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**PLAN FOR CONTINUED LEGAL AND REGULATORY
REFORM OF THE GEORGIA OIL AND GAS SECTOR**

**Georgia Oil and Gas Sector Reform
Contract No. LAG-I-00-98-00005-00
Task Order No. 5**

Final Report

Prepared for:

U.S Agency for International Development
Bureau for Europe and NIS
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PLAN FOR CONTINUED LEGAL AND REGULATORY REFORM OF THE GEORGIA OIL AND GAS SECTOR

This is the Plan for Continued Legal and Regulatory Reform called for by Subtask B of Contract No. LAG-I-00-98-00005-00, Task Order No. 5, that Hagler Bailly develop an updated 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." The plan draws upon the following:

- ▶ The revised work plan for Subtask B of Task Order 5, submitted to USAID for review and comment in draft form on March 22, 1999;
- ▶ Hagler Bailly's work and experience under Task Order 5, which began in September 1998 and has continued to date.

Of necessity, Hagler Bailly's work under this Subtask relates to and must be integrated with our work under each of the other Task Order 5 Subtasks, particularly Subtasks A (Restructuring), C (Commercialization) and D (Privatization). This Legal and Regulatory Reform Plan therefore refers to activities under the other Subtasks, as appropriate.

This Plan identifies and discusses each of the major items of work that Hagler Bailly has been implementing and/or will implement under Subtask B for the duration of Task Order 5. In general, the plan lists the items of work in order of importance to the legal and regulatory reform effort.

1. Oil and Gas Law

From the earliest days of the energy sector reform program, USAID identified the enactment of a law to govern the exploration and development of Georgia's oil and gas resources as a legal reform priority. Under existing Georgia law, Saknavtobi, the state-owned petroleum enterprise, handles all contractual relationships governing the exploration, development, and refining of crude oil and natural gas produced in Georgia. Saknavtobi lacks, however, legal standards for the contents of such contracts, and as a result, existing production sharing and related contracts with foreign investors include various, often inconsistent or conflicting, privileges and responsibilities. Moreover, in Saknavtobi, the government's sovereign, regulatory, and

commercial interests are inappropriately intertwined. It is essential that an Oil and Gas Law, setting forth appropriate standards and delegating government interests to different agencies, address and correct these deficiencies. As stated in Task Order 5 and in the Subtask B work plan, the Oil and Gas Law should address, at a minimum, licensing requirements for exploration and development (including the identification of the appropriate agency to issue licenses and to regulate conduct under them), the elements of contracts for upstream production, regulatory standards, and production sharing. The Law should confirm the validity of existing oil and gas contracts, and separate the Government's regulatory authority from its commercial interests, and delegate these items to two different agencies. The statute should also rationalize tax treatment for oil and gas investments, contracts and production, and provide for international arbitration of disputes.

Timing: Hagler Bailly has been working on the many different drafts of an Oil and Gas Law (and drafted one of the earliest versions) since mid-1997. Drafting and re-drafting the Oil and Gas Law, and consulting with counterparts regarding international standards, served as a major activity under Delivery Order 16, which expired at the end of September, 1998. Hagler Bailly continued its work on the Oil and Gas Law with the commencement of Task Order 5, and that work has continued unabated during the Task Order. Indeed, Hagler Bailly has had an oil and gas lawyer/expert in Georgia virtually continuously since September, 1998, for the express purpose of following the progress of the Law (in its many forms) and working with the Ministries, and now the Parliament, on its contents. We have continued to devote appropriate resources to advocate the passage of the Oil and Gas Law before the Georgian Parliament during Task Order 5.

Parliament conducted its third and final reading of the Law on Oil and Gas on 16 April 1999. President Shevardnadze signed the Law on 3 May 1999.

2. Amendments to the Electricity Law to create a program of regulation of natural gas supply, transportation, and distribution

Although there are Georgian laws on the books permitting municipalities, with the approval of the Ministry of Economy, to regulate retail rates for natural gas, the authority is sporadically and ineffectually utilized, and the industry (to the extent that there is one) is essentially unregulated. The absence of regulation became a concern in the context of the reform effort in early 1998, when affiliates of Gazprom purchased six large distribution companies (including Tbligas, the distribution enterprise for Tbilisi) and Rustavi Cement, the largest industrial consumer of natural gas in Georgia. At about the same time, another Gazprom affiliate executed an agreement with Saktransgasmretsvi, the Georgian natural gas pipeline enterprise, under which it would operate and manage the pipeline for the Georgians. Although the specter of Russian-controlled gas

hegemony in Georgia has abated somewhat,¹ the possibility of an unregulated monopoly in natural gas prompted an examination of the question by USAID and World Bank. Eventually, World Bank included a requirement for natural gas regulation in its ESAC conditionalities in December, 1998, a possibility that USAID had already anticipated in Task Order 5. Hagler Bailly will prepare amendments to the Electricity Law of 1997 (to be renamed to reflect its post-amendment identity as an energy law) to give the Georgian National Electricity Regulatory Commission (also to be renamed) the authority to regulate the supply, transportation, and distribution of natural gas through a system of licenses and tariffs.

