



EITI IN GEORGIA: SHORT HISTORY AND PROMISING PERSPECTIVES



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Economic Development Center

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FOREWORD

Successful energy industry is a precondition for every nation's prosperity and realization. A transparent energy sector is therefore vital to the entire economy's progress and proper development. Georgian National Energy Policy has to go hand-in-hand with prudent administrative mechanisms to create a public-oriented, robust and sustainable energy system through the following policy directions:

- Continually support implementation of best western business practices and code of conduct for the companies of the energy and mining industries;
- Strengthen the legislative and regulatory framework through gradual compliance with the EU's business standards and market transparency principles;
- Make information available regarding development of renewable resources, exploration and production of hydrocarbon resources, mining and revenue streams associated with the industry activities;
- Ensure transparency in Georgia's midstream sector;
- Improve and sustain a strong national energy security including strengthening the financial transparency of the key energy entities;
- Establish Georgia as a regional leader in industry operation reporting standards;
- Develop an equal ground fields for domestic and foreign actors so that they more actively explore, commercialize and develop Georgia's own oil & gas resources (both conventional as well as unconventional).

National economy with energy system at its corner stones to be built on policy framework that meets the European criteria. It is easy to agree that greater transparency would facilitate more informed policy making and hence help the overall development in the best way. Present report discusses matters as they stand now and highlights efforts for introducing EITI in Georgia.

SECTION I

CH 1 | CHANGES AND EFFECTS – LAST THREE YEARS OF POLICY ENVIRONMENT

CURRENT SETTING: ENERGY SECTOR OF GEORGIA

Georgia has achieved significant success in its journey as an independent state since the breakup of Soviet Union, which in many ways, incurred a devastating blow to the economy and particularly – to the energy sector of the country. Against this backdrop of ill functioning state apparatus and general political insecurity, the country remained burdened for a while by a difficult course of economic and political reform, variable pace of market liberalization process and general systemic transition. After attaining a stable growth and policy governance strength, the situation has positively improved in Georgian energy sector, which remains one of the strategically important sectors of the country's economy.

Georgia's geostrategic location defines the country's role as a dynamic transportation corridor for oil, natural gas and electric power, enhancing economic growth and facilitating private investment. It is worth admitting that the long-existing problem of energy security was only resolved successfully after putting the transnational trunk gas pipelines and high-voltage power transmission lines into operation. Hence, it is understandable that this report will equally concentrate on the transparency aspects of the country's midstream sector, as it is at the moment more sizeable in absolute terms than the traditional hydrocarbon upstream or mining industries.

When it comes to implementation of energy policy and regulatory supervision pertinent to disclosure, financial accountability and reporting standards - Ministry of Energy of Georgia and Ministry of Finance of Georgia are the key institutions, alongside with special agencies in charge of regulation – GNERC and SAOG. GNERC regulates the downstream activities of the natural gas sector and entire electricity sector, including licensing and tariffs. Upstream activities are regulated by Oil and Gas Agency (SAOG), which is currently a subsidiary of the Ministry of Energy. SAOG is also responsible for creating an enabling environment and regulating the oil and gas sector in accordance with the Oil and Natural Gas Law.

MINISTRY OF ENVIRONMENT AND NATURAL RESOURCES PROTECTION OF GEORGIA

Ministry is mandated with the mission to ensure long term sustainable development of the country in the field of environment; It manages state policy and runs environmental planning system and national environmental action programs; Ministry also stands to protect flora and fauna of the country and ensures preservation of biodiversity and natural resources; implements administration and oversight on waste management and chemicals movement.

Ministry also manages public access to environmental information and knowledge funds and is tasked with the mission to raise general environmental awareness. Throughout the EITI project activity, Ministry stood attentive and au fait in respect to the key aspects of the process and supported project's advocacy efforts.

MINISTRY OF ENERGY OF GEORGIA

The Ministry of Energy is the State institution implementing executive authority and State policy in the domestic energy markets, including the various segments of the energy sector. Following the enactment of the Law on Electricity and Natural Gas of 1999, this Ministry, which operates under the Law on the Structure of the Government of Georgia (11.02.04), has relinquished its ownership, regulatory and operational rights in the natural gas (and electricity) sector and has only certain regulatory functions and rights. Its main remit is to establish the main directions of and awarding of tenders and auctions and the preparation of contracts, negotiations and signing of hydrocarbons exploration and production agreements on behalf of the State. It also issues licenses for oil and gas operations to investors on behalf of the State and as well approves and issues all necessary authorizations, allotments, and permits. It is further responsible for supervising the implementation of licensing terms and conditions and for issuing normative acts required to establish a clear, stable, non-discriminatory, market-oriented and effective legal and regulatory framework for the performance of oil and gas operations. However, nothing related to the transit arrangements or revenues generated thereof except as: “to promote cooperation between licensees, importers and exporters, suppliers and electricity and natural gas sector entities in foreign countries and to support transit and import/export relations in the electricity and natural gas sectors;”

