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ASSESSMENT OF THE STATUS OF PRIVATIZATION OF THE GEORGIA POWER SECTOR

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CONTENTS

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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 Tbilisi. 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.

Against a backdrop of civil war and raging inflation, customers either reduced their electric bill payments or stopped paying altogether. Management of the distribution sector failed to take the steps necessary to put electric utility service on a paying basis. Eventually, as the system failed to produce enough cash to meet financial obligations and began amassing extraordinary measures of debt, the electric system failed to supply customers with sufficient or reliable electricity supplies. As time passed, power outages became commonplace, yet the sector's management proved unable to improve the situation. In that context, the Government of Georgia (GoG) concluded that privatization of sector assets offered the best solution to the problems assailing the sector.

Acting without outside advice, GoG began an *ad hoc* restructuring in early 1995 by privatizing a number of small hydropower plants. This privatization was part of a general plan to put small businesses in the hands of local entrepreneurs. These privatizations were halted, however, in mid-1995 pending the development and implementation of an overall power sector privatization plan.

As instructed by Presidential Decree No. 437,[1] the Ministry of State Property Management, in collaboration with the Ministry of Fuels and Energy, prepared a plan for overall power sector restructuring and privatization in late 1996. The plan, which the President adopted as Presidential Decree No. 828,[2] called for the formation of Joint Stock Companies (JSCs) for generation facilities. These JSCs were to be the first offered for privatization, with 49% of the shares to be sold at public auction or given to employees. The remaining 51% were to remain in government hands until a strategic investor could be found.

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[1] "On Restructuring of the Power Sector," adopted 4 July, 1996.

[2] "On Approval of the State Program for Power Sector Privatization," adopted 19 December, 1996.

Georgia's donor community (including USAID and the World Bank) objected to this approach, noting that the distribution sector should be privatized first, so that customer collections could be improved. Then, with the distribution sector generating cash, generating assets would be more valuable and could be privatized in turn. The donors also recommended that shares should be first offered to strategic investors, reserving for employees only the minimum percentage required by Georgian privatization legislation. Finally, the donors suggested that GoG retain a financial advisor to ensure that the privatization program was compatible with investor expectations and received the widest possible attention.

Consensus among the different branches of the GoG and power sector institutions for adoption of a strategic investor privatization strategy took nearly a year to achieve, and was hampered by conflicting interests within the government. During 1997, for example, the Ministry of State Property Management and other elements within the Georgian power sector attempted several times to carry out individual asset privatizations, and other "pilot privatizations," by means of opaque transactions. The Georgian Parliament played a key role in resisting these piecemeal, uncoordinated attempts at privatization and in building consensus for strategic investor privatization. The advice and assistance of Georgia's donors and their technical assistance organizations, particularly the provision of funds from the World Bank's Structural Adjustment Credit to support a financial advisor, were important in making the strategic investor privatization option a reality.

1. Electric sector privatization in general

GoG has prepared the electric sector reasonably well for privatization. As provided by Decree No. 437, all generation assets have been spun off into Joint Stock Companies, one for each generation project. Similarly, the government has created JSCs for generation enterprises, and spun off generation assets to those JSCs. GoG has enacted a Law on Privatization to set out the procedure for privatization of state-owned assets, and a Law on Entrepreneurs to define how for-profit enterprises shall be organized and operate on a corporate basis. Finally, the government has selected Merrill Lynch to serve as its financial advisor in the privatization process. GoG gave Merrill Lynch an exclusive right for 18 months to privatize all eligible electric sector assets.

With the ground thus prepared, all that remains is to select the electric sector assets to be privatized, to define the terms and conditions under which they will be offered for sale, and publicly to outline bid procedures. That, in fact, is the procedure recently followed in GoG's privatization of Telasi.

Issue

There is evidence, anecdotal and otherwise, that the general public lacks understanding and awareness of the reasons why its government has selected privatization as the solution to many of the problems facing the electric sector. Public opposition to privatization will not help the program to succeed, and may retard or even threaten the success of privatization, to the extent that public opposition finds political expression.

