricity Law, which President Shevardnadze signed in late June, 1997. The Law's major features include:

- ▶ Removal of the Ministry of Fuel and Energy from regulatory, ownership, and operational responsibilities in the electric sector.
- ▶ Creation of the three-member Georgian National Electric Regulatory Commission (GNERC or Commission), an independent regulatory agency with comprehensive jurisdiction over the rates, terms and conditions of service of electric sector enterprises.
- ▶ Establishment of a system of licenses and tariffs to regulate the operations of electric sector enterprises, with different requirements for generation, transmission, dispatch, and distribution licensees.
- ▶ Statement of competition and development of a market economy as fundamental Government of Georgia policies for the electric sector, along with regulation of those parts of the sector that are non-competitive.

The Law defines the composition and operations of the Commission in some detail. At the same time, it leaves considerable leeway to the Commission to fill in the regulatory blanks in ratemaking and licensing.¹

Issues

As time has passed since enactment, the Commission, electric sector licensees, and donor groups have identified certain respects in which the Electricity Law should be clarified or strengthened. For example:

1. Clause 38 of the Law provides: "Tariffs shall become effective 150 days after submission to the Commission for review . . ." Where a licensee's tariff submittal requests a rate increase, neither the timing of GNERC action nor the Commission's authority under Clause 38 are clear. For example, whether the Commission may approve, or disapprove, a rate increase during the 150-day period following submittal is not certain. Similarly unclear is whether a rate increase

¹ Two other statutes that currently relate to, but do not directly control the operations of, the electric sector are: the Law About Privatization of State Property, pursuant to the terms of which electric sector assets are being offered for sale, beginning with Telasi, the distribution company for Tblisi; and the Law On Entrepreneurs, under the terms of which newly-privatized enterprises will operate.

becomes effective 150 days from filing, irrespective of whether the increase is justified. For another example, Clause 38 gives the Commission no apparent authority to make the consumer whole in cases where a licensee begins collecting a rate increase on the 150th day after filing (the Commission having been unable to conclude deliberations on the merits of the increase), but the Commission later finds that all or part of the increase is unjustified.

2. Under Clause 29 of the Electricity Law, the Commission may revoke or suspend a license for non-compliance with its terms and conditions.² While suspension and revocation may be appropriate remedies for gross violations or derelictions of the Electricity Law or GNERC's regulations, they are not practical enforcement tools with which to ensure compliance with regulatory standards on a day-to-day basis. Under the terms of the Law, suspension or revocation would require the licensee to cease providing the service that the license authorized in the first place, meaning that the licensee would have to cease generating, transmitting, or distributing power upon suspension or revocation. Were that licensee to be, for example, Sakenergo transmission, then the entire power grid in Georgia would cease to function.

Recommendations

1. Amendments to the Electricity Law should be recommended to give GNERC the power to suspend tariff filings subject to refund, and otherwise to clarify the Commission's authority and the timing of tariff proceedings under Clause 38.
2. Amendments to the Electricity Law should be recommended to allow a variety of administrative sanctions, such as the imposition of fines and other penalties, and to give GNERC the discretion to adopt a scale of responses to different violations.

3. GNERC Regulatory Initiatives

Status

In August, 1997, in Decree # 351,³ the President appointed the three commissioners (Elizbar Eristavi, Demur Chomakhidze, and Paata Tsintsadze), and named Mr. Eristavi Chairman, as authorized by Clause 40 of the Electricity Law. The Commission commenced doing business that month and by early October, with technical assistance from Hagler Bailly, the Commission

² The Law separately authorized the Commission to revoke licenses for generation (Clause 31.2), transmission (Clause 32.5), and distribution (Clause 34.2) licenses.

³ "On Assignment of the Initial Members of the Georgian National Electricity Regulatory Commission," August 8, 1997.

had completed and formally adopted its Charter, internal operating rules, and general regulations.⁴

The Commission, which completed its first full year of operation under the Electricity Law in September, has begun to set in place the framework for regulation of the sector. The Commission has:

- ▶ Issued interim licenses for electric sector enterprises
- ▶ Issued interim rates for certain generation facilities
- ▶ Adopted a tariff methodology for cost-based rates
- ▶ Developed model permanent licenses for generation, transmission, and distribution licensees
- ▶ Commenced long-term, cost-based rate proceedings for generation, transmission, dispatch, and distribution licensees
- ▶ Adopted an interim rate increase to 6 tetri/kWh (from 4.5 tetri), pending completion of the longer-term rate proceedings

The Commission will continue with its regulatory program over the next year.

Issues

1. The Commission has recently been called upon to evaluate the rate proposal of AES Corporation, in connection with privatization of the Telasi distribution enterprise. Essentially, AES proposed a margin cap, escalating in increments every six months for a total period of five years. Because, however, AES failed to disclose much in the way of cost or other information to support its margin proposal, it proved difficult for GNERC to evaluate the proposal. This problem could be repeated, as GoG offers additional enterprises in the sector for privatization.
2. Even the 6 tetri/kWh rate does not permit many, if not all, of the sector fully to recover their costs.

Recommendations

1. For generation and selected distribution assets to be offered for privatization, GNERC should consider establishing a benchmark rate against which all bidders would bid, in advance of

⁴ Georgian National Electric Regulatory Commission Resolution # 1, "On Approval of the Charter, the Regulation and the Internal Operational Rules," October 6, 1997.

privatization. The bid might consist of two parts, one for the asset as is, and another for a rehabilitated asset.

2. The Commission should continue with its long-term, cost-based rate proceedings.

4. Presidential Decree # 421: The Market Rules

Status

In July, 1998 the President approved Decree # 421, "On Main Principles of the Georgian Wholesale Electricity Market." The decree approved a statement of principles, attached to the decree, that will govern a restructured wholesale electric market beginning in 1999.⁵ The principles, which were prepared over a period of months by representatives of the Commission, the Ministry of Fuel and Energy, and Sakenergo, provide:

- ▶ For a new wholesale market into which generators will sell power, and from which distributors and direct customers will buy power.
- ▶ For the elimination of Sakenergo as the middleman purchaser and reseller of electricity; the new market will not have a centralized buyer/reseller
- ▶ For the separation of dispatch, settlements, and billing and collection functions, each function to be undertaken by a contractor or service provider selected by the market members
- ▶ For a governance structure in which the market members appoint their representatives to an Executive Board, which will also include government representatives
- ▶ For a pricing scheme in which rates for generation will initially be set by the Commission, but over time will be set by the open market

The new wholesale market represents significant changes for the sector, the two biggest of which are the elimination of the middleman in transactions between buyers and sellers, and the separation of functions so that buy/sell transactions will be recorded with far more accountability and transparency than at present.

Issue

Much remains to be done to get the wholesale market up and running.

⁵The decree also approved an ambitious schedule for implementing the market rules, setting various documentary and organizational deadlines for the balance of calendar 1998, and on into 1999.

Recommendations

Our recommendations on the wholesale market appear in the Restructuring Assessment.

Conclusion

The Electricity Law and the Market Rules principles, and the regulatory and other initiatives being undertaken under each of them, provide a solid legal basis on which the electric sector may proceed with the important work of reform. Hagler Bailly will incorporate the recommendations reflected in this assessment in the updated plan to be prepared under the terms of Subtask B of the Task Order, as set out in the work plan.