The Ministry of Energy is tasked with the mission to develop a state policy in the energy sector, to secure its implementation and to create and adopt the legal framework for the whole energy sector. It also makes decisions on energy deregulation based on the approved State energy policy and is responsible for promoting efficient uses of energy and for ensuring the operation of competitive markets. As regards the gas sector, the Ministry is also in charge of tariff policy for internal energy markets (including the retail and wholesale tariff policies for natural gas) and approves, subject to public hearings, the Natural Gas Market Rules that regulate commercial relations for gas trade within Georgia including the transit arrangements. It further issues certain normative-administrative legal acts, which have policy content.

MINISTRY OF FINANCE OF GEORGIA

The Ministry of Finance of Georgia represents a body of executive branch, established in accordance with the Constitution of Georgia and the Law of Georgia "On Georgian Government Structure, Authorities and Activities Guidelines", which executes management in the financial-budgetary, tax and customs areas; provides for abidance by tax and customs laws on the territory of Georgia and exercises control over their execution; carries out preventive and operative-preventive, inquiry and preliminary investigation activities in the area of economic crimes. Activities of the Ministry of Finance shall be guided by the Constitution of Georgia, International Treaties and Agreements, the Law of Georgia "On Georgian Government Structure, Authorities and Activities Guidelines", the Law "On Budget System of Georgia", Tax and Customs Codes, the Law "On Financial Police", other legislative acts, Presidential Decrees, Resolutions, Government Resolutions and other legal acts. In carrying out its functions, the Ministry represents the State.

The Ministry of Finance of Georgia is accountable to the Government and executive tasks, provided by the Law and the Prime Minister.

It is notable, that The Government is directly involved in relation to the transit of oil and Gas thru BTC and SCP pipelines where it benefits from direct administration of royalties in lieu of transit revenues. However, the railway transit and transit revenues of other pipelines are either monetized by operator companies and paid as indirect tax payments to the budget or are being accumulated within the companies and are later released as state designated dividend.

GNERC

On the regulatory front, the Georgian National Energy and Water Supply Regulatory Commission (GNEWSRC) have been entrusted with the function of regulation in the spheres of transportation (transmission), distribution and supply of natural gas. GNEWSRC is tasked with establishing the licensing rules for natural gas supply, transportation and distribution, as well as for the granting, suspension and annulment of licenses; it is also responsible for fixing prices for gas imports and exports, setting transportation, distribution, wholesale and retail tariffs for the gas sector and for resolving disputes among market participants as well as ensuring compliance to the established rules . GNEWSRC has the status of an independent regulatory authority - having full financial independence from the government in its decision-making process as well as in the implementation of any legal activity within the bounds of its competences.

STATE OIL AND GAS AGENCY

State Oil and Gas Agency, which is now part of the Ministry of Energy, is entrusted with the state management of oil and gas operations and oil refining, gas processing or transportation activities. This Agency is assigned a wide variety of functions that are stipulated in the Oil and Gas Law of 1999. These, among other things, include the organization, performance and awarding of tenders and auctions and the preparation of contracts, negotiations and signing of hydrocarbons exploration and production agreements on behalf of the State. It also issues licenses for oil and gas operations to investors on behalf of the State and as well approves and issues all necessary authorizations, allotments, and permits. It is further responsible for supervising the implementation of licensing terms and conditions and for issuing normative acts required to establish a clear, stable, non-discriminatory, market-oriented and effective legal and regulatory framework for the performance of oil and gas operations. The law also stipulates that State Oil and Gas Agency shall oversee the transit related tariff policy; however, we do not see such in practice. State is also represented thru its wholly owned business entities; in particular: thru its oil and gas major - GOGC, transportation backbone – GRail and a special purpose organization - Partnership Fund.

GOGC

The State participation in the domestic energy sector is channeled through the Georgian Oil and Gas Corporation (GOGC), which is the integrated national gas and oil company involved in

upstream exploration, development and production, gas transport as well as transit fee management, whose stock is 100% government owned. The company was established in April 2006 by order of the Georgian Minister of Economic Development in the form of a Joint Stock Company following the merger of the Georgian International Gas Corporation (GIGC), the Georgian International Oil Corporation (GIOC) and the Georgian National Oil Company (“Saknavtobi”), each of which earlier performed different tasks and responsibilities on behalf of the Georgian government in the domestic energy sector.