Recommendation

USAID might usefully design public information campaigns calculated to explain the reasons for and benefits to be expected from privatization, aimed at local and regional officials, the media, and citizens generally.

2. Distribution

GoG, with advice from Merrill Lynch, decided to privatize Telasi, the distribution enterprise serving Tbilisi, first. On that basis, Merrill Lynch circulated an Information Memorandum on Telasi to the international investment community in June 1998. In July, GoG issued a formal tender for Telasi, with a schedule for preliminary and final bids. At least three potential investors submitted preliminary bids for Telasi on 15 September. Two prospective purchasers submitted final bids on October 15. GoG selected American firm, AES Corporation, as the winner. GoG and AES executed a final purchase agreement on 22 December, 1998.

AES proposed an initial purchase price of $25.5 million and a commitment to retire approximately $10 million of Telasi's debts. Equally important in the winning bid was the pledge to make some $83 million of capital investment over the coming 10 years to renovate the system and implement modern customer accounting, metering, billing and collection procedures.

Although Telasi represents approximately one-half the electric load in Georgia, it serves only about one-third of all Georgian distribution customers. The rest are supplied through some 65+ distribution enterprises. The assets of these enterprises have been transferred to JSCs owned by GoG and held by the Ministry of State Property Management, although their operations are currently managed by local municipal governments. GoG and Merrill Lynch plan to offer all remaining distribution assets for sale to strategic investors during 1999.

Issues

1. A major issue that emerged in the AES-GoG negotiations over a final agreement for privatization of Telasi was the margin to be allowed. AES proposed a rate cap approach, under which its margin would start at approximately two tetri/kWh, and escalate in increments every six months for five years, with a final margin of approximately 3.75 tetri/kWh. For some time, however, AES refused to provide the Georgian National Electricity Regulatory Commission (GNERC) with any cost data to support its rate proposal, which proved problematic because AES's rate cap proposal diverged from the cost-based approach to rates that GNERC had taken to that point.

2. Electric rates for the entire sector remain below full cost-recovery levels. This may provide a disincentive to privatization, although the Telasi privatization suggests that bidders will simply make their own rate proposals.

3. As noted, distribution assets are now owned by numerous (over 65) Joint Stock Companies, each managed by local authorities. Donor and other organizations have consistently recommended that these assets be grouped for purposes of privatization, although the number of groups and their composition have been the subject of debate.

4. In order to prepare and circulate an Information Memorandum (or Memoranda) for the two distribution enterprises to be offered for sale under the tender to be undertaken in 1999, Merrill Lynch must gather and organize substantial information.

5. The attractiveness of at least some distribution enterprises would be enhanced if their rates of cash collection were increased.

Recommendations

1. For the upcoming privatization of further distribution assets, it may be useful to attempt to set a margin--a target rate--against which all bidders may bid. This would eliminate a major variable (and ground for disagreement) from the bidding process, leaving cash price, debt retirement, and proposed level of investment as the major variables for bidding. Hagler Bailly proposes to work with GNERC and Merrill Lynch in seeking to establish such rates ahead of time.

2. GNERC should continue with its long-term, cost-based rate proceedings. Hagler Bailly will continue to offer expert assistance in that regard.

3. The grouping of distribution assets appears to have been resolved by World Bank. In order to qualify for an Energy Sector Development Credit, GoG has agreed (among other conditions to be implemented by 11 February, 1999) to "offer for sale all remaining electricity distribution companies (consolidated in two packages)". Hagler Bailly will offer its assistance to Merrill Lynch and GoG in determining the allocation of assets to each of the two groups.

4. Much of the information gathering relating to distribution enterprises was accomplished during 1998. Hagler Bailly will offer its assistance in this regard to Merrill Lynch and GoG in connection with the next round of privatization.

5. As noted in the Commercialization Assessment dated January 1999, Hagler Bailly will prepare a business plan under which distribution managers may adopt all or any part of the successful commercialization pilot plan implemented at Rustavi, in an effort to increase collections.

