



ADVISORY ASSISTANCE TO THE MINISTRY OF ENERGY OF GEORGIA

WHITE PAPER: “ENERGY SECTOR PRIVATIZATION IN GEORGIA”

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WHITE PAPER: ENERGY SECTOR PRIVATIZATION IN GEORGIA¹

Executive Summary

The Government of Georgia has stated their intent to privatize significant energy sector assets within the next year. This note assesses alternative forms of sale or transfer, what results might be expected from each, and the relative merits of these actions. The White Paper concentrates on possible sale of UDC, but also note other pertinent transactions as examples or for context.

The Government appears to be very cautious about conduct of an open tender for privatization of UDC. One reason is their apparent belief that open tender may not assure a desired class of buyer, and in particular can not assure an ultimate taker. They seem to view their choice as to sell through a nominally transparent process but whose outcome may be in any event forecasted in advance because it is difficult to assure no subsequent transfer occurs, or to transfer without an open tender, but to thus more deliberately select the ultimate taker and the actual terms of purchase.

The Government may also be under pressure from fuel supply creditors, and from fuel suppliers by way of price negotiations. The matter becomes even more precarious, if Armenia is able to secure gas supplies through routes that do not require use of the Georgian North-South pipeline. In that event, loss to Georgia of transit revenues and in-kind payments may make it difficult or impossible to continue to operate that pipeline simply for Georgian uses.

These conditions appear to have led Georgia to seek alternative international partners. The Protocol signed between Ministry of Energy of Georgia and of the Ministry of Energy and Mineral Resources of Kazakstan exemplifies that effort, though other discussions with other Governments may also be taking place. Thus an important alternative may be expanded international negotiations, with additional parties. Any such agreement would need to assure that the beneficiary is the State of Georgia or its people, not particular private parties. (A more detailed analysis of the Kazak Protocol from the viewpoint of United States interests is given as Annex 6.)

A conservative analysis of present conditions in Georgia properly argues that a sale to a desirable buyer via tender may be difficult. This is compounded by the relatively unstructured Georgian Law on Privatization of State Property, which has few requirements, and offers an unserious appearance to foreign investors accustomed to more deliberate treatment of major asset sales.

However, with suitable additional considerations sale, through a properly structured open tender, may be possible. One important tool may be a restructure of debt in a manner that

¹ White Paper on Privatization Issues, prepared for USAID by their contractor for Advisory Assistance to the Ministry of Energy, CORE International, by their Chief of Party Paul Ballonoff. The opinions in this document are only those of the author.

substantially improves the balance sheet of the company and thus improves its prospects of a quality buyer. A mechanism to support this may be for the United States to assist to structure a "Brady Bond" type refinancing, but making the Bond, or the security purchased by the State of Georgia to support it, callable if improper subsequent share transfer occurs. In assisting to achieve that the United States might also seek to include enforceable restrictions on subsequent transfers of shares, offers of IFI supporting instruments, or involving other Governments in other forms of direct participation.

It has been suggested that the assets of UDC together with the right to operate, might be separated from the remaining balance sheet and sold separately, as a means to "resolve" the debts. This mechanism may be feasible in Georgian practice, but would only be attractive to a buyer who believed such device in fact shielded the assets from subsequent suit; a difficult belief to sustain. Also, this device does not resolve the issue of avoiding subsequent undesirable transfer. Thus, while it changes the form of risks that must be balanced, it does not substantially change the problems that must be resolved, and thus, does not increase the chance of successful sale at open tender.

Alternatively, transfer of operating companies as a result of proper international agreement seems a feasible mechanism. The outcome of this form of transfer could probably only be affected by the United States if it becomes a party to such agreement, and actively seeks mechanisms (such as noted above) to assure the form of ownership, and to avoid subsequent undesirable transfer. Also, if the Government of Georgia has decided to use other proper means than a tender, then it would also be best to simply openly recognize that is the case; use of the vocabulary of transparent tender in that event simply adds confusion and false expectations.

A related course may be to induce an agreement by the Government of Georgia to not tender or otherwise transfer the UDC to other owners for some period, by use of similar mechanisms as discussed above, by use of extended management contract, and/or by use of MCC grants. USAID or other donor assistance for privatization of UDC may be more readily available if the Government also took sufficient time to better prepare, and clearly agreed on an open transparent process to an international standard. A final option is to not participate in the process of UDC privatization.

In summary, the Government of Georgia seems intent to privatize, by some means, the UDC and thus relieve itself of a financial burden. It seems apparent that ready takers exist, in the form of existing fuel creditors, fuel suppliers, allied companies and perhaps others. To allow the Government of Georgia to use open international tender may require assurances that such tender will result in a desirable buyer. Such assurance may be very difficult to achieve. Thus, if the United States wishes to affect the outcome, it may be necessary to engage directly in some form of intergovernmental agreement. The object of that agreement may be to offer conditioned assistance such as MCC grants; continued support of the management contract; properly conditioned assistance in the UDC privatization tender; advice in debt restructure that materially improves the balance sheet of the company being sold, coupled to enforceable restrictions on subsequent transfer of shares; and perhaps other devices.

1. Background

1.1 The potential privatization sales of existing power sector operating companies announced by the Ministry of Economic Development include the power distribution companies UDC and Adjara, and six medium sized hydro power plants². Impliedly the Khaketi power distribution company, if it is bought by UDC following bankruptcy procedures, would be sold with or at the same time as any sale of UDC. The Tbiligaz natural gas distribution company is currently in bankruptcy and thus impliedly available for disposition at discretion of the Government of Georgia. The major GGIC “North-South” gas transmission pipeline has apparently only avoided transfer to Gazprom based on agreement of the Georgian Government to temporarily not make such sale, pending grants by MCC for rehabilitation of that line. The Ministry of Energy is discussing “tender” to private or foreign capital sources of the right to construct and operate the proposed Khudoni Hydro Power Plant (Khudoni HPP), and the South Georgia 500 kv transmission line. It is widely believed and probably true that Russian companies, such as Gazprom and RAO UES have active interest in purchasing all or most of those assets, and very likely have the financial capability to do so. It is known that Kazak governmental and quasi-governmental interests may have interest in acquiring some of the principal assets listed above. Other governments or Government owned operating companies including Chinese) may also be interested.

2. Options for Form of Transaction

2.1 The options for form of transaction are wider than simply whether to hold an open tender (asset sale). There seem to be at least eight options:

- (1) Open tender for competitive bids from qualified buyers is the normally expected choice for privatization of existing government owned operating companies, which might be sold as a business unit, or their assets sold. To date, the Government of Georgia, via a posting on the Ministry of Economy web site, and via the Energy Policy prepared by the Ministry of Energy, adopted by the Government but not yet submitted to Parliament, implies that this course will be followed in privatization of UDC, Adjara, and the selected hydro power plants. (See Annex 1 for summary of Georgian requirements for tenders of privatization sale of state property under the Law on Privatization of State Property. Compared to processes normally expected for major assets sales, that the law gives an appearance of lack of serious intent. If the only procedure applied is the minimal requirement of that Law, that fact alone will discourage many desirable participants.)
- (2) Direct agreements for sales of assets following “simplified” versions of the tender processes. The unspecific language used by officials to describe the processes of paragraph (1) above leave open that the political announcement of an intent to conduct a sale may be treated as a “call for expressions of interest”, though not meeting any international understanding of that term, based on which direct

² The listed plants are: Rioni HES, Kaskad Dumas HES, Ladzhanuri HES, Dzevruli HES, Shaori HES and AchES.

