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**RECENT DEVELOPMENTS IN THE
PRIVATIZATION OF THE ELECTRIC
AND NATURAL GAS SECTORS OF
GEORGIA**

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RECENT DEVELOPMENTS IN THE PRIVATIZATION OF THE ELECTRIC AND NATURAL GAS SECTORS OF GEORGIA

SUMMARY

This report provides an update on developments in the privatization of the electric and natural gas sectors of Georgia since the last report (April 2000) was issued.

Significant progress has already been made in the privatization of Georgia's power sector. Following the privatization of the first major component of the Georgian electric sector in January 1999, when AES Silk Road Holdings won the international tender and purchased 75% of the shares of Tbilisi distribution enterprise "Telasi," the Georgian Government offered two "clusters" of power companies for privatization. Cluster I included the Khrami I and Khrami II hydro plants, units 9 and 10 of the Gardabani Thermal Plant and the Relasi distribution company. An agreement was signed for purchase of the thermal units along with a 25-year right to manage the Khrami hydro plants. AES assumed control of Units 9 and 10 in April of this year. Agreement on the purchase of the Relasi distribution company has failed, partly due to investor concerns related to so-called "micronets" (i.e., parts of the distribution network that are not owned by the utility but are already in private ownership) and the unwillingness of the Government to transfer 35 kV and 110 kV lines serving large customers in the Rustavi area to Relasi.

Cluster II included the Rioni, Shaori, Gumati, Tkibuli and Lajanuri hydro plants (with a total capacity of 346 MW) and the Kutaisi distribution company (serving about 70,000 customers). The Government and the preferred bidder, a mainland Chinese enterprise, were unable to reach agreement; as a consequence, the Government decided to offer the Cluster II assets for competitive direct sale. An investor was identified and a draft agreement was developed; negotiations with the investor are currently under way.

In addition to these two Clusters, the Vartsikhe hydro plant (with a capacity of 184 MW) was offered to investors through an international tender for either a short-term management contract or 25-year concession.¹ A preferred bidder was identified but negotiation of the terms of the contract failed. Consequently the Government offered this asset for direct sale to a subsidiary of RWE, the German regional utility but after this effort failed the Government renewed

¹ It was left to the bidder to decide which approach was more desirable.

negotiations with the preferred bidder, Terna of Greece. Currently, the proposal is focused on a 3.5-year contract for the rehabilitation, operation and management of the cascade.

Also, the distribution enterprises serving the Kakheti region (eight companies in all) were sold to Georgian companies and the small Tbiltsi Combined Heat and Power Plant in Tbilisi was purchased by Sakgazi.

Other major initiatives underway at present include the offering of five-year management contracts for the electricity transmission, dispatch and wholesale market management functions.

In the natural gas sector, efforts continue to privatize Tbilgazi continue. The right to negotiate the sale of Tbilgazi was transferred from the Ministry of State Property Management to the Municipality of Tbilisi. Within the last month, proposals were received from AES and ITERA International for the privatization of Tbilgazi. The Municipality is now reviewing the proposals. There is also the possibility that additional proposals will be received from Agas of Italy and Sakgazi.

Cluster II

The Government offered Cluster II assets for competitive direct sale to a consortium of "SIIF Energies SA," "MECAMIDI SA" and the "GMT Group (Georgia). Participation of Electricite de France (EdF) has been claimed, but EdF's involvement seems unlikely. A draft purchase agreement was developed and negotiations are now underway.

The Cluster II assets offered for privatization include the distribution companies serving the areas of Zestaphoni, Senaki, Lanchkhuti, Chkorotsku, Samtredia, Tkibuli, Sachkhere, Chiatura, Poti, Ozurgeti, Chokhatauri, Vani, Terjola, Khoni, Tskaltubo, Bagdati, Abasha, Martvili and the generation enterprises of Lajanuri, Tkibuli, Shaori, the Gumati Cascade and the Rioni hydro plants. Through competitive direct sales, the Government offered 75% of the shares in each distribution company and a 100% stake in each of the generating enterprises.

