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GEORGIA: OIL & GAS SECTOR REFORM PROGRAM

Assessment of the State of Commercialization in the Oil and Gas Sectors of Georgia

Final Report

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EXECUTIVE SUMMARY

TASK OBJECTIVE - COMMERCIALIZATION

It is the objective of this task to strengthen the operation of the Oil & Gas sector companies of Georgia by introducing sound western commercial business practices as well as by mandating the adoption of open and transparent accounting systems.

At this time, the oil and gas "companies" remain State Owned Enterprises (SOE's), though the Ministry of Fuel & Energy has committed to their corporatization, and has specifically requested assistance in their commercialization.

The following report, then, is a brief assessment of the status of the commercialization of those enterprises, which are engaged in E&P (Saknavtobi), oil products' distribution (Saknavtoproducti), and the transport and sale of gas (Saktransgazmretsvi).

CONCLUSIONS

Not one of the oil & gas sector SOE's 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/pa); 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 SOE's 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.

We would argue that change will only occur when foreign assistance and multilateral lending institutions make mandatory, as a condition precedent to the provision of further assistance or loans, the immediate adoption of western accounting and management reporting systems (it is ironic to note that this is already the law of the land); and, using that handle, force commercial discipline upon the system.

Easier written than done. The reasons for opposition to this type of reform are rooted in the sub-rosa benefits derived from the maintenance of opaque operations by private parties who are also employed by the government. The remedy will thus not come from the executive branch of the government, nor is it likely to come from Parliament. It must be externally forced.

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

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

RECOMMENDATIONS

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

1. The immediate introduction of accounting, budgeting, costing, and credit and billing systems.

2. The simultaneous identification and training of qualified agents for change within each organization and the wholesale replacement of those persons within the organization who fail to adapt.

3. The corporatization of the oil and gas enterprises and the immediate devolution of government ownership and control in favor of new management, outside investors, the remaining employees and the public.

4. The abolition of Saknavtoproducti through the sale of its assets to the private sector.

5. The establishment of an enforcement agency within the Ministry of Fuel & Energy which ensures product quality and enforces 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.

CHAPTER 1
THE OIL SECTOR

1.1 SAKNAVTOBI

Saknavtobi is the de facto national oil company of Georgia. It functions as the country's sole exploration and production enterprise and reports to the Ministry of Fuel and Energy, though it is supposed to soon be corporatized and therefore transferred over to the supervision of the Ministry of State Property Management. In 1993, the enterprise employed 7,538 employees. Today it employs only 20% of that number, the majority of whom are unpaid.

Beginning in 1970 and effectively ending in 1986, Georgia enjoyed a brief period of indigenous oil production. At the height of production (in 1980), the country was pumping over 3 million tons of oil annually, but this was short-lived as poor field management, soviet era equipment and technology, and the absence of secondary recovery all conspired to reduce output. By 1986, production had fallen to 180 thousand tons, and it consistently stayed at low levels till 1993 when civil disruption caused production to fall away to a mere 40 thousand tons. Current oil production has recovered somewhat to about 100 thousand tons per annum.

Throughout the 1980's, Georgia's consumption averaged over 4.4 million tons ($616 million at current prices). But Georgia has always been a net importer of fuel, even in the halcyon days of 1980, when imports even then stood at 1.6 million tons.

Estimated proven reserves for Georgia are 12 million tons, and estimated probable reserves are 580 million tons. (It should be noted however, that these figures are highly questionable, and are derived from the Georgian's own estimates. Chevron has independently reviewed the data and concluded that reserves may be no more than 300 million tons.)

Saknavtobi also had been responsible for the operation of all oil pipelines in the country through its budgetary sub-unit, the Industrial Amalgamation of Main Oil Pipelines. The principal asset of this enterprise was transferred to the Georgian International Oil Company, GIOC, as part of the contract with AIOC for the rehabilitation of the Gachiani/Supsa portion of this line.

Finally, Saknavtobi had been responsible for the operation of the Batumi Oil Refinery, which was build in 1928, and which had the capacity to refine up to 2.5 million tons of low grade crude. This facility experienced a number of fires and now has ceased operations.

Independent surveys have concluded that rehabilitation of the refinery is not economic.

1.2 SAKNAVTOPRODUCTI

Oil product wholesaling and retailing were once handled exclusively by this budgetary enterprise through its 43 depots located around the country. In the past five years private wholesalers and retailer have taken over most of the business, though they use the assets of this SOE for storage and transportation.

The infrastructure at these depots is extremely poor, threatening the environment and evidencing a widespread disregard to public safety. The situation is complicated by the fact that private companies make extensive use of this enterprise's depots but are suspected of paying little or nothing for the service. By the Ministry of Fuel & Energy's own account as much as 90% of the country's consumption is wholesaled and retailed privately.