Timing: Hagler Bailly prepared a first draft of the natural gas amendments during the Fall of 1998, and circulated the draft for review and comment to USAID and World Bank prior to having the draft translated and presented to counterparts in November. In December, 1998, Hagler Bailly joined the working group formed by GoG for the purpose of finalizing the natural gas amendments to the Electricity Law, and worked with the group on the amendments during the last half of December and the first half of January. When in late February the Chancellery presented the Parliament with a package of amendments that differed from that on which the working group had earlier agreed, Hagler Bailly worked with the staff of Chairman Tskitishvili's Committee on Reform of the Economic Sector to prepare appropriate revisions. Hagler Bailly continue to work on the amendments for the balance of Task Order 5.

Parliament approved the natural gas amendments on their third reading on 30 April 1999. President Shevardnadze signed the legislation two weeks later.

3. Natural gas transportation and distribution tariffs

The Georgia National Electricity Regulatory Commission (GNERC) consists of three commissioners, all of whom come from the electric sector of the former Soviet apparatus. Although they have assiduously studied ratemaking fundamentals with respect to the electric sector to the point of preparing and adopting a tariff methodology to govern the calculation of rates for electric generation, transmission, and distribution, and although the electric and the natural gas sectors are somewhat similar from the regulatory perspective, the sectors are nonetheless sufficiently different to require technical assistance in tariff and other regulatory issues. Hagler Bailly will gather information on pipeline and distribution sector costs, and

¹ For one thing, the Ministry of State Property Management declared, during the first quarter of 1999, that the Gazprom affiliate had breached its agreement to purchase Tbilgas by failing to agree to assume an appropriate share of the distribution enterprise's debt, and declared the purchase agreement void. For another, Saktransgasmretsvi repudiated the management agreement, claiming that the Russians had failed to abide by their obligations.

design a tariff that will accommodate the unique circumstances currently presented in Georgia, where the main natural gas pipeline from Russia has a high replacement cost, is (or should be) significantly depreciated, and is lightly utilized by the consumer. Hagler Bailly will also conduct orientation and training sessions on the tariff model for GNERC and its staff, as well as for representatives of the transportation and distribution sectors.

Timing: Hagler Bailly commenced gathering cost information on the natural gas sector in the Fall of 1998. Its experts also met with the GNERC commissioners and selected staff to introduce them to the natural gas business and to outline regulatory issues, and with representatives of the pipeline and Tbilgazi to outline tariff concepts and to ask for assistance in gathering cost data. Hagler Bailly recently completed the preliminary spreadsheet for natural gas transportation tariffs, and will conduct seminars for GNERC to introduce the tariff to the commissioners and staff during April, 1999. Hagler Bailly continued this technical assistance through the balance of Task Order 5, culminating in the presentation to GNERC of a recommended tariff methodology in June 1999.

4. Eminent domain law

Early drafts of the oil and gas law included a provision for the right to the use for lands within contract areas to conduct exploration and development and other petroleum operations. At some point, Government of Georgia (GoG) representatives suggested that because eminent domain was likely to become necessary in such areas as electric power, water utilities, communications, roads, and other public or quasi-public uses in addition to the oil and gas sector, it would prefer to enact a single law to govern all cases in which the power of eminent domain would be used. USAID and World Bank agreed to this approach. Accordingly, Hagler Bailly will prepare a comprehensive eminent domain law, taking into consideration the Georgia Constitution and other legal requirements, and tailored to circumstances otherwise presented in Georgia.

Timing: Hagler Bailly prepared a draft eminent domain law in February, 1999, which it circulated to USAID for review and comment. Hagler Bailly has also conducted extensive consultation with counterparts on the law. We further revised the draft, based on consultation, in April, and presented GoG with a completed final draft in June 1999. Hagler Bailly has continued to offer technical assistance to GoG as Parliament has taken up the bill.