- negotiations may take place leading to a sale of assets. This path could be applied to any of the assets, including, to UDC, Adjara, and the hydro plants.
- (3) Transparent tenders of sale might be conducted for the right to do business when state assets are implied in effecting that right, but when no transfers of state assets takes place. For example, the Khudoni or South Georgia projects appear to require use of assets or rights currently owned by the state, or under state control, which rights could then be sold or leased.
 - (4) Given the conditions of debts of most of energy sector operating companies, those might have their assets transferred and/or the entire company transferred to new owners, using bankruptcy procedures. This may involve an “auction” but under far less stringent and very different qualifications than an open tender for sale. Thus this could apply to UDC, Adjara, possibly the hydro power plants, and appears to be the instrument of choice for Tbilgaz (which is not a national government owned company).
 - (5) Some transactions could be construed as a tender for the Government to purchase services, and are thus not a “privatization” nor asset sale at all. This could be applied especially to the Khudoni or the South Georgia transmission line projects. (See Annex 2 for summary of the provisions of Georgian Law for the tender for purchase of good or services by the Government of Georgia).
 - (6) Transactions can be construed as a sale of an abstract right to conduct business; in effect, they amount to simply a decision of whether to issue a license to operate. This is also an option especially for the Khudoni or the South Georgia transmission line projects.
 - (7) Some transactions could be conducted as if entirely by private companies with no government involvement, or with involvement limited only to contractual actions of a government owned operating company. For example, the CC unit purchase appears to have been effected by contracts for provision of services by or purchases from, government owned companies. The transaction is structured as a private JSC leasing space at a facility owned by a government company, and selling to another Government company, UDC.
 - (8) Finally, actions may be construed as a transaction in fulfillment of an international agreement, in which assets are transferred to meet contractual conditions. Any of the assets listed in paragraph 1.1 could conceivably be transferred in this form.

2.2 This note will use the term “tender” to refer to any of the above processes (1) through (7). When clarity as to which specific process is intended, it will be noted explicitly. Option (8) is analyzed separately.

2.3 Separation of a company into its operating assets plus right to operate, from the remainder of its balance sheet, is a technique sometimes used in post-Soviet countries for resolution of bankruptcies. The practical results are a potentially viable operating company with no debts, and what is essentially a collections agency for the receivables of the prior company, to pay against the payables. Assuming this action can in fact remove all legal claims of creditors against assets of the former company, then the result is a “clean slate” for the operating company. Though a peculiar seeming way to reach it, that result is also the primary purpose of bankruptcy laws in western countries. The willingness to believe that all claims have in fact been thus settled or avoided, would probably weigh strongly in the due diligence of any potential investor at sale. If believed, such separation of assets

could enhance salability. However, the possible renewal of prior claims implies that if the intent is a true transparent privatization, then debt restructure by more traditional means, so that legal risks are assessable, and that only realistic and commercially viable debt remains, is the better course, and likely more acceptable to western buyers.

2.4 Recent changes in Georgian license law remove the requirement for a supply license to sell natural gas at retail. This does not necessarily remove the supply function from a gas distribution company, but does imply that the company is in some degree, possibly in full, only a distribution transport provider. If one assumes this is accompanied by suitable devices and systems for billing and metering, and proper contractual means for assuring that only sellers of supply have risks for losses, the practical effect on the gas company is to significantly reduce its working capital requirements, reduce its exposure to future debt accumulation through losses or non-payments for supply, and thus reduce its overall financial risk. The resulting distribution company would thus have much lower gross billings, but also much lower risk, and thus probably be financially more viable. The principal issue left open by that policy is how the public interest (meaning especially interest of smaller customers who can not easily contract for their own supply) can be protected. The change in Georgian license law that removes the ability of the regulator to set license terms, and thus to regulate important features of behavior in the public interest, will make it difficult to assure that result. On balance, however, Tbiligaz is probably a more viable company as a pure distributor than as a seller of supply.

2.5 An implication of the previous paragraph, is that if similar retail sales policies were applied to UDC, the same result may occur. UDC without the large financial risk of supply may be a more financially viable company. But achieving that result would be complex, and is contrary to the direction currently assumed for the power market: creation of direct contracts for generation to a transmission and supply company serving most customers at retail. Achieving a retail open access policy also involves entities other than UDC, such as, restructured operations of the power market operator GWEM. It also requires billing and metering systems, regulations related to technical and commercial losses, and operational and contract devices to assure system reliability. The existing billing and metering systems would certainly not sustain an open retail market for supply. Given the apparent haste for transfer of UDC the Government of Georgia probably will not wish to take the required time to properly implement retail open access, nor understand the subtleties of effecting it properly.

2.6 Expectation regarding transparent tenders is low. Many recent Georgian privatizations, both in and out of the energy sector, have been heavily criticized for their outcomes and often challenged in court. The experience of the Georgian government in the sale and eventual fate of the Telasi power distribution company does not increase the trust of responsible officials in the reliability of "transparent" processes to produce stable or expected results. The current efforts of the Government to acquire and install new CC generation units at the Gardabani generating station has apparently caused the Government to believe they have found a viable alternative model for conducting sales, finding financing, and acquiring management for new projects.

2.7 Lack of trust by the Government for transparent tender is accompanied by actions of the Government that remove transparency in other areas where it nominally exists.

Georgian law creates a National Energy Regulatory Commission (GNERC) which must act procedurally under the Administrative Law of Georgia. Taken together these laws appear as if an independent regulator with transparent process exists in Georgia. Assessments by international advisors find few technical flaws in those laws. However, practical observation shows that the regulator is not independent, and was never independent. An example demonstrating this is at Annex 4B, paragraph 5, at which the Prime Minister in April 2005 gave an instruction, nominally to the Ministers of Finance and of Energy, that the GNERC “should be instructed” to suspend actions required by law in relation to a particular tariff, unless a further instruction is given. But neither Ministry has any such power to “instruct” the GNERC. At present there are draft laws in preparation which might affect the structure or the powers of the GNERC, in diverse ways. Whether any might pass or their final content is not presently known. However, even if revision to law compromises some part of the “perfect” legal structure in current law, it is unlikely that fact would materially change the due diligence assessment: an environment in which rule of law is not fully established. An exception to this conclusion regarding change in law may be if an actually passed law clearly assigns tariff decisional authority to a political body, such as the Cabinet. Such provision would make the political risk assessment greater, eliminate decisional independence of the regulator, and remove transparency as normally understood, but paradoxically, would also more clearly state where the actual exercise of authority lies.

3. Possible Results of Privatization Sales

3.1 Options 2.1 versions (1) through (7) are for transparent open tender of a company (that is for the purchase of the shares of a company), or for its assets including presumably the right to do business using those assets. Until now, the Government of Georgia and especially the Ministry of Energy, have discussed that “international tender” is the intended form of transfer for UDC, Adjara and certain hydropower plants. Questions related to this form of transaction include whether it will be conducted as a tender at all, whether any buyers will appear, whether those buyers are likely to be desirable ones, expectations for events post-sale, and whether any actions can be taken to affect the choices made by the GoG and/or the outcomes of those actions.

3.2 The Ministry of Energy appears to have two principal questions concerning whether a fully transparent tender of UDC should be conducted. These are: (1) would any desirable buyer appear, and (2) if such buyer purchased, could their continued presence be assured. In the AES Telasi sale for example, the initial buyer appeared to have been a desirable buyer, but within a short number of years sold the Company, to a buyer (RAO UES) who may not have qualified for and did not participate in the initial sale, who for obvious geopolitical reasons was not the first desired operator, and in which the transfer of shares may have violated a term in the original Share Purchase Agreement prohibiting transfer of the shares for a restricted time which had not expired at time of sale. If the Government agreed to that transfer, such agreement is a non-public document. Thus, the necessity to assure both questions (1) and (2) have positive answers may be and probably is, a pre-requisite for the conduct of an open tender for UDC.

3.3 Definition of success of sale has three parts: that a sale (or other desired transfer) is made at all, that the buyer or taker has sufficient resources and management capability to

properly operate and develop the company, and that adequate guarantees are in place to assure the public interest. If the company meeting those criteria were also RAO or Gazprom or a subsidiary of one of them, that creates an expanded regional energy monopoly, which for obvious public policy reasons is not desirable

3.4 Achieving the desired buyer will be difficult, but may not be impossible. The experience of western companies investing in foreign power sector operations including in Georgia over the last decade has caused most to withdraw from the market, or exercise greater caution. Often privatization advisors suggest that a company must be free of debt, have collections near “normal” levels to find buyers, and have a new cost compensatory tariff in place prior to sale. At present UDC has extensive unrestructured debt, collection rates in the perhaps 60% to 70% range, and a non-cost compensatory tariff. On that classical analysis, it is very unlikely to find a desired buyer.