3. Transmission and dispatch

Decree No. 437 provided that the "transmission/dispatch subsector of Sakenergo shall be transformed into a single, commercialized, financially autonomous state enterprise * * * not subject to privatization" for the foreseeable future. GoG apparently included the limitation on privatization for at least two reasons: first, the perception that no strategic investor would want to buy the transmission system; and second, the perception that the grid was important to national security. The transmission and dispatch assets are not part of the privatization process supervised by Merrill Lynch, and no reexamination of the privatization issue is currently scheduled.

In the summer of 1998, following orders of the Minister of Fuel and Energy, Sakenergo unbundled and separated its transmission and dispatch functions. These functions are now handled by two different enterprises.

Issues

1. Whether GoG's decision to exclude Sakenergo's transmission assets from privatization should be reexamined.

2. Whether GoG's decision to exclude Sakenergo's dispatch assets from privatization should be reexamined.

Recommendations

1. As discussed in the Restructuring Assessment prepared in December 1998, under the new market structure reflected in the market rules principles and the draft market rules, Sakenergo will be removed as the middleman in power sale and purchase transactions. It therefore appears that the principal problem that privatization of transmission assets would, in theory, address, will be resolved by other means. No other compelling reason currently appears to promote privatization of transmission assets. We recommend, however, that the issue be reexamined in late 1999 in light of the experience with the new wholesale electric market and privatization of other assets.

2. As transmission assets, no compelling reason currently appears to support privatization of the dispatch assets (more properly, the dispatch function, there being few dispatch assets with appreciable market value). We note, however, that dispatch will serve as an important component of the new wholesale market, and propose that Sakenergo's performance in this role be monitored. If its performance proves problematic, the privatization issue should be revisited. We note that in many markets, the dispatch function is one put up for bids by the market, and such a procedure might be appropriate for the Georgia wholesale market, depending on Sakenergo's performance. In time, putting dispatch up for bids might be advisable in any event, simply as the means for evaluating competing cost proposals. We recommend, therefore, that the dispatch privatization issue be revisited at six-month intervals.

4. Generation

Georgia's generation assets consist of 103 hydropower plants in a variety of sizes, the Gardabani thermal plant, consisting of ten units of varying sizes and states of operability, and three five-megawatt units at the Tbilisi Central Electric and Heating Plant.

The GoG has privatized 19 of Georgia's 103 hydro plants. These plants were sold between 1993 and 1995 as part of the government's overall business privatization program. The privatized plants range in size from one to 21 MW, with the majority in the one to two MW range. The largest hydro plant to be privatized was the Chitakhevi station in the Borjomi region of Georgia. The plant was built in 1949 and has an installed capacity of 21 MW. Chitakhevi is much larger than the average size of the other privatized plants, and it is not clear why it was included in the privatization list. The purchase price for Chitakhevi was reported to be in the US$200,000 to 300,000 range – around $12/kW. This is a low price for such an asset, but is within the range of the discounted cash flow value of the plant at the time, given the huge investment risks during the "Tbilisi War" period. This plant was recently re-sold to an Australian/American investment group for a price Hagler Bailly estimates to be in the US$2 to 3 million range.

GoG has leased another four plants, totaling some 200 MW, to private operators; these include the strategically important 130 MW Jinvali storage/peaking plant near Tbilisi, and the Ortachala and Zaghesi hydro plants located within the Tbilisi metropolitan area. The current leaseholders are operating under five-year lease arrangements granted in the 1993-1995 time period. It is not clear why only these plants were offered for operation by private leaseholders, but the leases are due to expire soon. Current leaseholders hope that their lease arrangements can be converted to outright sale agreements by way of privatization. The majority of new owners and lessees of these hydro plants are longtime power sector insiders and/or former directors of the plants.

Most of Georgia's generating capacity is under the control of Sakenergo Generatisia, the state holding company organization that will operate the capacity until it is privatized. The capacity is concentrated in one thermal station and one hydro plant. The Gardabani thermal plant with 10 units totaling 1 800 MW is a candidate for privatization although the deteriorated state of several of the older units makes it doubtful that a strategic investor would seek to buy the entire plant. Currently, about half of the nameplate capacity is operational in the form of 2 units (units 9 and 10) of 300 MW each and 3 units rated at roughly 120 MW each. The latter three groups are among the original 8 with design outputs of between 150 and 160 MW each. Preliminary civil works have been prepared for an eleventh unit rated at 300 MW and unofficial reports suggest that some private investors are interested in completing it as a combine cycle facility. Unofficial reports have also indicated investor interest in the existing 300 MW units.