The purchase price for the Clusters has initially been set at US \$19 million, with an additional \$3.5 million in debt to be assumed by the investor (this is debt owed by Rionhesi to the EBRD). Out of the total price, generation assets account for US \$17.1 million and distribution assets account for 10% of the total purchase price, or US \$1.9 million.

An installment arrangement was negotiated for purchasing the Cluster. The initial instalment is US \$4 million payable to the State upon the signing of the purchase agreement. The remaining instalments are based on a payment schedule with the actual payment amount being influenced by an Energy Market Ratio. Four additional payments are initially set at US \$2.5 million, \$3.5 million, \$4 million and \$5 million; the actual amount to be paid will be determined by applying the Energy Market Ratio² to the initial amount.

Additionally, the investor is required to make an investment commitment. According to the latest proposal, the investment commitment to be undertaken within five years after completion of the agreement is US\$ 28.5 million. This is an aggregate of investment commitment of US\$ 21.5 million in the generation companies and US\$ 7 million in the distribution companies; the total investment may rise to US\$94 million following the five-year period if further investment is warranted.

² The ratio of actual payments from the Georgian Wholesale Electricity Market to the price of produced power at prevailing generation tariffs for the supply period.

The latest investor proposal include the following additional conditions:

- The Georgian Wholesale Electricity Market shall purchase the entire volume of power offered by the generation companies;
- Cluster generation companies will be allowed to sell power by direct contract to the distribution utilities;
- The investor agrees that in case of bilateral purchases by the distribution utilities from the generation companies, the cost difference between the average wholesale market tariff and the tariff of the specific generation company will be accumulated and paid to the Georgian Wholesale Electricity Market after five years;
- The generation tariff shall equal US\$ 0.012 per kWh for the next five years;
- The distribution tariff will be the same as for Telasi;
- The VAT payable on energy sales shall be calculated based on actual payments received from consumers;
- All amounts due to the budget (regional, national, energy market) will be discounted from the purchase price.

As of the date of this report, the Georgian party does not agree with the proposal. Two problems for the Georgian Government include:

- The investor's proposed deferral of paying the cost difference between the bilateral contract price and wholesale market price to the Georgian Wholesale Electricity Market for five years; and,
- What appears to be an insufficient amount of proposed investments in the distribution companies.

Vartsikhe Cascade

The tender for the right to manage and operate the Vartsikhe cascade was conducted and the winning bidder, a Greek company called Terna, was selected. However, this bidder was later disqualified and the direct sale of the Vartsikhe cascade was considered. The President authorized the direct sale of the cascade to RWE Energy Trading Limited (RWE) by decree. The sale assumed investment, in two steps, of US \$48.9 million by RWE within a two-year period in the Georgian energy sector (not just Vartsikhe). This effort failed and the Government renewed negotiations with Terna. Currently, the proposal being discussed is to rehabilitate, operate and manage the cascade for 3.5 years.

The tariff level requested by Terna to operate and manage the facility is US\$ 0.007 per kWh, but Terna is also seeking payment guarantees. The rehabilitation plan forecasts a considerable increase in the cascade's output after rehabilitation but there is no assurance that this boost in output will in fact be realized. Thus, Terna is seeking some protections from the Government and this is the major reason for the delay in concluding the contract. While the management contract is not in place, KfW will not release its loan of 63.5 DM for rehabilitating the cascade.

Recently, another company included in the original Varzikhe shortlist, Lahmeyer International, expressed renewed interest in participating in the Varzikhe management contract.