3.5 However the classical analysis arises from the need by privatization advisors, for professional and liability reasons, to exercise great caution in advice. It thus does not reflect a necessary inability to make a sale under less than perfect conditions. Companies in all parts of the world are sold regularly with debts in place. Buyers evaluate the structure of that debt, and discount their expected purchase price accordingly. Thus, if a sufficient restructure of a significant part, but not all, debt were carried out, sale may be possible, though at a lower price. Second, any potential buyer in this environment will be looking toward future expectations, as much or more than present or past condition. The recent strong increases in collection rates imply further improvements are possible. Third, provided there is trust in the tariff process (which may require a more transparent process than so far attempted in Georgia), sales have been made without prior adjustment of the tariff. Also, as happens as well in many western contexts prior to a deregulation, “costs” may be overstated, and/or inefficiently incurred, while the role of competent management in improving services with relatively low capital costs, and the effect of increased collections on net income, are underestimated. Also, buyers can be induced to participate in developing country conditions by use of various IFI instruments, including shared investment (minority positions by an IFI), partial risk guarantee insurance, government guarantees in enforceable contracts or against bonds, or other devices. The geopolitical condition of Georgia which causes much of the risk, also makes possible many of these kinds of subsidy mechanisms. Thus, the Government can also help create conditions for successful sale. Successful sales have taken place under conditions similar to those in Georgia, when the buyer was also able to gain from some (and not usually all) of the combined factors just listed. This implies that Georgia can be advised that a successful sale in this sense may be possible, and if suitable buyers not produced, the sale withdrawn prior to bid date

3.6. A draft law on resolving the debts of energy companies in Georgia is in process. The terms of that law are not yet known. If one assumes that the law results in a commercially sensible restructure of debts, then that clearly increases the viability of the operating companies, whether for sale or other transfer. Three alternatives to such law exist. (1) if the company is placed in bankruptcy a directed transfer of the assets and operating rights is the likely result, with separation of debts. The likely transfer of the company through bankruptcy would have fewer assurances of transparency than a proper open tender, but may be little different than the other options if no tender is intended. (2) debts may still be

restructured through some other mechanism, such as, as a result of international agreement. This would have the result otherwise here discussed for that option. (3) the existing moratorium law on debt actions against principal energy companies might be extended beyond January of 2006, thus postponing resolution of the issues.

3.7 The Georgian Government may want assurance that post-sale, the buyer will remain for a sustained period. There is a large demonstrated risk from Georgian and other post-Soviet country experience, that shortly post-privatization, the shares will be transferred to an undesired buyer, or, that the pre-screening process could not avoid the undesired buyer. Because the AES-Telasi Share Purchase Agreement contained a clause assuring this, but which was not enforceable (or easily avoided), simply including such clause in a future Share Purchase Agreement will probably not induce agreement to tender. Other contract devices, such as requiring a large bond posted by the buyer for a substantial time, or imposing large financial penalties should an early transfer occur, may act to substantially reduce the pool of desired buyers. Therefore, one key to assuring a tender, or indeed, any sale to a desired buyer, is to find some form of assurance that no early subsequent transfer will occur. Some concepts for doing this are addressed in the discussion of policy instruments below.

3.8 Many of the devices listed in Paragraph 2.1, other than (1) of transparent tender, exist because experience with tenders has not avoided undesired buyers, thus, have not served the purpose for which an open tender is designed. Therefore, the Government of Georgia may be devising techniques which allow more direct control on the outcome of the transaction. This of course could also occur for less transparent reasons, such as corruption, which we thus note but do not need to further evaluate here. The desire to avoid that outcome is assumed.

4. Policy Instruments to Affect Results of Sale

4.1 The US Government, because it is a government and not simply a development agency, has available diverse instruments it might use to seek to affect the results of a transfer of assets, and especially, of the transfer of ownership of the UDC. These are discussed in the paragraphs below, and include: technical assistance including through USAID or TDA, grants such as through MCC or other direct monetary assistance (discussed in this Paragraph 4), and executive actions including participation in international negotiations for various purposes (discussed in Paragraph 5). Note that similar forms of TA to those noted in Part 4, that might not be offered in the case of a tender believed to be not open, might however be offered when the process is a direct intergovernmental transfer subject to a proper international agreement.

4.2 Technical assistance from USAID or TDA is often used to assist developing country tenders. When the transaction is one that could result in business opportunities for American business, then TDA may conduct a definitional mission and choose to support a feasibility study or similar task. The first step has already occurred in Georgia relative to the Khudoni HPP and South Georgia transmission line projects. A TDA definitional mission recommended full feasibility studies, but TDA decided the costs were too great and declined to fund those studies. Thus, that action is not available as a tool in those transactions to assure transparency in any subsequent tender.

4.3 USAID technical assistance in tenders of any of the types (1) through (7) of Paragraph 2.1, typically is a package of certain services, with certain procedural requirements. Procedurally, any such assistance requires that the eventual action by the local government be taken under some international standard of transparency, which may be at least the legal standard of the host country, but might also be the standard of an IFI, TDA or other development organization if their assistance or capital resources are also involved. A difficulty in Georgia has been to obtain clarity from the Government about which specific legal processes will be followed in event of tender of UDC. In the case of the CC unit purchases, which appear to have been an example of tender method (7) of paragraph 2.1, it is not known what if any specific legal tender rules were applied. In that case, it may be that the transaction was treated as a wholly private action, to which the Government was merely an incidental but helpful bystander. When such clarity is lacking, then USAID and its contractors such as CORE International, will (and in that case did) decline to assist the transaction. If clarity of process can not be obtained for the tender of UDC, then declining to assist is probably also the necessary conclusion.

4.4 When USAID (or TDA) has assurances of sufficient transparency, then technical assistance (TA) can be offered. These typically take two forms. One, to offer on how to structure and conduct the transaction. Such advice may be on how to set tender prequalification requirements to assure buyers of the proper quality. Paragraph 3 above concluded that criteria for prescreening of buyers (or ultimate takers) for tenders of energy sector assets in Georgia involve geopolitical considerations that are at least, very difficult to assure by normal forms of pre-screening criteria. Therefore, the Government of Georgia, or at least the Ministry of Energy, may conclude that normal processes of “transparent” tender assure neither a transparent result, nor desired forms of buyers. Since the Government or the Ministry appear to have already thoroughly considered such issues, provision of that form of TA to further refine them is not likely to be regarded by the Government of Georgia as a significant additional benefit.

4.5. The second form of TA often offered by USAID is in preparation of the technical materials required to support a transaction. This can include preparation of accounts, presale technical descriptions (including the “information memorandum” when the tender is a sale), valuations, contracts, and so on. These services can be provided as “purely technical” services when the form of transaction is already agreed, and/or when independent advisors are hired for services such as those included in paragraph 4.4 above. That is, offering “pure TA” of this type presumes agreement on the purposes of the process. In the event of a tender (transaction types (1) through (7) of paragraph 2.1) that agreement is reached by defining the form of transparency used, and also by defining TA as described in paragraph 4.4. Therefore as well, if the purposes of the process are instead agreed through mechanism (8), in support of a proper intergovernmental agreement, then USAID might be able to provide this form of TA, even when the process is not an open tender.

4.6. TA of type 4.4 is often included in the services of a private commercial bank as “Investment Bank” (IB). In that case, the IB pays for services such as in 4.5 from its own accounts, and is in turn compensated as a percentage of the proceeds of the sale. When sales are of smaller companies or those believed difficult to sell at prices adequate to

compensate the IB, then a donor such as USAID may provide technical TA as summarized in this paragraph 4.5, to reduce the costs of the IB. This allows the developing country government conducting the tender to then engage an IB to assist to find properly qualified buyers, which IB which is compensated by normal means. By reducing the IB costs, it is assumed they then receive a “normal profit” despite a lower price, and will find qualified buyers in the normal manner. This kind of TA has often been provided by USAID or IFI’s.