Although the World Bank, EBRD and KfW have all lent sizeable sums for renovation work on units 9 and 10, significant further capital investment is still needed to bring these units up to modern standards of reliability and performance. This need makes strategic investor privatization essential. Unfortunately, there have also been unofficial reports in the Georgian press of proposals to privatize Gardabani through fuel brokerage groups such as ITERA or Anglo Oil. Under these proposals the buyer would make no initial payment for the plant, but would commit to provide a certain quantity of free electricity to the Georgian government annually for 15 or 20 years. Production above the output representing this payment would be sold on the Georgian and foreign markets with some of the proceeds being supposedly used to refurbish the station. Such a scheme would undoubtedly delay modernization of the plant and thus limit the contribution it could make to a reliable electricity supply for a number of years.

The Inguri storage hydro plant is the other large concentration of Georgian generating capacity. A five unit, 1300 MW facility located on the border of the secessionist province of Abkhazia, Inguri's design output is some 4000 GWh annually, but in recent years generation has been limited to less than 3 000 GWh because of problems with one of the 260 MW units and with certain control structures on the dam. Privatization of this facility is not planned for the foreseeable future due to the sensitive political and military circumstances of its location on the border of Abkhazia.

The remainder of Georgia's generating capacity is in 13 hydro stations totaling just over 1 000 MW of capacity. Six of those plants have reservoirs. All are candidates for privatization and all are in need of substantial renovation investment.

Issues

1. The current rates allowed to generators may not be enough to allow full cost-recovery, much less to allow financing of rehabilitation of the facilities, which in many cases is urgently needed.

2. The timing of distribution and generation assets privatization may present a cash collection issue. Generally, distribution assets should be privatized first; as the new owners improve their commercial operations, they pump the resulting cash into the system, which allows enough money for other sectors to be paid.

3. During the negotiations over the purchase of Telasi, AES stated a strong preference to secure generation resources to serve its distribution load by outright purchase, or by direct contract, or both. Under the Electricity Law, GNERC has the power to control cross-ownership of generation and distributions assets by the same licensee, and also the power to limit the total capacity dedicated to direct contracts. This issue is likely to surface again, as additional distribution assets are privatized.

4. A number of donor organizations have loaned money to GoG to finance rehabilitation or improvements of a number of hydropower projects in Georgia. These loans may limit GoG's freedom to privatize the projects.

5. In order to prepare and circulate an Information Memorandum (or Memoranda) for the generation enterprises to be offered for sale under the tender to be undertaken in 1999, Merrill Lynch must gather and organize substantial information in a short period of time.

Recommendations

1. Bidders for generation resources will probably propose their own rates in connection with privatization. In the meantime, however, GNERC should continue with its long-term, cost-based rate proceedings. It should also examine the possibility of setting rates in advance of privatization for all generation resources scheduled for sale, so that all bidders would bid against a single rate (rather than proposing individual rates). Such rates might include incentives for rehabilitation investments.

2. The timing issue appears to have been mooted by GoG's agreement with World Bank to offer all remaining distribution assets, and generation assets with a capacity over 15 MW, for sale.

3. GNERC should evaluate the cross-ownership and direct contract issues in advance of privatization. Its approval of such proposals in the context of privatization will require a balancing of interests.

4. GoG and Merrill Lynch should consult with donors to resolve any issues that might preclude privatization of relevant hydropower resources.

5. Hagler Bailly has already offered substantial documentation relating to generation to Merrill Lynch, and will continue to offer assistance.

Conclusion

Despite problems, experience gained by the Government of Georgia during the Telasi privatization will be invaluable to Merrill Lynch as it continues the privatization of remaining distribution and generation assets. With the Telasi privatization experience behind them, the GoG, Merrill Lynch, and Georgia's donors and technical assistance organizations should be able to cooperate more easily to achieve expanded power sector privatization.