Other Distribution

Georgia has made considerable progress in privatizing some of the distribution assets of the country. Telasi is the largest distribution company and accounts for almost half of the country's power consumption. However, at this stage privatization of Relasi has failed and it is uncertain if the Western Georgian distribution companies will be privatized; most of the remaining assets of the country have failed to attract foreign investments with the exception of the sale of eight distribution companies in the Kakheti region to a local company Takla Ltd. and the sale of the Marneuli distribution company to the Russian Electric Machinery Construction Corporation.

In order to make the remaining distribution companies more attractive to potential investors, the Ministry of Fuel and Energy is consolidating them into larger units. Thus, the distribution companies of the Adjara region were consolidated into a single company based on Presidential Decree # 177 (February 29, 2000) and consolidation of the Eastern Georgian distribution enterprises into two companies should be completed this year (although no timetable has yet been set). A Presidential Decree (# 232) to consolidate the Eastern Georgian companies was issued on March 17; a subsequent decree (# 561, June 5, 2000) revised the earlier decree and ordered the creation of two companies rather than one. Somewhat surprisingly, the latter decree also required two private companies (EnergyService Ltd. and Peri Ltd.) to be consolidated into one of the two state-owned distribution companies. The legal basis for requiring two private companies to be "folded in" with a newly created state owned company is very questionable.

Management Contracts

Five-year management contracts for the management of the Georgian Wholesale Electricity Market, Electrogadatsema and Electrodispatcherizatsia were developed, having been authorized by Presidential Decree #1488 (December 12, 1999). The use of management contracts received the endorsement of the multi/bilateral development banks active in Georgia as a way to improve the financial performance of the power sector. Separate contracts and contractors are expected for the wholesale market and the transmission/dispatch enterprises. Expressions of interest were received from 39 parties and the Government has prepared an initial "short-list."

Major effort was spent working with the various enterprises, the Georgian Wholesale Electricity Market and Ministries to develop the Request for Proposals (RFPs) for the management

contracts and to agree to the contractors' responsibilities, authorities and compensation. At present, the RFPs have been approved by the Government's Tender Committee and were submitted, along with the short-list, to the World Bank, EBRD and KfW for approval. It is likely that the World Bank will request the draft RFPs to be sent to potential bidders for comment before the RFPs are in fact finalized. Although it was anticipated that the management contractors could be in place by year-end, based on several delays in the review and approval process, it is more likely that the contracts will not be in place until March/April of 2001.

NATURAL GAS SECTOR PRIVATIZATION – CURRENT STATUS

The only privatization initiative underway in the natural gas sector currently is the sale of Tbilgazi. After the failure to privatize the company through a competitive tender, the Ministry of State Property Management made a decision to consider a direct negotiated sale of a 75% stake in the company. After significant lobbying, the Ministry forwarded a proposal with the conditions for a direct sale to ITERA International (ITERA), the supplier of gas from Russia widely believed to be an affiliate of RAO Gazprom. This proposal was ultimately rejected.

On May 15, Presidential decree # 450 transferred responsibility for the privatization of Tbilgazi from the Ministry of State Property Management to the Municipality of Tbilisi. In June, the Municipality received a proposal from AES for the purchase of 100% of the assets of Tbilgazi. AES offered an up front purchase price of US\$ 1.0 million and payment of the debt owed by Tbilgazi to ITERA over four years (50% up front and the remaining 50% over four years). AES also proposed a 12 year rehabilitation program at a cost of US \$300 million.

In early July, ITERA issued another proposal for the purchase of 75% of the shares of Tbilgazi. Although short on details, the ITERA proposal included a \$1.5 million up front contribution in natural gas, \$10.3 million in debt forgiveness, and a 10 year rehabilitation program at a cost of US \$200-250 million.