The rationale behind bringing together under the umbrella of the new holding company of GIGC, GIOC and GNOC primarily purported the improvement of the coordination of natural gas supplies to Georgia, since each of these companies has contracts for gas supply from different sources (GIGC from Gazprom, GIOC from the Shah Deniz field in Azerbaijan, and GNOC from domestic sources where it supervises oil and gas production). In particular, GIGC owned and operated the medium and high pressure gas pipeline network in Georgia. The GIOC represented the Government of Georgia in all Caspian oil and gas transportation projects passing through the territory of Georgia. The GNOC represented the State in all production sharing agreements, served as the State’s commercial agent in securing receipt of the state’s share of oil and gas, monetizing it and transferring the taxes to the state budget; it was also a player in the upstream field and held several exploration and production licenses itself.

GOGC's activities are chiefly centered on the gas (and oil) exploration and production sector where its functions include, inter alia, to partake in the preparation of gas (and oil) contracts (Production Sharing Agreements, etc.) , to take over and deal in the government’s share of oil production in such contracts and to set up coordination committees in cooperation with the investors for the purposes of overseeing and administrating commercial and operational issues related to such contracts. It is also in possession of most, if not all, geological, geophysical, production and other information needed to evaluate and manage oil and gas prospects and projects and operates few fields on “grandfathered” terms.

In the gas transportation sector GOGC, through its subsidiary Gas Transportation Company, is in custody of the entire main gas pipeline transmission system and it is also entrusted with its operation, maintenance, rehabilitation as well as the construction and operation of new infrastructure. It also represents the Government of Georgia in the agreements for gas transit from Russia to Armenia via the North South Caucasus Pipeline and gas transit from Azerbaijan to Turkey via the South Caucasus Pipeline. In addition, it is in charge of storing, preparing, refining and recycling oil and gas resources and end-products both within and outside the Georgian territory. Finally, it conducts extensive marketing operations in the gas distribution and wholesale.

GEORGIAN RAILWAY

The railway assets of Georgia were formed into the new 100% government owned company The Georgian Railway LLC, which operates under the public law of the Enterprise Management Agency, part of the Ministry of Economic Development.

Georgian Railway LLC and its subsidiaries comprise Georgian limited liability companies as defined in the Law of entrepreneurship of Georgia. The Company was established as a state-owned enterprise in December 1998 by the Decree of President of Georgia # 929 as an entity engaged in the provision of railway transportation services in Georgia. The Group's principal activity is the operation of a nationwide railway system providing freight and passenger transportation services, maintenance and development of railway infrastructure and construction of railway lines within Georgia. The Group is wholly owned by the State of Georgia represented by the State Enterprise Management Agency of the Ministry of Economic Development of Georgia.

PARTNERSHIP FUND

The JSC Partnership Fund was created by the GoG to acquire, manage, evaluate and sell shares in companies carrying out business activities in the areas of production, extraction, transmission, transiting, storage, management, distribution, sale and/or purchase of natural gas, coal, electricity, heat and other forms of energy and raw materials. Currently, JSC Partnership Fund owns 100% of the transmission/dispatch company GSE, ESCO, GOGC and Georgian Railway and 24% of shares of electricity distribution company Telasi.

TRANSPARENCY CHALLENGES BY SECTORS

Energy sector of the country is loaded with various challenges and difficulties - Transparency being one of them. Georgia, like many other countries with transition economies, needs to meet increasing demand in resources. Changeover into an efficient, low-carbon economy will require substantial investments in domestic hydro-energy production, transport infrastructure and storage capacity. This complex and costly transition is happening now, amidst the global slowdown, when the largest FDI provider states of the region (Russia, Azerbaijan and Kazakhstan) are about to embrace the oil-related economic crisis. In the situation, when the industry's public and private capital is restricted, transparency and prudent accountability comes as a top priority. Below are short descriptions of the two major industry sectors that are particular to the challenges of transparency in revenue disclosure.

HYDROCARBON TRANSPORTATION

The transport of natural gas is primarily undertaken through the national main gas pipeline network. The owner of the main transmission system is the Georgian Oil and Gas Corporation (GOGC). The gas transportation system is managed by an independent Transmission System Operator (GTC - Georgian Gas Transportation Company). The latter is also in charge of the system's operations, maintenance and rehabilitation.

When it comes to the access regime to the natural gas transmission network, a regulated access system has been adopted whereby the operator of the network to which a customer requests access is obliged to grant such access based on the general network terms and conditions and tariffs that have been set by the GNEWSRC. The methodology is based on the principle of recovery of reasonable costs for natural gas supply transportation and distribution, but it does not stipulate what the asset base is to apply such tariffs for example whether such tariffs are based on optimized replacement costs or on historical cost, although it has to be noted that the regulation itself coupled with the methodology and instruments – are quite transparent and the respective information is readily available upon request from the GNEWSRC.

GOGC also represents the Government of Georgia in the agreements for gas transit via the South Caucasus Pipeline (SCP) that is privately operated and which transports Azeri gas to Turkey through Georgia in return for an in-kind transit fee. Considering the growing export potential of natural gas from the Caspian basin and the existing framework of cooperation between, Azerbaijan, Georgia and Turkey, Shah Deniz field is considered as the priority source of gas supply for Georgia. Taking into consideration Shah Deniz Stage II development, the volume of gas delivered via SCP is destined to grow vastly after Year 2018.