The oil distribution sector (when viewed from the perspective of the private operators) is one of the most profitable businesses in Georgia. It generates substantial profits for the private sector which is using the state assets nominally held by this enterprise.

Prior to the breakdown of the economy, 49% of products consumed were Heavy Fuel Oils (HFO) of which 42% was used in electricity generation. The next largest product category was gasoline which represented 24% of total fuels consumed. Diesel Oil was the third largest product group (13%),with the majority of that fuel being used for agriculture. Based on figures available for Poti Port, the current oil products mix is preponderantly gasoline by a factor of 2/1 over HFO. This is consistent with the general collapse of the Georgian economy, and the revival of private transport usage in the past 18 months.

Russia and Azerbaijan were the traditional suppliers due to favorable credit terms. Now that the business has been put on a cash and carry basis, oil products are being imported from Bulgaria and Greece (Gasoline), Turkey (Kerosene, LPG and lubricants), and Diesel (Azerbaijan).

Due to a complete lack of cooperation, we were unable to obtain any information regarding the state of commercialization of this enterprise. We were informed that its operations were a state secret and that if we wanted information we should apply to the Ministry of State Security.

The issue, then, is that the infrastructure is being exploited by the private sector and it is unclear whether the State is receiving an economic rent for the use of these assets.

Meanwhile the assets are deteriorating, threatening the environment and public safety.

The challenge is to get the private sector to take over responsibility for these assets for the purposes of rehabilitation, maintenance and public safety, This, obviously has not happened, and it is a failure on the part of the Ministry of Fuel & Energy as well as the Ministry of Environment to set and enforce rules governing the operation of the distribution of oil products.

It is for these reasons that we recommend the abolition of Saknavtoproducti and the liquidation and sale of its assets to the private sector.

CHAPTER 2
THE GAS SECTOR

2.1 SAKTRANSGAZMRETSVI

The entire gas sector of Georgia has collapsed.

Historically, natural gas had been the single most important energy source for the Georgian economy, accounting for over 70% of Georgia's primary energy use in 1989.

After the breakup of the FSU and beginning in 1992, the price of imported gas rose by 2500%, thus ruining the Georgian economy. Turkmenistan is currently owed close to $400 million, which Georgia can not pay. The inability of Georgia to pay has resulted in an almost total interruption of gas supplies. A small amount of gas is still imported as and when funds are available, principally for the Rustavi Metal Works (0.5 mcm/day) and for electricity generation at Gardabani (2.5 mcm/day - when operating).

Thus, annual gas consumption has dropped from a high of 6.2 bcm in 1989 to an estimated 0.7 bcm in 1996. Industrial production in Georgia had fallen by 96% by 1995.

Gas was historically used in Georgian industry (metallurgy, cement, chemicals and fertilizer), the energy sector (electricity generation and district heating), agriculture and food processing, as well as in households (250,000 in Tbilisi alone).

Natural gas production in the country has been negligible. Proven reserves are approximately 2.5 bcm, however, and estimated probable reserves are 95 bcm (15 years supply at 1989 consumption rates). The historic reason for the lack of exploration and production of indigenous gas was a plentiful and cheap supply from the FSU. Georgia could, given the will, develop it's own gas production, however, certain alleged commercial relations between policy makers and importers may have acted as a disincentive to do so.

Until 1991, Georgia's sole source of gas supply was Russia. Beginning in 1992, Georgia started imported gas from Turkmenistan through the Itera International Energy Company (a company with offices in St. Petersburg, Florida, and reputedly controlled by the number two at Gazprom) via pipelines transiting Russia.

Georgia is paying Itera about $54 per tcm for imported gas, which, on an annualized basis, equates to an import bill of approximately $38 million at current consumption rates. At pre-1990 rates of consumption, Georgia's gas bill would be $335 million at current prices. The IMF estimates Georgia's total exports in 1996 at only a little over $500 million and its total imports at over $850 million, yielding a trade imbalance of close to $350 million/year.

Georgia is supplied (or was supplied) with natural gas from Turkmenistan. The gas is transported via a 1200 mm pipeline through Uzbekistan, Kazakstan and Russia. It enters Georgia from the north. The main trunk line continues through Georgia to Armenia. Within Georgia the transmission network was over 2300 km long, and traversed the length and breadth of the country servicing all major population centers. At one time the organization employed 12,300 people.

Due to poor construction, a lack of maintenance, a paucity of investment and civil disturbance, the entire system, save the main trunk line transiting the country to Armenia, has collapsed. The cost of repairing the system is well beyond the means of the country at present. Moreover, users and potential users are, for the most part, un-metered (nor is the gas metered when entering or leaving the country). Hence, there is no effective way to collect tariffs. Moreover, the complete absence of accounting systems renders any discussion of tariff methodologies moot.