4.7 Donor provision of “pure TA” discussed in 4.4 in conditions of Paragraph 4.6 therefore assumes that an IB, if used, will find suitable buyers. However, the skepticism of the Government of Georgia on open tenders for sale, discussed in Paragraph 3 results from the sale of Telasi, where despite the presence of a qualified IB and prohibitions on subsequent transfer of shares, the ultimate result was that the final taker was not the kind of company intended by the IB screening process. In other examples, IB’s knowing that a sale was likely difficult, have followed the incentive to profit from a quick sale to any buyer, to create less than the desired quality of buyer. Since the Government of Georgia has observed these difficulties in other sales from this form of private IB combined with donor-funded TA, the offer of this package is not likely to induce them to undertake an open tender.

4.8 The facts summarized in 4.7 also imply that if USAID has decided to offer TA to a tender, and IB services are required to locate potential buyers, then those services should not be provided by independent commercial means. Instead, to avoid improper incentives on the provider of IB services, USAID should include them in the contracted TA. In that case, the IB has no reason to seek unqualified buyers simply to assure a sale. Doing this assumes that some IB would be willing to work under contract conditions typical of USAID.

4.9 Direct assistance such as grants via MCC or specific projects otherwise funded by appropriations have been used, when there is agreement on the purposes of the grant and the conditions under which it may be used. The example of MCC assistance to the rehabilitation of the North-South pipeline in Georgia demonstrates that the Government of Georgia does respond to such monetary incentives and may at least defer tendering actions as a result. The principal difficulty of this form of action, as also demonstrated by that example, is assuring the permanence of the result (essentially the same problem as assuring an ultimate taker from a tender). A second difficulty is that the relative costs are higher. As well, because the resources required depend on direct appropriations and therefore a more cumbersome process, the unpredictable outcome and timing of that process may not lend itself to affect a practical decision by the Government of Georgia.

5. Direct Involvement in Intergovernmental Agreements

5.1 The above arguments imply that some form of direct intergovernmental agreement (beyond the MOU normal to provision of USAID assistance) may be considered. The simplest form of this is a bi-lateral agreement. An example of this noted in Paragraph 4.9 is to use conditionalities on MCC grants. The principal advantage to that option is that the mechanism exists and has had some demonstrated success on a related form of transaction (deferring the pipeline sale). The principal limitations of this form of action are its relative cost, its relative times for execution, and the limits on intended purposes of MCC funding. To use MCC funds the motivation needs to be defensible within the statute

of that body. If however the purposes are essentially geopolitical, MCC may be a more difficult instrument to use.

5.2 Another form of direct involvement may be through multilateral agreements. An example may be multilateral treaties, such as the Energy Charter Treaty. However, there does not seem to be an extant treaty or similar document whose provisions would be effective in this instance.

5.3 The remaining form of multilateral agreement would be direct negotiations with affected governments. The willingness of the Government of Georgia to engage in intergovernmental agreements for this kind of purpose is demonstrated by the August 1 2005 Protocol signed between Ministries of the Governments of Georgia and of Kazakstan, attached as Annex 3. A detailed analysis of that document and its relationship to possible United States interests is given as Annex 6.

5.4 Summarizing briefly, the Protocol offers Georgia a ten year supply of 2 bcm annually of natural gas (and an implied favorable price which we believe may be similar to the existing price of near \$60/bcm). In return, Georgia will assist Kazakstan to open certain transit routes, and will consider assuring Kazak ownership of certain important Georgian energy operating assets. Those assets most specifically include Tbilgaz, potentially include UDC and other extant operating companies, and may include Kazak participation in the Khudoni HPP and South Georgia transmission projects. Because the Protocol is signed by two Ministers (one from each government) it may be taken as a serious statement of intent, though because it has not (to our knowledge) been adopted by the Parliaments of either government, it is not in the status of a treaty nor enforceable contract. None the less, the strength of the intent expressed is evidenced by the terms of the subsequent September 30 2005 working meeting Protocol (also included in Annex 3). The immediately subsequent actions in early October of the Georgian Tax authority to put Tbilgaz into bankruptcy, with accompanying press reports that Tbilgaz will/may be transferred to the Kazaks, as also discussed in the September 30 Protocol, tends to support that the Protocol is more than a simple statement of possible intent.

5.5 Two of the apparent purposes of the Protocol seem to also meet United States geopolitical purposes: that the result may help assure greater independence of Georgia from Russian company control, and that it may tend to open regional markets. This last purpose is sought by the United States both because it is simply good economics, but also because one effect is to reinforce the first: assuring greater Georgian political independence by offering greater ranges of critical economic choices. Under such analysis, the Protocol may therefore pose an opportunity for United States participation in that or a similar intergovernmental agreement.

5.6 The Protocol references two entities to which the Protocol states the respective Governments will issue certain "instructions". The instructions to be issued are to study certain possibilities listed in the Protocol. One of those is KazRosGaz, a subsidiary of two major oil and gas companies. Majority ownership appears to be in the wholly Kazak government owned company KasMunaiGaz. Minority ownership appears to be with GazProm, of at least 25%. KazRosGaz appears to be a marketing company for supplies produced by both owners.

5.7 The second entity named in the Protocol is a Georgian JSC called Energy Invest. Energy Invest seems to be the same company that will purchase and operate the CC generation units at the Gardabani station in Georgia. (For a description of that relationship see Annex 4). The purpose for mention of these two entities may be because Energy Invest is or would become an identified customer for the gas exported by KazRosGas. However, the mention of a private company at all is problematic. It would seem better that if the intent of the Protocol is to benefit Georgia, or Georgian consumers, that a generic statement should be made (such as that all Georgian consumers may be able to purchase gas supplies at the same price agreed upon in implementation of the Protocol, not only to benefit a particular private company).

5.8. The remainder of the Protocol speaks generally of “Kazak capital”, and does not discuss any named companies as investors or buyers of Georgian operations. From this, one may infer that actual investing parties are not yet identified, but do not include the private Georgian JSC Energy Invest.. If so, then that fact is one of the issues, perhaps one of the principal issues, which may become subject to United States participation. The United States might seek that any “Kazak capital” be wholly Kazak (such as, KazMunaiGa, not KazRosGas). If the intent of the Protocol is to specifically benefit private companies as consumers, such as Energy Invest, then that would preclude United States involvement in the agreement, or be a matter to revise in a later agreement. For example, if the purpose were to similarly benefit all Georgian consumers, not a specific named company, then the Protocol might be revised to clearly reflect that intent.

5.9 Paragraph 2.1 (8) above lists transfer of assets as condition of agreement between governments, as an alternative to any form of tender. The presumption of that paragraph is that if the assets or entities (operating companies) involved are all only objects owned and controlled by Governments, that it might be that intergovernmental transfers of such assets not require an open tender. In such agreement, then the United States might participate as a party, seeking to affect the terms, by offering additional or related considerations. For example, the United States might seek to assure that the Kazak company participating as taker of any operating companies, be wholly Kazak owned. For example, the taker of Tbilgaz might be requested instead to be the wholly Kazak KazMunaiGaz. The United States might also seek that the shares also contain a restriction on form of subsequent transfers.

5.10 Another mode of participation may be to seek to involve additional parties, whose Government owned companies might participate as well. For example, the Government of Norway might be interested for similar commercial reasons as the Kazaks, with somewhat similar resources to offer, and with better knowledge of hydropower development. Chinese (Peking) government owned operating companies have recently visited Georgia to explore especially the South Georgia transmission line and Khudoni projects. Other governments may have similar interest in participating in such agreement. Turkey for example, may be interested in the provisions affecting regional transit, and is engaged in a newly established working group for assessing technical issues related to eventual construction of the portion of the South Georgia line connecting to the Turkish grid.

5.11. The option of participation using capabilities of the MCC are noted above.

5.12 Indirect assistance in negotiating restructure of the UDC debt, and perhaps other power or energy sector debts, may also be a useful tool. While the United States thus would not (and as a matter of practical politics, could not) act as payor for any such debts, several debt-related tools may exist. Assume that the result is some form of bond of which UDC is the, or a, debtor. As a condition of any indirect assistance, the United States might seek that such bond become immediately payable if shares of UDC are transferred to certain kinds of parties. If the bond mechanism is a form of Brady Bond (see Annex 5 for description of the mechanism) then the payor might be the UDC, the guarantor the Government of Georgia, and the bond backed by a security bought by the Government of Georgia from the US Treasury, presumably under favorable terms to Georgia. In that case the United States might also place a condition of forfeiture on that security if inappropriate share transfer of UDC takes place. Other options for form of indirect assistance or for other conditionalities may also exist.