OIL AND GAS UPSTREAM

Although Georgia currently does not have large-scale proven oil and gas reserves or production (current production – approximately 1,100 BOPD), it is worth noting that Georgia is within a hydrocarbon basin. The country is located geologically in the so-called upper Kura Basin, which is the east part of the same geological basin as neighboring Azerbaijan and contains the same reservoir and source rocks as the North Caucasus Basins. Up to 17 oil and 3 natural gas commercial fields have been discovered in Georgia so far.

The country's 15 oil fields have confirmed reserves of about 8.3 million tons but larger oil reserves are only assumed to exist. In order to successfully commercialize above resources, prudent industry management and extensive investment activity is needed.

RECENT CHANGES IN GOVERNANCE

Since regaining its independence, Georgia aspires to build democratic governance and become integrated with Euro-Atlantic institutions. The first wave of democratic transformation started in 2003 when Georgia's new government actively engaged itself in fight against deeply-rooted endemic corruption in public administration. The efforts resulted in Georgia's success of becoming a regional leader in implementing anti-corruption reforms and eradicating lower- and mid-level corruption. However, previous government was widely criticized for its heavy-handed methods of governance and for falling short in building democratic institutions.

2012 Parliamentary elections became Georgia's major achievement in democratic change of power. The new government pursued the process of democratic transformation. The biggest success on the path of European integration became signing of Association Agreement with the EU, including

Deep and Comprehensive Free Trade Agreement, with the EU in June 2014. Ongoing reforms within the legislative, executive and judicial branches aim at enhancing independence of judiciary, liberalization of criminal justice and improving transparency. Nevertheless, Georgia still faces outstanding challenges in developing effective and impartial state institutions. Transparency International's 2014 Corruption Perceptions Index, which ranked Georgia 50 out of 177 countries, reflected the poor progress Georgia made in this respect.

After 2013 Presidential elections, the constitutional amendments came into effect and Georgia shifted from a presidential to a parliamentary system. The reinforced role of parliament provides for more effective checks and balances of governance.

Most important reforms since 2012 relate to efforts to de-politicize justice system and decentralize administration. The process of reforming local self-governance has started. According to the new bill - mayors and heads of municipalities in twelve self-governing cities are now being directly elected. Government introduced important legislative changes for improving judiciary independence from Prosecutor's office and reducing political interference in criminal investigations. Information control in general has become a widely discussed topic. Any attempt to introduce disclosure responsibility be that on a personal or corporate level is met with resistance and at times – hostility. An Inspector on Personal Data has been appointed; however, legislative reforms on personal data protection have become subject of severe criticism from local civil society organizations, on alleged claims that risks of illegal surveillance remain high. Major challenges remain in economic development, which is reflected in decreasing indicators of GDP growth. No significant initiatives in increasing fiscal transparency of Tax administration were noted. There is a so called Anti-Corruption Council, with wide representation, that meets regularly and far-reaching public sector reforms are under discussion, but that only relates to the fiscal transparency of the state operations such as budget preparation process, treasury operations and function of a monetary regulation body (The national bank remains independent and the government is not involved in the banking sector). No sizeable policy initiatives were expressed to improve transparency and accountability in the operation of the large scale business enterprises, state owned corporation, agencies or private companies involved in the industry from the standpoint of their compliance to the best business practices, information disclosure or reporting.

Caucasus, in general, and, Azerbaijan and Georgia, in particular, have from the very beginning generated interest and attention for many countries of the western world. In many cases, such concentration was largely associated with the alternative sources of hydrocarbon deliveries to global markets and respective transportation routes. In many ways principle difficulties in developing the region's economic potential (especially in the case of Georgia) to overcome the social hardship include a lack of coherent policies, inefficient public management and the public's poor understanding of the benefits of the revenue generating industries, such as oil and gas upstream, mining and transportation. The latter is particularly important for the future of Georgia, since it is destined to expand exponentially with the increase of Hydrocarbon production in the Caspian basin. The gas which will be produced at the second stage of Azerbaijan's Shah Deniz field development will be the main source of the Southern Gas Corridor, which envisages the transportation of the Caspian gas to European markets through SCP, TANAP and TAP corridors. Georgia is expected to derive various benefits from this process, including the collected tax revenues from the midstream.

It is an unchanged foreign policy of Georgia – to pursue integration with the European Union single energy market. Since 2007, the process of adaptation of country's governing legislation and industry regulation with the legislation of the EU has been ongoing and active under the European Neighborhood Policy EU-Georgia Action Plan. In January 2013, Georgia formally applied to join the Europe Energy Community; thus making the liberalization of the country's energy market and its integration with the European system irreversible.