Finally, the fact that a good part of the compression system was powered by Sakenergo, means that the system will require its own compression power sources if it is to be restored.

The investment needed to restore the system easily exceeds $100 million.

Unless Georgia develops its indigenous gas resources, Georgia's reliance on imported gas as a primary energy source will emasculate its ability to recover its industrial base, undermine its currency, ruin its budget, and compromise its existence as an independent state.

CHAPTER 3
COMMERCIALIZATION ISSUES

3.1 ACCOUNTING

As indicated above, there is no accounting system worthy of the name within the aforementioned organizations. This makes setting tariffs impossible; it also makes it impossible to plan, budget or even pay salaries. The organizations are totally unsupported by management information systems. Management cannot provide information about operations, distribution costs, or the technical state of their networks. Finally, there is no way for the organizations to track, invoice or collect on sales.

3.2 CORPORATE STRUCTURE & MANAGEMENT POLICIES

We examined how well, if at all, these enterprises were prepared to:

I. articulate a profit goal;
II. plan for profit;
III. budget cash;
IV. manage working capital; manage fixed capital; and
V. plan for the enterprise's capital structure.

None of the organizations had even the most rudimentary systems for performing these tasks.

With respect to corporate structure and management policies, we examined on:

I. The organization's management and financial credibility as it appears to outsiders
II. The adequacy of financial disclosure and availability of audited financial statements
III. The ownership and definition of corporate assets/liabilities
IV. Equipment requirements for the development of Management Information Systems.

We found that:

I. there was a total failure to emphasize profitability;
II. no financial statements were available which would be recognizable as such, consequently these organizations have no credibility whatsoever to outsiders;
III. business critical issues to improve economic performance were not identified;
IV. reports were not formatted against key financial objectives;
V. the value of financial information was not understood; and
VI. considerable investment is required in MIS equipment to support commercialization.

3.3.1 The Organizations' Management And Financial Credibility As It Appears To Outsiders

Credibility is judged by a standard of apparent openness. In the Georgian Oil & Gas Sectors, a culture of secrecy prevails.

Credibility is also judged by evidence of the organization's ability to plan for profit. The Georgian Oil & Gas Sector is devoid of any evidence of an ability to plan for profit.

At the three state enterprises, crisis planning and ad hoc management remain the norm; no financial plans are drawn up; no budgets to control expenses exist, and no forecasts of sales are made; nor is there evidence of even a rudimentary understanding of working capital management. Return on investment, both short and long-term, is an alien concept. Even more significantly, there is no single individual or department within these organizations who or which carries the responsibility for the profit planning function.

Financial controls do not exist in any form.

3.3.2 The Adequacy Of Financial Disclosure And The Availability Of Audited Financial Statements

Audited financial statements obviously do not exist; what documents that do exist are contradictory, incomplete, and totally useless.

Financial reports will have to be created which are based on the notion of a 'going concern', which are consistent and prudent, prepared on an accrual basis. and are substantive as opposed to merely detailed. Moreover, accounts will need to be consolidated across the organization, adequately disclose contingencies, use appropriate inventory valuation methods, and reflect appropriate depreciation rates consistent with asset life.

None of these standards are being applied now.

3.3.3 The Ownership And Definition Of Assets And Liabilities

Assets and liabilities are impossible to identify. Considerable effort will be required in this area to augment investor confidence in the commercial viability of these organizations. The management of the enterprises have no appreciation of this fact.

Any investor trying to evaluate one of these enterprises will face the issue of understanding its liabilities. Management needs to fully appreciate the requirement to disclose all of the liabilities to which an investor/financier would be exposed. Subsequent discovery of liabilities undercuts management's credibility. The greater the apprehension of undisclosed liabilities, the greater is the reluctance to provide capital. This in turn translates into higher costs of capital and a demand for faster pay-backs, or, more probably, no investment at all.

3.3.4 The Development Of Management Information Systems - Equipment Requirements

We noted the following areas where equipment was requested, and, in our opinion, needs to be provided, or at least assistance in the selection of which should be given. Specific requests were made for:

I. Accounting platforms and software
II. New metering technologies.
III. Maintenance, construction and material management systems.
IV. Telecom circuits particularly as they relate to managing operations.
V. Database management systems.
VI. Customer billing systems.

Skills also need to be augmented in the areas of bidding, contractor selection, contractual performance, and contractor warranty compliance procedures when dealing with foreign suppliers.

3.4 THE PATH FORWARD

The path forward will be an arduous one. For the Oil and Gas Sectors of the Georgian economy to function, the following has to be done:

I. Mandate the Adoption of a Rate of Return as the Principle Goal of the Organization.
II. Establish Accounting Systems
III. Re-train all Management Personnel
IV. Set up Procedures to Collect and Report Financial Data on a Timely Basis
V. Prepare Audited Financial Statements and Project Prospectuses

3.4.1 Mandate the Adoption of the Rate of Return as the Goal of the Organization

Fundamental to the commercialization of an enterprise is the generation of a profit. The revolution will have to come from the outside. The Supervisory Council of each enterprise will have to instruct the Managing Director to mandate the adoption of an overall profit objective for the enterprise and the incorporation of financial criteria in decision making throughout the organization. Without such a decree, the organization as a commercial entity will fail.