5.13 Mechanisms discussed in Paragraph 5.12 might also be used in support of and to seek to induce an open tender, by improving the quality of the instruments in the balance sheet of the entity being sold, and thus enhancing the prospects of finding a desirable buyer.

ANNEX 1: REQUIREMENTS FOR TENDERS FOR PRIVATIZATION SALES OF STATE PROPERTY

Below are selected principal parts of the Law on Privatization of State Property. The law allows a high degree of discretion on the form of sale, and has relatively few requirements on process of sale. The law offers four forms, but does not state what if any requirements must be met for a particular form to be selected, not require that major assets, such as large industries, must follow some more detailed standard than minor assets, such as a local baker. The one month minimum notice prior to sale date does not allow serious buyers sufficient time to conduct a suitable review of a major asset. Compared to similar law and processes in other jurisdictions, the relatively undefined nature of this law as to major assets offers a source of confusion to potential participants. A sale for a major asset would more often have more comprehensive regulation of the tender process, with much more detailed disclosure, notice periods, possible requirements for qualifications on potential purchasers, specifications of review procedures, and other detail. Thus, if a sale is conducted in Georgia that strictly followed Georgian law, but no more than the minimally required procedures, many external observers would find the process lacking, despite that it meets local legal standards.

Article 6. Forms of the State Property Privatization

1. Privatization shall be carried through competitive bidding, auction, lease-redemption or purchase of property through direct sale methods.
2. The purpose of sale through the competitive bidding is to transfer the ownership right to the Buyer, who bids the best terms to the seller.
3. The purpose of sale by auction is to transfer the ownership right to the Buyer, who offers the best price in the bidding process.
4. The aim of privatization through the lease-redemption process is to provide The opportunity to independently manage economic and other activities, and Before the redemption of the leased property to transfer the long-term paid Possession and use right of the territorial value
5. The purpose of direct sale is to attract investments proceeding from the peculiarities of the property for sale based on proposed business plan.
6. The Ministry of Economy, Industry and Trade of Georgia or its territorial unit makes a decision on the form of privatization, while the President of Georgia decides on the matter of the direct sale.
7. Regulations on the forms of the state property privatization shall be approved by the Minister of Economy, Industry and Trade of Georgia in compliance with legislation in

force.(28.03.2003 #2032)

Article 7. Determination of Initial Price of the Property to be Privatized and Payment Rules

1. Rules of determination of the initial price of the property shall be approved by the President of Georgia.
2. In case of privatization of state property through competitive bidding, auction and lease-redemption, the sale price of the property is established on the competitive basis.

...

Article 9. Information on Property to be Privatized

1. Information on state property privatization through a tender, auction, lease-buy out or direct sale shall be published in an official publication of the Ministry of Economic Development of Georgia, publications widely disseminated in Georgia and local press (if the privatization is carried out by a regional division of the Ministry of Economic Development of Georgia). Besides, the information shall be announced on TV and placed on the web page of the Ministry. Other means of information dissemination are also allowed.
2. Information on the form (through the competitive bidding, auction, lease-redemption, direct sale) of privatization of state property shall be published at least one month prior to the established date of privatization.
3. Information that shall be announced on the web page of the Ministry of Economic Development of Georgia and disseminated through other publications shall include the land area, characteristics of the buildings and structures located there, address of the privatization asset and privatization conditions. The Ministry of Economic Development of Georgia shall provide the Buyer with all the information regarding the privatization assets; Information disseminated by means of TV shall include the name of privatization assets and starting and final dates for receiving applications.

ANNEX 2: REQUIREMENTS FOR STATE PROCUREMENT UNDER GEORGIAN LEGISLATION

State procurement in Georgia is regulated by the Law of Georgia on ‘**State Procurement**’ and the Order of the Chairman of the Georgian State Procurement Agency (GSPA) on ‘**State Procurement Rules**’.

General

Under these regulations there are several ways through which state procurement may be implemented. These include:

- a) Open Tender;
- b) Close Tender;
- c) Price Quotation Method;
- d) Negotiating with one Person.
- e) Procurement of Intellectual Services;

a) Open Tender

Open Tender should be held when estimate cost of procurement exceeds 70 000 GEL; in case of construction when the cost exceeds 230 000 GEL (**Article 7, Paragraph 1**).

b) Close Tender

Close tender should be held when estimate price of purchase doesn't exceeds 70 000 GEL, but exceeds 25 000 GEL, though in case of construction work doesn't exceeds 230 000 GEL, but exceeds 120 000 GEL (**Article 7, Paragraph 2**).

c) Price Quotation Method

Price Quotation Method should be used when estimate cost of purchase exceeds 10 000 GEL but does not exceed 25 000 GEL; in case of construction work exceeds 50 000 GEL but does not exceed 120 000 GEL (**Article 3, Sub-Paragraph 'h'**).

d) Negotiating with one person

Negotiation with one person may be held in one of the following cases, when:

1. estimate price of purchase does not exceed 10 000 GEL; in case of construction work does not exceed 50 000 GEL (**Article 22, Paragraph 1, Sub-Paragraph 'a'**);
2. delivery of goods or fulfillment of task or provision of services is an exclusive right of one Person (**Article 22, Paragraph 1, Sub-Paragraph 'b'**);
3. there is a *force majeure* situation which necessitates implementation of immediate procurement (**Article 22, Paragraph 1, Sub-Paragraph 'c'**);
4. in order to avoid loss of quality of recently procured goods, fulfilled task or provided service, or to provide proper exploitation of recently delivered goods, fulfilled task or provided service, it is necessary to make additional procurement (if needed) of goods or service from the same supplier (except the case when the price of additional procurement exceeds the recent procurement price) (**Article 22, Paragraph 1, Sub-Paragraph 'd'**).

e) Special Type of Procurement of Intellectual Services

This type of procurement involves procurement of scientific or other type of consulting services. (**Article 3, Sub-Paragraph 'i'**)

SELECTION OF THE METHOD

Since the subject of transactions will be construction works (installing gas turbines, constructing 'Khudoni' HPP or/and 500 Kv. transmission line 'Enguri-Axaltsikhe-Gardabani') estimate cost for these actions clearly exceeds 230 000 GEL and terms of cases b, c, d(1), d(2), d(4) and e are inadequate for the existing situation, only options 'a' (Open Tender) and 'd.b' (negotiation with one person due to *force majeure*) are considered for assessment.

Open Tender

There are a set of rules which apply to the conduct of open tender and which guarantee substantial time consumption if this process is involved in procurement. Such procedures particularly involve following steps:

- a) Creation of a Tender Commission (**Article 8**);
- b) Announcement regarding beginning of the tender process should be made in a newspaper "24 saati" ('24 Hours') (**Article 9, Paragraph 1, Sub-Paragraph 'a' and order on 'State Procurement Rules', Article 8, Paragraph 2, Sub-Paragraph 'a'**);
- c) If procurement price exceeds 600 000 GEL, though in case of construction work exceeds 8 000 000 GEL, announcement should be made (**Article 9, Paragraph 1, Sub-Paragraph 'b'**):
 - b.1.) in a newspaper "24 saati" ('24 Hours');
 - b.2.) in a foreign language accepted in international trade relations;
 - b.3) in particularized editions, which are widespread worldwide;
 - b.4) to foreign diplomatic and consulate representatives.
- c) Announcements must be made 15 days prior to receiving applications from suppliers(**Article 9, Paragraph 6**);
- d) Preliminary selection of applicants must be finished not earlier than 10 days from the deadline for receipt of the applications (**Article 11, Paragraph 2**).
- e) There are several specific rules applying to the announcement and mandatory composition of a procurement contract which further slow down the tender process.