The European Union and Georgia have been engaged for some time now in an aspiring process towards reaching a "Deep and Comprehensive Free Trade Area". This has become one of the most important issues in the country's political agenda. The agreement (DCFTA) includes several provisions aiming at reforming of Georgia's economic and trade policies, in line with, and on the basis of, the EU regulation. These will provide for facilitation of European investments in the economy, better and more predictable policy environment and increased transparency. Chapter 12 of the agreement deals with basic transparency provisions and specifically provides for various mechanisms in administrative proceedings on acts relating to the implementation of trade policy;

It is a well-recognized notion that transparency and accountability are understood as very much a work in progress, not a position that has already been achieved. Efforts are underway in the US and Europe to formulate more solid and well-designed procedure for ensuring transparency in the extractive and energy trading sectors of economy.

Just recently one of the commodity trading giants - Trafigura said it will disclose oil-related payments in all EITI countries. As announced, its disclosures would be very much in line with other companies in oil and gas businesses that are listed in UK and under EU directives. EU regulations require extractive industries to disclose payments such as tax and royalty concessions to foreign governments. Most of the disclosures are made at the country level and since at times these companies have very extensive geography with many different partners in the field, these disclosures are expected to come out in a project-by-project reporting form.

Actually, the EU Commission mostly went along the path of general developments in this field, in particular the inclusion of a requirement to report payments to governments in the Dodd Frank Act in the United States. The Directive introduces a disclosure requirement for payments to governments by listed and large non-listed companies with activities in the extractive industry. It reflects the fact that large non-listed companies can potentially make significant payments to governments in the countries in which they operate. Once these regulations take effect, information will be out and available and Civil society will be in a position to question whether the contracts entered into between the government and extractive and logging companies had delivered adequate value to society and government.

In tax and contract transparency, there is general consensus that change is coming, one way or another. NGOs' are considerably more active recently focusing now on organizational structures, since there are often very sophisticated and tangled intra-group transfers that serve the purpose of funneling profits away from host countries to tax havens.

There are significant changes in EITI standard as well. The revised EITI Standard introduces a new requirement for ensuring disclosure of license holders, key production figures and description of the fiscal regimes as per contracts. The data in the EITI report must now be presented by individual payment type in a disaggregate form and where countries collect significant revenues from the production and transportation of oil, gas and minerals – the government is required to disclose the revenues received from such transportation arrangements.

SECTION II

CH 4 | PROGRAM STRATEGY

With the recent change in government and with the renewed hopes for the initiative implementation - Project team put forward efforts in waging a campaign for transparency of government interaction with energy transit industry in Georgia. Decision was made to tie in advocacy activities with the research / information gathering and, as a result, the program activities focused on the three main directions: (1) working with the relevant branches of Government (2) working with companies involved in hydrocarbon transportation industry of Georgia and (3) working with the EITI Secretariat.

In accordance with the Grant Award and Usage Agreement executed between "Open Society Georgia Foundation" and "International Business and Economic Development Center" on December 28, 2012; The ultimate and ambitious goal of the approved project "EITI International Conference in Tbilisi" was set: to give the Georgian government opportunity to officially declare its consent on joining the EITI initiative.

In order to achieve the said goal, the Project team went through multiple stages of the following activities:

- Preparatory works were conducted for Georgia's joining EITI initiative, proposal and recommendations for implementation of the transparency initiative of production sectors in Georgia were developed;
- Legislative amendments have been drafted as draft laws to make amendments to respective laws;
- Training "EITI basics" was conducted by Extractive Industries Eurasia Knowledge Hub experts;
- Memorandum of Understanding between concerned parties (on readiness to publish revenues received from production of natural resources and energy transit) was drafted.

In many ways the Project Team relied on findings and outcomes of the already existing study reports that were developed under the auspices of the program in the previous years. Among them:

Y2012 REPORT ON “PROMOTING HYDROCARBON TRANSIT TRANSPARENCY IN BULGARIA, GEORGIA, TURKEY AND UKRAINE”

This report was a result of a research project undertaken under the auspices of the Open Society Georgia Foundation across four participating countries – Bulgaria, Georgia, Turkey and Ukraine. The major objective of the project was to achieve Transparency in Hydrocarbon Transit sector in the above mentioned countries of the east-west energy corridor. To achieve this important objective, project team undertook a country-by-country research of transit operations and examined their degree of transparency in the context of state revenue generation. Document contained a concise overview of hydrocarbon energy sectors of Bulgaria, Georgia, Turkey and Ukraine. Country chapters attempt to highlight challenges that exist in the oil and gas transport industries, challenges to get public information on transited volumes of oil and gas, state budget revenues and tariffs in the discussed countries.

Lack of transparency of the revenue schemes relevant to transit arrangements and unavailability of reliable data and basic communication impediments with key actors are the major problematic areas. Based on these preliminary findings, report sets forth generalized policy recommendations with suggestions for further actions.