At this time, most of the Municipal officials tend to view the ITERA proposal more favorably for several reasons: 1) the ITERA proposal is for 75% of shares rather than 100% of the assets; 2) the rehabilitation program amount is more in line with what the Municipality and Tbilgazi specialists feel is justified; the AES \$300 million program is considered excessive; 3) ITERA would likely take possession earlier than AES, a particular benefit from the perspective of the Municipality given that the Municipality is required to meet from its budget, any shortfalls in payments to the gas supplier (ITERA)

The Municipality is continuing its review of both proposals. It is possible that other proposals may be received from both Agas of Italy and Sakgazi later this month. At this time, it appears likely that the Municipality will seek "best and final offers" due on the same day from both AES and ITERA (and any subsequent bidder) to select its preferred bidder for negotiations.

CONCLUSION

Since the last version of this report was issued (April 2000), the Government made additional progress on privatization. The Cluster I privatization made some progress; AES assumed control of Gardabani units 9 and 10. Similarly, there is now more movement on the Cluster II privatization than was seen late last year. Progress was also made on the proposed management contracts and their implementation is likely, although some opposition still poses a threat.

In the gas sector, the sale of Tbilgazi has become increasingly promising as bids were received from both AES and ITERA International (and further bids are in fact possible). In the near-term (i.e., the next six months), it is likely that the privatization of Tbilgazi will make considerable progress.

In summary, overall, the Government of Georgia has made good progress on privatization, especially with the successful privatization of Telasi and Gardabani units 9 and 10. Assuming the privatization of Cluster II is completed, the Government will have completed the privatization of most of the distribution and generation sectors. If the management contracts for transmission, dispatch and wholesale market management are successfully concluded, the Government will be far ahead among the nations of the Newly Independent States in the extent of private sector participation throughout the electric sector. This result would permit the country's economy to benefit significantly from the market reform and restoration of the power sector, arguably the most critical sector underpinning the country's overall economic

Appendix

Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Generation					
Martkofi		Local Investor	1993-94	Sale	100%
Dashbashi		Local Investor	1993-94	Sale	100%
Satskhenisi		Local Investor	1993-94	Sale	100%
Kabali		Local Investor	1993-94	Sale	100%
Abhesi		Local Investor	1993-94	Sale	100%
Misaktsieli		Local Investor	1993-94	Sale	100%
Bjuja		Local Investor	1993-94	Sale	100%
Alazani		Local Investor	1993-94	Sale	100%
Chkhorhesi		Local Investor	1993-94	Sale	100%
Sioni		Local Investor	1993-94	Sale	100%
Tetrikhevi		Local Investor	1993-94	Sale	100%
Chitakhevi		Local Investor	1993-94	Sale	100%
Kakhareti		Local Investor	1993-94	Sale	100%
Machakhelahesi		Local Investor	1993-94	Sale	100%
Skuri		Local Investor	1993-94	Sale	100%
Ritseula		Local Investor	1993-94	Sale	100%
Khertvisi		Local Investor	1993-94	Sale	100%

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Tiriponi		Local Investor	1993-94	Sale	100%
Kurzu		Local Investor	1993-94	Sale	100%
Dmanisi		Local Investor	1993-94	Sale	100%
Igoeti		Local Investor	1993-94	Sale	100%
Shida Kartli		Local Investor	1993-94	Sale	100%
Achihesi		Local Investor	1993-94	Sale	100%
Kinkisha		Local Investor	1993-94	Sale	100%
Mashavera		Local Investor	1993-94	Sale	100%
Sanalia		Local Investor	1993-94	Sale	100%
"Tetsi" (Combined Heat and Power)		Sakgazi	1999	Sale	100%
Tkibuli	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	Right of Management	100%
Gumati	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	Right of Management	100%
Rioni	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	Right of Management	100%
Lajanuri	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	Right of Management	100%
Shaori	Cluster II	"SIIF Energies SA" "MECAMIDI SA"	Pending	Right of Management	100%