Negotiation with One Person

Negotiating with one person due to *force majeure* circumstances can be a procedure for state procurement implemented with circumvention of several formal procedures. In such case procurement involves quite a simple procedure:

- a) Decision for implementation of this kind of procurement should be submitted to GSPA (**order on 'State Procurement Rules', Article 26, Paragraph 1, Sub-Paragraph 'c'**);
- b) Results of the procurement must be reported within ten days to the GSPA (**Article 24, Paragraph 3, Sub-Paragraph 'b'**);

- c) The text of the signed contract on state procurement should be announced in “24 saati” (‘24 Hours’) within 30 days after signing a contract (***order on ‘State Procurement Rules’, Article 26, Paragraph 3***).

ANNEX 3: KAZAK PROTOCOL**PROTOCOL****Follow-up of the Meeting between the Minister of Energy and Mineral Resources of Kazakhstan and the Minister of Energy of Georgia on Cooperation in Oil and Gas Sector****Astana****August 1, 2005**

Based on the Decision of the President of Kazakhstan and the President of Georgia, declared during official meetings in March-April 2005 in Astana regarding giving a priority to the cooperation in the Energy sector and special importance of deliveries of Kazakhstan gas to Georgia, also agreements reached by the representatives of JSC “KazMunaiGas” and JSC “KazRosGas” (Kazakhstan) and JSC “International Gas Corporation (Georgia),

The Parties agreed on the following:

1. The Ministry of Economy and Mineral Resources of Kazakhstan and the Ministry of Energy of Georgia will support cooperation between the authorized economic entities in order to supply Kazakhstan gas to Georgia.

The Parties will instruct JSC “KazRosGas” (Kazakhstan), JSC “International Gas Corporation (Georgia) and JSC “Energy Invest” to study the possibility and commercial issues of Kazakhstan gas deliveries to Georgia from January 1, 2006.

2. The Ministry of Economy and Mineral Resources of Kazakhstan and the Ministry of Energy of Georgia will continue cooperation in the energy sector and review the possibility of:
 - participation of Kazakhstan companies in the privatization of the energy sector assets in Georgia;
 - possible participation of Kazakhstan capital in the construction of generation facilities in Georgia – hydropower plants (Khudoni HPP), thermal power plants (gas turbines), also Tbilisi Thermal Power Plant units;
 - study of possible participation of Kazakhstan companies in the formation and operation of the infrastructure for transit of Kazakhstan oil and oil products across the Georgian territory;
 - formation of joint ventures and mutual participation in the management of energy sector companies in order to support the investment climate in the relations between the two countries.

Minister of Energy and Mineral Resources of Kazakhstan	Minister of Energy of Georgia
V. Shkolnik	N. Gilauri

ANNEX 3, CONTINUED: SEPTEMBER 30 2005 WORKING BODY MEETING

Draft

Protocol

First Meeting of Inter-Governmental Committee for
Economic Cooperation between the Republic of Kazakhstan and Georgia

Tbilisi

September 30, 2005

First Meeting of Inter-Governmental Committee for Economic Cooperation between the Republic of Kazakhstan and Georgia was held in Tbilisi on September 29-30, 2005.

Members of the Committee from Georgian and Kazak parties participated in the Meeting, employees of the Ministries and other Governmental agencies were invited to participate in the Meeting of the Committee's Meeting. The list of the participants of attached (Annex 1).

The Meeting was chaired by:

U. Chogovadze – Minister of Economic Development of Georgia, Co-Chairman of the Georgian side.

A. Mamin – Minister of Transport and Communications of the republic of Kazakhstan, Co-Chairman of the Kazak side.

1. Approval of the agenda of the meeting

Parties agreed on the Agenda of the Meeting (Annex 2)

2. Cooperation in Energy Sector

Having expressed satisfaction with the status of cooperation of Georgia and Republic of Kazakhstan in the sphere of energy resources the Parties agreed emphasized the importance of mutual efforts for continuing and expanding mutually beneficial cooperation of the two sides, Parties also agreed to promote cooperation between the related agencies and organizations of the two countries in transportation and marketing of oil and gas.

Parties agreed to:

2.1 Instruct the related ministries and agencies of the Parties to provide completion of the long-term agreement on delivery of Kazak gas to Georgia as of January 1, 2006 with the 10-years term by 2 m² billion gas per year;

- 2.2 Instruct the related ministries and agencies of the Parties by end of 2005 develop the issue of purchasing the assets of Tbilisi gas distribution system – JS “Tbilgasi” and the related infrastructure by Kazak legal entities.
- 2.3. Kazak Party proved the possibility of participation in the privatization process of Georgian energy enterprises – UDC and six hydro power plants, as well as Vartsikhe HPP Cascade, which are now under State ownership.
- 2.4. Instruct the related ministries and agencies of the Parties to elaborate the issue of possible access of Kazak oil to available capacities of Baku-Supsa Oil Pipeline, by determining technical and commercial conditions of transporting Kazak oil to this direction.
- 2.5. Continue cooperation in implementation of the Project of Energy Corridor “East – West”, which will ensure transportation of Kazak oil by route: Aktau –Baku – Tbilisi – Ceihan.
- 2.6. Instruct the relevant ministries and institutions to work out and review possible participation of Kazakstan capital in the construction and rehabilitation of power generation facilities in Georgia: Khudoni HPP, new gas turbines, also rehabilitation of the Tbilisi Thermal Power Plant units, and to inform the Governments of the countries on the decisions and proposals before December 31, 2005;
- 2.7. The Georgian Party proposed to study possible participation of Kazakstan capital in the construction of the high voltage transmission line interconnecting the Georgian and Turkish power systems.

ANNEX 4: JSC ENERGY INVEST DOCUMENTS:**4A: CONTRACT WITH GOVERNMENT OF GEORGIA AND UDC****Memorandum
On Cooperation in the Field of Electric Energy**

Tbilisi

April, 2005

Georgian State, represented by its Government, represented by Prime-Minister Mr. Zurab Nogaideli, JSC "Energy Invest", represented by its General Director Mr. Genadi Malazonia and JSC "United Energy Distribution Company of Georgia", represented by its General Director Mr. Dean S. White, by signing this Memorandum, have agreed on the following:

1. JSC "Energy Invest" shall undertake an obligation to:
 - 1.1. With own and/or attracted funds ensure on the territory of Georgia, until the end of 2006, construction and putting into operation of power plant (hereinafter the "plant") operating at gas turbines of up to approximately 300 MW capacity, with a possibility of their transformation to combined cycle. It shall ensure construction and putting into operation of up to 100 MW capacity until the end of 2005;
 - 1.2. Supply electricity, generated by plant indicated in paragraph 1.1. of this Memorandum, in amount of approximately 1.500.000.000 (one milliard five hundred million) kWh per year, including at least 100MW capacity during until the end of 2005, to JSC "United Energy Distribution Company of Georgia", on the basis of Contract concluded with it;
 - 1.3. Within 90 days from signing this Memorandum submit to JSC "United Energy Distribution Company of Georgia" draft Preliminary Contract on electricity supply indicated in paragraph 1.2. of this Memorandum.
2. JSC "United Energy Distribution Company of Georgia" shall undertake an obligation to: within 2 (two) weeks from submission of draft Preliminary Contract indicated in paragraph 1.3. of this Memorandum, with observance of this Memorandum and provisions of the legislation, conclude a Preliminary Contract on electricity supply with JSC "Energy Invest" if electricity tariffs, supply schedule and other terms and conditions provided in the draft are acceptable for it.
3. Georgian State shall undertake an obligation to:
 - 3.1. Within the term of this Memorandum, annually at the time of final formation of draft State budget of Georgia, take into consideration in the allocations of Ministry of Energy of Georgia relevant financial resources for subsidizing full compensation of difference between electricity cost to be compensated and actually compensated by JSC "United Energy Distribution Company of Georgia" to JSC "Energy Invest" (if such difference exists) within the framework of Contract on electricity purchasing between JSC "United Energy Distribution

Company of Georgia” and JSC “Energy Invest” concluded on the basis of this Memorandum.