The research was well aligned with general scope of Extractive Industries Transparency Initiative. However, EITI focus in this report has been slightly shifted from Extractive Industries to Transit Industries Transparency. Principles of EITI - engagement of civil society in the oversight of management and deployment of revenues for the benefit of effective economic and social development – were transposed into the EITI Transit initiative unchanged.

YEAR 2010 REPORT ON “HYDROCARBON TRANSIT REVENUE TRANSPARENCY IN GEORGIA”

Report provided a concise review of the legislative and institutional framework, applicable to the various segments of the Georgia’s Energy Transit sector. Transportation of Hydrocarbon Resources is carried out as a separate operation on the territory of Georgia and is less related with the other activities in the Energy Sector (Such as oil and gas production, or refinement and processing of oil and oil products). Therefore, a review of the other segments of the energy sector would have not contributed to facilitation of the analysis and discussion pertaining to the legal and institutional framework that is needed to regulate the hydrocarbon transit operations and transparency of revenue generating process related thereto.

The review ascertained what legislative gaps need to be filled in and provided recommendations with regard to amendment of existing legislation and reasoning whether introduction of new legislative initiatives is needed in respect of:

- Transportation of natural gas, crude oil and oil products on the territory of Georgia;
- State Revenue reporting transparency;
- Readiness for the legislative framework for multimodal and multilateral transit initiatives in the future.

The report also illustrated the situation pertaining to access to the information and regulated process of disclosure. Also, the legislation directly or indirectly affecting the carrying-out of the Project was assessed and evaluated. In this respect, the rules applicable to the process were examined and appraised. The underlying objective of this exercise was to identify and assess any stumbling blocks that could hinder the Project's implementation and provide concrete recommendations for any amendment of the legislation currently in force that could fill in any existing lacunae.

The training "EITI basics" conducted by Eurasia Extractive Industries Knowledge Hub experts under the auspices of "International Business and Economic Development Center" at "Beaumonde Garden" Hotel, Tbilisi on February 26, 2013 facilitated raised public awareness of the initiative significantly. The training was attended by 21 representatives of all concerned parties from all three sectors. The training gave the attendants a full understanding of the production sector transparency initiative as well as prospects of joining it and respective steps that are needed to be taken.

This occasion offered a platform for dialogue and engagement between civil society and government agencies, the private sector and regulatory authorities. Through this dialogue, everybody had an opportunity to gain a better understanding of the role of different actors in promoting and supporting revenue transparency in general, as well as get an overview of various approaches to promoting transparency.

Project team was able to reflect and review the project activities which were conducted towards achieving transparency objectives, as well as to report about challenges and obstacles that were encountered.

With the organization of the International Business and Economic Development Centre and the financial support of the Natural Resource Governance Institute (NRGI, former RWI), an important International events took place in Batumi, Georgia (Radisson Hotel) on 20-22 September 2013: "Regional Capacity Building Training on the new EITI Standards/9th Eurasia Regional Transparency Network Meeting".

The events were attended by 30 civil society and international organizations from 10 different countries. Main focus of the training was put on the new EITI Standards for Publish What You Pay civil society coalition of Eurasia region. Also 9th Annual meeting of Eurasia Regional Transparency Network was hold at the same time.

The event offered an effective platform of multi-topic discussions and intensive debates. Representatives of each country were given an opportunity to make the country presentations about the progress of natural resources transparency issues in their countries. Speakers covered many different aspects of the initiative, including implementation issues, on-going statuses, reporting requirements and good practices.

It was well accepted that the time period from the October 2012 government change until the presidential elections the following year was a time period for political cohabitation, which would effectively translate into political hibernation when not much could have been done to promote the Project and to engage the stakeholders. Therefore, efforts were spent on preparation of the general basis for the operation strategy of the project and identification of the new faces in the government for interaction.

The preparatory stage implied efforts to ensure “awareness of concerned parties and establish a respective initiative group” which should consist of concerned parties from three sectors: state sector (Ministry of Energy; Ministry of Finance and Ministry of Environmental Protection and Natural Resource Management); companies producing natural resources and implementing transit, and civil society.

Project staff conducted meetings and consultations with concerned parties from the above three sectors, including Mrs. Khatuna Gogaladze, then Minister of Environmental Protection and Natural Resource Management, Mr. Iliia Eloshvili, the First Deputy Minister of Energy, Mr. David Lezhava, Deputy Minister of Finance and representatives of respective sectors of these agencies. Project also met with the private and non-governmental sector, namely JSC “RMG Rich Metals Group”, BP Georgia, “Greens Movement of Georgia”. In parallel, legal experts retained by the project prepared draft legislative amendments to be made to respective laws.

Updated EITI Fact Sheet were translated and published.