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
		GMT Group & EDF			
Khrami 2	Cluster I	AES Corporation	December 23, 1999	Right of Management	100%
Khrami 1	Cluster I	AES Corporation	December 23, 1999	Right of Management	100%
Gardabani TP (Units 9&10)	Cluster I	AES Corporation	January, 2000	Right of Management	100%
Vartsikhe		RWE	Pending	Sale	100%
Enguri and Vardnili	-	-	-	-	-
Zahesi	-	-	-	-	-
Jinvali	-	-	-	-	-
Atsehi	-	-	-	-	-
Dzamahesi	-	-	-	-	-
Arbohesi	-	-	-	-	-
Intsobahehi	-	-	-	-	-
Khazbegihesi	-	-	-	-	-
Zvaretihesi	-	-	-	-	-
Kekhvihesi	-	-	-	-	-
Distribution					
AES "Telasi"		AES	January 1, 1999	Sale	75%

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Adjara Distribution Company					
West Georgia Region					
Ozurgeti	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Lanchkhuti	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Chokhatauri	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Chkhorotsku	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Senaki	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Poti	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Abasha	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Khobi Martvili	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Mestia					
Kutaisi	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Tskaltubo	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Tkibuli	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Vani	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Bagdati	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Khoni	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Samtredia	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%
Zestaphoni	Cluster II	"SIIF Energies SA" "MECAMIDI SA" GMT Group & EDF	Pending	sale	75%

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Terdjola	Cluster II	“SIIF Energies SA” “MECAMIDI SA” GMT Group & EDF	Pending	sale	75%
Chiatura	Cluster II	“SIIF Energies SA” “MECAMIDI SA” GMT Group & EDF	Pending	sale	75%
Sachkhere	Cluster II	“SIIF Energies SA” “MECAMIDI SA” GMT Group & EDF	Pending	sale	75%
Zugdidi	-	-	-	-	-
Tsalendjikha	-	-	-	-	-
Khragauli	-	-	-	-	-
Ambrolauri	-	-	-	-	-
Oni	-	-	-	-	-
Tsageri	-	-	-	-	-
Lentekhi	-	-	-	-	-
Meskheti	-	-	-	-	-
Akhalsikhe	-	-	-	-	-
Borjomi	-	-	-	-	-
Akhalkalaki	-	-	-	-	-
Aspindza	-	-	-	-	-
Ninotsminda	-	-	-	-	-
Adigeni	-	-	-	-	-
Vale	-	-	-	-	-

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Abastumani	-	-	-	-	-
Shida Kartli Region					
Gori	-	-	-	-	-
Khashuri	-	-	-	-	-
Kareli	-	-	-	-	-
Kaspi	-	-	-	-	-
Mtskheta	-	-	-	-	-
Dusheti	-	-	-	-	-
Tianeti	-	-	-	-	-
Kazbegi	-	-	-	-	-
Akhalgori	-	-	-	-	-
Kvemo Kartli Region					
Rustavi "Relasi"	Cluster I	AES Corporation	Failed	Sale	75%
Rustavi "Rustavmsheni"	-	-	-	-	-
Gardabani	-	-	-	-	-
Marneuli	-	Energy Machinery Corporation (Russia)	1999	sale	75%
Bolnisi	-	-	-	-	-
Tetritskaro	-	-	-	-	-
Manglisi	-	-	-	-	-
Tsalka	-	-	-	-	-
Dmanisi	-	-	-	-	-

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Company	Offer Unit	Privatized By	Date	Sale/Lease/ Concession/ Management Contract	Ownership
Kakheti Region					
Gurdjaani		"Takla" (Georgian Company)	1999	Sale	75%
Signagi		"Takla"	1999	Sale	75%
Sagarejo		"Takla"	1999	Sale	75%
Lagodekhi		"Takla"	1999	Sale	75%
Dedoplis-Tskaro		"Takla"	1999	Sale	75%
Telavi		"Takla"	1999	Sale	75%
Akhmeta		"Takla"	1999	Sale	75%
Kvareli		"Takla"	1999	Sale	75%
Transmission					
"Electrogadatsema"				MC	
Dispatch					
"Electrodispatcherizatsia"				MC	