- 3.2. Carry out subsidizing provided by allocations defined in paragraph 3.1. of this Memorandum each month, within 5 (five) banking days from submission of documentation, prescribed by effective legislation, by JSC “Energy Invest” to Ministry of Energy of Georgia and provide JSC “United Energy Distribution Company of Georgia” with relevant information on this matter;
- 3.3. Within the term of this Memorandum not to submit for approval to Parliament of Georgia draft Georgian State budget or draft on making changes to State Budget without taking into consideration in the allocations of Ministry of Energy of Georgia subsidy indicated in paragraph 3.1. of this Memorandum;
- 3.4. Privatize (or dispose in any other form) shares or assets of JSC “United Energy Distribution Company of Georgia” only under condition that purchaser of the shares (assets) fulfills obligations defined by Contract indicated in Article 2 of this Memorandum within a remaining term of the Contract indicated in the same Article;
- 3.5. Within its competence, until conclusion of the Contract defined by Article 2 of this Memorandum, promote conclusion of Contracts, necessary for providing plants to be built by JSC “Energy Invest” with natural gas, between JSC “Energy Invest” and relevant subject;
- 3.6. Ensure allocation of appropriate land for implementation of the project provided by this Memorandum.

4. The parties agree that:

- 4.1 This memorandum will in force for the period of power purchase agreement between JSC “United Energy Distribution Company of Georgia” and JSC “Energy Invest” or any other agreement within this Memorandum but no later than implementation of activities considered in clause 4.1 or until full reimbursement of the conducted capital investments necessary for building a station by JSC “Energy Invest”;
- 4.2 The tariff application necessary for JSC “Energy Invest” to present to the Georgian National Energy Regulatory Commission (GNERC), for estimating the electricity sales tariff for the power that is generated on the station, needs the preliminary consent of the Government of Georgia and JSC “United Energy Distribution Company of Georgia”;
- 4.3 The subsidy, considered in clause 3.2 of this Memorandum does not create any financial liabilities of the JSC “United Energy Distribution Company of Georgia” towards the GoG or any third parties in the amount of this subsidy. Moreover, default of the GoG on the obligations provided in Article 3.2 of this Memorandum will not provide the “Energy” with rights for any kind of demand from the JSC “United Energy Distribution Company of Georgia”.
5. Upon approval of this Memorandum by the Government of Georgia and JSC “Energy Invest” and signing it by the parties within the 30 days after conclusion of the agreement considered in Article 2 the agreement will be concluded where the responsibilities of the parties will be described in detail for the implementation of the responsibilities considered in this Memorandum as well as the procedures for the dispute settlement, taking into account the following: any dispute including issues

connected to its operation, validity or termination of its operation, reimbursement of harm, including the non-received income, is transferred for study and is finally decided through arbitration according to Georgian Legislation based on the rules of London Court of International Arbitration (LCIA) that are incorporated in this Article. The place for arbitrary review is London, England. The arbitration will be conducted by 3 (three) judges.

6. The Government of Georgia expresses the readiness, in the scope of the authority described by the active Legislation, to secure the timely issuance of the necessary licenses or any other public permits necessary for the implementation of the project.
7. The parties express the full readiness and will, in accordance with the legislation, to conduct all the necessary activities for implementation of the project and fulfillment of this Memorandum.
8. This Memorandum is operated in accordance with Georgian legislation. The issues that are not considered in this Memorandum will be regulated in accordance with the Georgian legislation.
9. The Memorandum is outlined in Georgia in 3 (three) copies. All three copies have the same legal power and are stored by the parties.

In the name of the Government of Georgia

Zurab Noghaideli

In the Name of JSC "Energy Service"

G. Malazonia

In the Name of JSC "United Energy
Distribution Company of Georgia"

D. White

ANNEX 4: JSC ENERGY INVEST RELATED DOCUMENTS:**4B: DECREE CREATING CONDITIONS FOR THE CONTRACT****Decree of the Government of Georgia**

#162 April 29, 2005 Tbilisi

On urgent arrangements regarding construction by the end of the year 2006 of the 300 MW combined cycle gas turbine thermal power plant

In order to improve electricity supply in the country using construction till the end of the year 2006 and accelerating process of putting into operation the 300 MW combined cycle gas turbine thermal power plant and also, to ensure its proper operation:

1. Memorandum "On Cooperation in the Field of Electric Energy" between Government of Georgia, JSC "Energy Invest" and JSC "United Energy Distribution Company" shall be approved.
2. In order to reimburse difference, if any, between payable and actually paid cost of electricity by the JSC "United Energy Distribution Company" to the JSC "Energy Invest", in the framework of the electricity purchase contract between JSC "United Energy Distribution Company" and JSC "Energy Invest", for the effectiveness of the Memorandum the Ministry of Finance of Georgia shall on yearly basis and according to the memorandum allocate corresponding financial resources within appropriations assigned for the Ministry of Energy of Georgia in the process of final creation of the draft state budget of Georgia.
3. The Ministry of Energy of Georgia shall provide the subsidy, using appropriations defined in paragraph 3.1 of the Memorandum, on monthly basis within 5 (five) banking days after JSC "Energy Invest" will present to the Ministry of Energy of Georgia necessary documentation in compliance with active legislation. JSC "United Energy Distribution Company" shall be provided by the Ministry of Energy with corresponding information on abovementioned issues.
4. Respective bodies shall allocate building lot for construction of thermal power plant referred in this Decree.
5. Georgian National Energy Regulatory Commission should be requested to review tariff application presented by JSC "Energy Invest" according to the rules set by legislation only in case of prior consent of the Government of Georgia and JSC "United Energy Distribution Company".
6. Supervision for fulfillment of this Decree shall be provided by the Minister of Finance V. Chechelashvili and the Minister of Energy N. Gilauri.
7. This decree shall become effective as of the date of its signing.

Prime Minister

Zurab Noghaideli

ANNEX 5: BRADY BOND CONCEPT SUMMARY³

“Brady Bond” is the name of a financial device used to resolve severe debt problems of certain countries in the 1980’s. The situations were in some important ways parallel to that of the energy sector in Georgia. Thus, a similar device might help resolve the problem here. About 15 nations eventually used Brady Bonds, each with its own variation on the pattern based on the specific facts of the country and the interests being negotiated. The Brady Bonds of at least 6 countries are still trading (see web references at the end of this note).

The typical condition which a Brady Bond resolved was as follows. Many commercial loans had been made to diverse borrowers in a country, by foreign commercial banks, usually denominated in dollars. As a result of domestic policy of the Government, perhaps funding their budget by inflation instead of taxation, the currency suffered severe devaluation. This left the private commercial borrowers in the country unable to pay their debt in dollars. Even if the creditors had wished to foreclose on the debtors and take or sell their assets there were simply insufficient assets to cover the debts. And, with the concurrent currency crisis, the national Government also quickly risked insolvency. Thus it was necessary to restructure the debts in some credible form, while also making the government solvent and its own bond ratings acceptable.

This is not an exact parallel to the condition of Georgian energy sector, but many of the elements are present: large current debts, insufficient security to cover them in foreclosure, it is highly improbable to sell the companies in their financial condition, and there is belief that government policies had to some large degree caused the problem.

The Brady Bond resolved these situations. The following are typical elements of the restructure leading to issue of a Brady Bond. The creditors together with the Government and the debtors, agreed to write down the face amounts of the debts, to some fraction of their original value; say, 50%. Second, it was agreed that these debts, whatever their original terms or current status, would be repaid over a fixed longer term, say 15 or 20 years, at some agreed manageable interest rate and principal repayment schedule. Third, the bonds became Government instruments; that is, while payments might be made on them by the original debtors, the instrument called the “Brady Bond” traded as a Government issued security. The original creditors then received these Brady Bonds, as full payment of and in proportion to their original claims, and were free to trade them on ordinary bond markets.

The payments of the Brady Bond were secured by three concurrent devices. First, the creditors made payments against the renegotiated amounts due as agreed in the restructure. Second, the Government guaranteed those payments. But, third, the subtle part: as assurance of those payments, the Government also purchased a security which was deposited in escrow, assuring payment. Typically that security was a zero-coupon bond issued by the US treasury, for the specific purpose, and purchased by the local

³ This note was initially created by Paul Ballonoff, Chief of Party for CORE International, on Request of Minister of Energy Nika Gilauri.

Government. Thus, rather than the local Government itself paying on the bonds (thus making them a current obligation from their budget) the Government bought an asset, the zero coupon bond, and pledged that as assurance of payment of the tradable Brady Bonds. Thus, if at term of the zero coupon bond, there was no default, the local Government received its asset, the full value of the zero coupon bond at its term.