Further, as a result of consultations and meetings with concerned parties, it was outlined that the above issue required a more active involvement of the government in the process, detailed study of the issue by respective Ministries and preparation of conclusions regarding Georgia’s joining the initiative. Therefore, Project thought useful to appeal directly to Prime Minister with the hope that the question would be properly studied under his supervision and the EITI would be acknowledged and accepted in principle. The Prime Minister forwarded this request to respective Ministries to study the issue and prepare conclusions.

The most recent round of meetings and consultations took place with the Ministry of Environment and Natural Resources Protection of Georgia. Through a constructive process of planning and discussions it was agreed to hold a final roundtable meeting and a thematic workshop with the participation of all key stakeholders, including a wide representation of Georgia’s Non-governmental sector. Such multi-party meeting would offer an opportunity of thoroughgoing review of EITI project activity in the country; The key aspects of the process and various arguments of all concerned parties would be heard once again.

In addition, the idea of forming of an NGO coalition would make an essential part of the event’s agenda. Taking into account an array of organizations that would be attending the meeting, the proposal to sign a coalition agreement is expected to be well accepted and timing seems well suited as well. Coalition is thought to stand for the support of strengthening the participation of CSOs in EITI process by increasing monitoring, advocacy, media coverage and general outreach activities. It’s ground laying document would be developed around the concept of “improvement of Transparency in Extractive Industry and energy transit through the coalition of Georgian CSOs”

It was tentatively agreed to hold this event by the Year’s end, in the last week of December 2014.

SECTION III

CH 8 | EXTRACTION INDUSTRY CHALLENGES

It is almost accepted that since Georgia's extraction industry is insignificant (it is nearly dwarfed in comparison with that of neighboring Azerbaijan), very little attention is paid on how well and prudently is the upstream industry or mining sector administered. The use of standards and globally accepted reporting principles to improve transparency in this area are simply overlooked.

Truth be said, one of the key challenges when it comes to the reporting - is how to custom fit it in the context of a particular industry operation. Complex value chains companies usually cannot avoid to use IFRS as a framework and general basis, however there is no specific industry guidance or ready-made solutions for any particular operation segment of the industry.

In today's world, oil and gas businesses are evolving rapidly, requiring more efficient external communication. Demand for capital through various instruments and markets becomes more apparent and need for more cooperative working relationship is already a standard.

Georgia boasts a well-developed upstream sectors, where all of the actors are independent international companies. Few of them are publicly listed at their main shareholder level, however operation is conducted and funds are channeled through subsidiaries that are usually registered in low-tax offshore jurisdictions. The whole upstream territory of the country (including its marine fields and prospective deposits) is divided into so called license blocks which are contracted out to these international investors and operators. State allows their operation under Product Sharing Agreements (PSAs). Such contracts make possible transition of risks (both financial and operational) from State to the investor and its operator company. If exploration on any particular field proves successful and commercially viable – State is allocated a certain predefined share of profit, generated from the production of hydrocarbons. In other words, government's share of the natural resources exploited and produced are a share of actual production (free of cost). They may be paid in cash, but since the State has a designated national oil company (GOGC) at its arm's length, payments are made in kind and later monetized by GOGC. It is essential that such sharing takes place after investor recovers its respective exploration and production costs; hence, the State has natural interest in close control of all associated costs and expenditures. Regretfully, no IFRS standards are mandatory for O & G activities and State usually relies on its own competence (through GOGC) to audit and approve company's spending on any particular block.

Needless to say - formalization of standards on joint arrangements, consolidated financial statements and disclosure of interests among these license holders will be of great benefit to the whole oil and gas sector of Georgia. At the end of the day, it is the disclosed revenues in notes to financial statements, together with other summary financial information that is interesting to look at. Oil and gas companies in Georgia are free of usual set of taxes such as royalties, excise, customs duty, VAT and similar levies for the expenditures attributable to O & G operations. This makes it even more difficult to quantify benefits derived from any particular product sharing contract or a respective FDI.

Despite the small scale of operation, there is still a potentially promising upside for hydrocarbon production in Georgia. It is essential to have further research under EITI initiative to obtain a deep level of insight into and commitment to helping GOGC, the Government of Georgia and companies in the sector report effectively.

Introduction of the Disclosure Requirements for Transit as a distinct activity / Initiative was mulled and widely discussed in the previous report of the EITI Georgia project. It was a general policy recommendation for the government of Georgia to create a regulatory and institutional framework that would ensure transit revenue transparency.

On a legislative level, one way for the implementation of such a regime would be through the introduction of new law that specifically dealt with oil and gas transmission in a comprehensive manner. Alternatively, any existing legislation dealing with the gas sector could be modified to provide for revenue disclosure activities. This legislative approach would require amendments to the Law of the Subsoil and Natural Resources, the Law on Oil and Gas and the Law on Electricity and Gas. Also, specific regulations in respect to certain gas transportation matters, such as tariffs administration, would be needed in conjunction with the above mentioned legislative amendments.