5. Environmental liability law

An issue that emerged during GoG's consideration of an oil and gas law was liability for certain environmental damage caused by enterprises conducting exploration, development, or other

petroleum-related operations, including transportation of hydrocarbons.² The Ministry of Justice offered its view that it would be more appropriate for Georgia to enact comprehensive legislation to address liability for all hazardous materials, rather than limiting such legislation to oil and gas products. Accordingly, Hagler Bailly will prepare a draft law providing for strict liability for the owners or possessors of hazardous materials in Georgia.

Timing: Hagler Bailly commenced consulting with counterparts on this issue in March, 1999, after which we began preparing a draft law. Hagler Bailly completed a draft law by mid-April, after which it conducted further consultations with counterparts to identify key issues and to provide optional solutions for such issues. Hagler Bailly completed a final draft law in June 1999, when it was presented to Parliament. Hagler Bailly has continued to offer technical assistance respecting the bill during the balance of Task Order 5.

6. Assessment of legal and regulatory framework

Subtask B.1 of Task Order 5 provides that Hagler Bailly shall prepare a brief assessment of the legal and regulatory framework of the Georgian oil and gas sector.

Timing: Hagler Bailly will prepare the assessment and circulate it for comment by mid-July, 1999.³

7. Mandatory insurance law

As provided in the work plan for Task Order 5, Hagler Bailly will provide technical assistance to assess the need for a law requiring oil and natural gas pipeline licensees or owners to secure liability insurance to cover the risk of accident in the construction and operation of such facilities. If appropriate, Hagler Bailly will prepare the draft of a law.

Timing: Hagler Bailly began consulting with counterparts in connection with the assessment in early April, 1999, and expects to complete it in July.

² The issue may have been prompted, at least in part, by AIOC's decision to forgo use of an existing, Soviet-era oil pipeline as part of the Early Oil Pipeline through Georgia. According to AIOC, the pipeline cannot withstand the pressure under which the EOP will operate. AIOC's decision (with which GoG disagrees) leaves several hundred kilometers of pipeline partly filled with crude oil. The Georgians, understandably, would like to avoid similar situations in the future.

³ Hagler Bailly has not treated the assessment as a priority item because so little has changed in the legal and regulatory arena in Georgia since Hagler Bailly prepared similar assessments under Delivery Order 16.

8. Technical assistance relating to rules and regulations of the State Agency on Oil and Gas Operations

We assume that the Georgia Parliament will enact an Oil and Gas Law some time during the current session (which ends in early June), and we anticipate that the Law will create what the current draft law identifies as the State Agency on Oil and Gas (identified in earlier drafts as the Competent Body). When the new Oil and Gas Law becomes effective, Hagler Bailly will offer technical assistance to the new agency in recommending rules and regulations, as provided in the assessment to be prepared under Subtask E of Task Order 5. The precise nature of the technical assistance will depend on the needs assessment, discussed below.

Timing: The work plan for Subtask E provides that Hagler Bailly will prepare a needs assessment of the institutional capabilities of the new State Agency on Oil and Gas (or similar agency by whatever name) once Parliament has enacted the Oil and Gas Law. The timing of the assessment and the technical assistance both depend on when Parliament enacts the law.

9. Technical assistance relating to natural gas licensing

As noted above, Hagler Bailly expects Parliament to enact amendments to the Electricity Law that will confer regulatory jurisdiction on GNERC over the supply, transportation, and distribution of natural gas. A principal feature of the regulatory framework contemplated by the draft amendments is a scheme of licenses. GNERC is somewhat familiar with the principles relevant to regulation by license due to its experience with the electric sector under the original Electricity Law. Hagler Bailly will supplement this experience with technical assistance specifically related to the natural gas sector.

Timing: Hagler Bailly began to offer this technical assistance in June 1999, after enactment of new legislation that gave GNERC the authority to regulate the natural gas sector.

10. Double taxation issue

When U.S. corporations do business in Georgia, they are subject to taxation under both U.S. and Georgia law. Without adjustment, taxation under the two separate tax schemes effectively results in double taxation, as both jurisdictions tax the same earnings without acknowledgment that taxes are calculated and due under the tax laws of both countries. The same phenomenon applies to corporations of other countries. This "double taxation" issue serves as a substantial disincentive to investment in Georgia.

The solution to the double taxation issue is a treaty under which the governments of the United States and Georgia agree on the allocation of taxes for American businesses doing business in Georgia. Such treaties are commonplace. GoG has requested, and Hagler Bailly will prepare, a brief memorandum summarizing the issue and the solution, as applied in other countries with which the United States has tax treaties.

Timing: Hagler Bailly presented a draft memorandum to USAID for review and comment in June 1999, and a final memorandum in July.