Lets put this into a package. Assume the original debt were \$200, which was written down to \$100, then spread over a payment term of 20 years at x interest rate. Thus the terms of the Brady Bond are to pay \$100 over 20 years at x percent. This is a Government of Georgia bond that trades on the normal securities markets. Assume that this Brady Bond says the Government of Georgia will secure the full face amount of that Bond with an escrow deposit of a zero coupon bond. The purchase price for a zero coupon bond that pays \$100 at term, in 20 years, as say 7 percent is about \$25. Thus, using this device, the Government of Georgia eliminates \$200 of current debt of enterprises, but pays nothing to the creditors; instead, the Government of Georgia actually buys an asset, the zero coupon security, whose full value is paid to the Government of Georgia at its term, if the conditions of payment on the Brady Bond are met. Also, no foreign government pay the loans from its budget either; the zero coupon security was actually a loan from the Government of Georgia to that of the issuing central bank (say, the US Treasury).

Clearly, part of this structure was the willingness of the US Treasury to issue (sell) the zero coupon security on sufficiently favorable terms. To achieve this, since part of the cause of the crisis was typically government over spending, the US Treasury, or whatever was the issuer, sought "conditionalities" typically on fiscal or policy changes by the local Government.

In the case of Georgia, the underlying repayment of the bond would probably be by the soon to be privatized distribution company(ies). Then very probably, the conditions that would be sought to issue (sell) the zero coupon security would be assurances on the process of tender or other transfer of assets, and quality of eventual buyer, and perhaps others. When necessary in other countries, legal devices (new laws) were used to give incentives to both creditors and debtors to negotiate in the fixed term allowed to complete the restructure.

The above outlines the general structure. In each situation all of the parameters of the above structure would be subject to negotiation in the process of creating the Brady Bonds. As well, in Georgia, the willingness of a major Central Bank, such as the United States Treasury, to issue the zero coupon securities, (and the conditionalities sought in that process) would probably be a very strong factor in securing the confidence of credible buyers for the companies being privatized.

See also for example:

Brady Bond Definition: http://www.investorwords.com/567/Brady_bond.html

Brady Bond Primer: <http://www.emgmkts.com/research/bradydef.htm>

Some Current Trading Prices: <http://www.emgmkts.com/pricing/latinbradys.htm>

ANNEX 6: ANALYSIS OF KAZAK PROTOCOL

The Kazak Protocol at Annex 3 appears to be more than simply a statement of "possible " intent. It is closer to a contract, since the actions listed enable the purchase of Kazak gas (at prices not stated) for up to 2 BCM a year for 10 years, and since actions listed, including transfer of ownership of the Tbilgaz company, appear to be underway. Depending of course on price, the promised gas supply can be a considerable benefit to Georgia.

What could the United States and/or USAID do with/about it this Protocol?

(1) The current course is to seek transparent process for any privatization of UDC and for any support to carry out the Khudoni and 500 KV line projects. Since they have gone so far as to sign these agreements, it is clear they do not intent transparent transactions in the "open bid" sense for any of those activities. Thus seeking transparency on principle of itself may prove only frustrating. The opposite approach is to:

(2) Treat the document as a status summary of a negotiation in process, and seek to participate in that negotiation in a way that advances US interests. To do that requires knowing (a) what are the US interests you may seek to advance; and (b) what practical tools exist to advance them in this context. I speculate on (a) and analyze (b):

2 (a) The US interests are:

2 (a) (i) to preserve to the maximum extent possible the economic freedom of action of Georgia, and thus its relative geopolitical independence;

2 (a) (ii) to achieve (i) if possible in a way that assures Georgia is integrated into the general international political and financial community in a form that strengthens the state of Georgia as an economic and political entity;

2 (a) (iii) to assure the financial integrity of the operating companies so they can serve Georgian economic development, as a general objective of USAID policies;

2 (a) (iv) to implement the general US and USAID policies of regional integration of markets, which also supports objective (i)

2 (b) The tools available include these:

2 (b) (i) It is unlikely that the US would participate in direct financial involvement in a non-transparent tender. But, the US could as an act of policy, participate in international negotiations, in which two of the parties are engaged for economic purposes.

2 (b) (ii) the strongest tool in such negotiations would likely be some substantial economic involvement; but given restraints on transparency of tenders, that involvement could only be something does as an act of executive powers normal to support of international transactions.

2 (b) (iii) The biggest area that seems ripe for such involvement, would be the Georgian energy debts. The constraint to use only executive powers means that no budget funds could be used. However, executive powers of the Treasury could be used

2 (b) (iv) Thus, (iii) implies, among other possible options, that some form of "Brady Body" instrument could be attempted, in which the US sells the underlying security, and in doing so engages directly into negotiations on the structure of the company that would secure payments (presumably the privatized operating companies as creditors);

2 (b) (v) since the ultimate guarantor of the Brady Bond would be the GoG, engaging this form of action thus contributes to Goal (a) (ii) since the resulting GoG Brandy Bonds would become negotiable instruments, state Bonds of Georgia, that trade commercially

2 (b) (vi) As this would be a negotiation, the US could require to include in it multilateral agreements that assure the development of regional energy markets - this fact should appeal both to the Kazak side, since part of their motivation seems to be access to markets outside of Georgia; and this would satisfy US Objective (a) (iv)

2 (b) (vii) in the process, try to remove the Service Invest entity from the transactions, unless they are the objective winner of some form of transparent tender. The reasoning is simple: Governments can negotiate for mutual national interests, but private entities should not receive personal benefits from that except by transparent tender. Service Invest is a private entity, hence has no place in these negotiations nor as any named beneficiary.

2 (b) (viii) Upon agreement such as above, then USAID could offer assistance in form of technical assistance to carry it out -- the Ministry of Energy has implicitly asked USAID to support these transactions with TA.

Depending of course on price (and availability of transit mechanism) there is a strong incentive to Georgia to want to carry this out. Second, the other most obvious barriers to this are economic (capital, and markets). The capital is potentially solvable given the resources of the Kazhaks (especially, if supplemented by Russian resources, Gazprom cash for example). Together the Khudoni and 500 KV line projects might e a \$1 billion investment, but the Kazaks (especially if supplement by Russian capital) probably can find that. The markets for at least some of the volumes could be created by the combined acquisition by the Kazhaks of UDC and Tbilgz. These distributors can sign contracts for purchase of significant gas imports, with UDC, as buyer of Energy Invest operating the CC units, buying the gas in form of CC unit generation, on the model of Annex 4. The remaining markets, for Khudoni generation, would be Turkey, over the transmission line also to be constructed. (And, thus producing the revenue benefits from transit fees back to the Kazak business interests that build that transmission line. Also, the transmission line could have capacity for export of Russian electricity south to Turkey.

We know the contract mechanisms are possible, since the intent seems to be the same structures as were used for the Energy Invest company. Finally, the UDC could mediate the possible impacts on Georgia of these import contracts (the gas and CC units) by Georgia allocating Enguri output to UDC at low prices, thus price averaging with the forced

purchases of CC output. They have already begun a process that allows this model, by their agreement for Telasi supply being a mixture of Gardabani (self-owned high cost gas and oil fired), and Khrami (self-managed low cost hydro). This not only provides the model, the concrete arrangements with Telasi liberate the Enguri capacity for use by UDC. Public evidence suggests that the parties have worked out the possible transactions to at least the extent just summarized.

What Georgia seems to have learned from the CC units is that Donors do not understand the realities of the transactions, and/or their own interests override their moral evaluation of it. It may be that these new transactions implied by the Protocol (especially that implied for UDC) are sufficiently large that the Donors will take a more careful look. But the evidence so far is that the Georgians might well give up the "benefits" of Donor assistance if it costs them discretion and free action in these transactions. If to get some still unknown level of World Bank funds for Khudoni only by many traps and fence jumps and a lot of time, and they can assure that \$1 Billion is committed in a few months for all projects, while ridding the state of the need to support to UDC, Georgians might accept this solution. Nor, from evidence, does it seem MCC would withdraw from a now very large public commitment for road construction, pipeline restoration, etc.