3.4.2 Establish Accounting Systems

Outside financial consultants should be brought in and tasked to develop a core of enterprise staff who in turn will develop new Financial Planning procedures consistent with the articulated rate of return objective. As part of this comprehensive reformation of the planning process, the creation of an internal financial management team is essential to achieving the prosperity and even the survival of the enterprise. Survival will only be assured through the development of a complete financial and operational plan for all levels of the enterprise and retraining.

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, in addition to re-training at all levels, a formal program that recognizes and rewards profit improvement achievements should be created. This will serve to institutionalize the profit planning philosophy and bring about the continued cooperation necessary to effect a successful program.

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 controllable, acted (and seen to be acted) upon. The budget for succeeding years will be derived using the results of the financial planning process.

The planning process must involve:

I. setting a goal for the enterprise to achieve in a future period
II. forecasting economic conditions which will effect demand
III. forecasting demand and selling prices
IV. determining how much demand can be satisfied from existing capacity
V. determining the required expansion of plant and equipment to meet increased demand
VI. determining costs at projected demand levels
VII. projecting selling and administrative costs
VIII. projecting cash required for working capital
IX. plant and equipment outlays
X. administrative expenses
XI. making profit estimates
XII. determining finance requirements

Once the planning process has been completed budgets must be developed for the divisions and the enterprises as a whole. By definition budgets should be prepared for one year forward, broken down by months. Budgets should be flexible in that they should allow for changing circumstances, and actual results should be compared against budgeted amounts for use as a management tool.

3.4.3 Re-train all Management Personnel

Extensive training programs are needed to inculcate western business norms. No training is conducted at any of the Oil & Gas enterprises at present. 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, and identify business critical issues to improve the economic performance of each enterprise.

3.4.4 Set up Systems to Record and Report Financial Data on a Timely Basis

With the assistance of outside financial consultants, enterprise staff must establish and routinize procedures for the collection financial data as a predicate to the development of financial statements and managerial reports. As the process becomes routinized, enterprise personnel will develop their own financial expertise, making further involvement by outside consultants unnecessary.

3.4.5 Prepare Audited Financial Statements and Project Prospectuses

The preparation of audited financial statements is a prerequisite for financing. An enterprise will not be able to raise any amount of funds on commercial terms without them. Where and when appropriate, a prospectus should also be eventually developed for each particular endeavor marketed to investors. The prospectus will contain information about the enterprise's planned use of the funds, 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 the previous steps, it will be in a good position to identify and approach potential partners, lenders, and investors.

3.5 CONCLUSIONS

I. A comprehensive profit strategy articulated by top management will be the key to successful commercialization and supported by the adoption of western accounting systems and management information systems.

II. All paths forward require common initial preparatory work, the foundation for which will be based on training.

III. Failure to re-orient management goals and policies will undermine the country's budget, and work against the re-industrialization of the country.

CHAPTER 4
PROPOSED TASKS FOR USAID ASSISTANCE

4.1 PROMOTE THE ADOPTION OF INTERNATIONALLY ACCEPTED ACCOUNTING PRINCIPLES AND TRAIN ALL MANAGEMENT PERSONNEL

We propose the creation of demonstration projects as a paradigm for Georgian industry as a whole by assisting in the commercialization of the Georgian International Gas Company and Saknavtobi. The reason for the choice of GIGC is that gas is vital to the recovery of the Georgian economy, and the company has recently been established out of the ashes of the former state enterprise, Saktransgazmretsvi. The reason for the choice of Saknavtobi is that it is imperative for the country to develop its own oil and gas resources rather than further relying on imports.

The steps toward successful commercialization of these enterprises are:

I. The establishment of financial planning and budgetary processes (as well as the installation of accounting systems) to support the rate of return on invested capital as a gauge of performance; this will involve developing financial planning and budgetary manuals, and

II. the design and implementation of new training curricula to teach Western business concepts under the auspices of the Georgian Institute for Oil & Gas. These courses would emphasize commercial over technical details, stress the notion of profit, and identify business critical issues to improve the economic performance of a business entity.

The purpose of this assistance is to leave structural methodologies for the institution of financial management planning and budgetary techniques for the entire Oil & Gas Sector. Additionally, the purpose is to create a self-sustaining educational support system which can act as a paradigm not only for the Oil & Gas industry, but for other commercial sectors as well, and to develop training assets within the system so that the process will become self sustaining.