In fact, according to the IMF research, hydrocarbon related revenues for transiting countries are easier to keep track of than revenues of producing countries. Producing countries receive “revenues in the form of profit taxes, royalties, signature bonuses, dividends, or licensing fees, and estimating overall government revenues from the sector is often complicated. In the case of oil or gas transiting countries, by contrast, estimating government revenues is straightforward: expected revenues can be derived directly from the volume that is transited and the agreed transit fee”. IMF purposely laid out its recommendation to allow EITI to develop a special, simplified template for oil and gas transiting countries. According to the report - Georgia would be a very good test case to help EITI develop such a template.

Another important issue that needs to be addressed in the terms of the transit revenue disclosure is the elaboration of the general obligation imposed upon the license holder under the disclosure requirement. For instance, in respect of its obligation to operate, maintain and develop the hydrocarbon transit under conditions of transparent, secure and clear regime, the license holder may be required to maintain at all times its financial statements in IFRS format and disclose annually certain key revenue indicators.

Government of Georgia should be committed to working with the oil and gas industry as well as with the NGO sector to create the right conditions for transparent and fair business environment development to the benefit of the whole population.

Despite the fact that some disclosure is taking place, and midstream operator BP, as well as Bureau of Statistics of Georgia, together with the Ministry of Energy and Environmental Resources of Georgia publish some limited data regarding revenue streams and contributions to the state budget, care needs to be taken in avoiding wrong assumptions and conclusions based on the analysis of the disclosed data which, quite often, appears in unmatched format and shape. Especially, when comparing the financial results of integrated Oil & Gas companies with independent actors on the Georgian market – very often it is observed that comparability is compromised by either different accounting practices or by inadvertent misrepresentation of the disclosed materials and data.

Companies must report information regarding their oil and gas operations and contributions, under the consolidated uniform templates (so called “score cards”) in order to maintain comparability among corporate disclosures. To this respect, administrative and lobbying power is essential and support from various professional associations is crucially important.

Professional networks and associations play a pivotal role in establishing various multi-stakeholder initiatives in the country. Georgian Association of Petroleum Companies (GAPC) was established in 2013 by Gas and Oil upstream companies, including license holders and service providers. The Association members are both Georgian and International, joined with a common interest in the development of the upstream oil business in Georgia.

GAPC is designed to serve the purpose of engagement with government and other external organizations with the goal to enhancement of the country's petroleum industry in a safe, environmentally and socially responsible manner with the help of stakeholders in the communities where operations are conducted.

Organization may play an important function in facilitating the dialogues for regulatory establishments and changes in Georgian petroleum and industry related legislation (including tax administration, PSA management, etc.), especially when it comes to the interaction with other internationally established and renowned non-governmental organizations and societies.

Resistance and Uncertainties

With the new administration in charge of the state and more or less stable policy environment (Active and inspiring legislative process in the parliament and signs of pursuing general policy reforms with a high pace) it is still uncertain whether the government is willing to proceed with bold decision in respect to EITI.

On a general level through meetings and consultations, the government made it clear that they regard EITI as an acceptable and probable initiative, however no position was made formal and there is no single governmental entity that is dedicated to study the process or pursue any specific objectives in regards to the Initiative. As it appears now, key concerns and challenges are the following:

Debates about the principles.

There is a sense of skepticism whether the transparency initiative in the extractive and transportation industries is instrumental for the overall standing of the country. Transparency is treated as a must-have attribute for the general policy environment by the current government, however participation and inclusion in the EITI world seems unimportant or simply unappealing as a concept.

Uneven response.

Although EITI, as a concept itself, suggests conceivably transformative thinking of civil society empowerment, general response and acceptance of this initiative from non-governmental sector was less robust than initially expected. As it appears, many NGOs treat such international initiatives merely as technical opportunities and instruments rather than essential 'basis' elements of their work. In many cases, their voice is not heard and their function is reduced to flagging general political or judicial inconsistencies rather than analyzing specific budgetary or monetary irregularities and other matters of economic nature.

Questions about the burden and materiality.

Uncertainty about their instrumental value is further worsened by the unclear view and some ongoing debate over the real cost of compliance to the industry and to the government if and when EITI is accepted by the State. Most popular examples of the world are from the producing states that earn significant budget revenues from upstream and mining sectors. To them, administrative costs and compliance related efforts are justified in proportion to the relative benefits generated from these industries, while in Georgia it is understood, that despite some promising developments, chances of these industries outgrowing other segments of the country's economy in the near future are less likely. Relationship between governance and economic development in this particular case plays its traditional game.

Inconsistencies on the Stakeholder side.

There is a possible concern that widening of the transparency agenda over the industry accounting and reporting premises will dilute the general image of transparent operations of the government and contribute to a false impression of "struggling undertakings" or even be interpreted as an attempt to exert pressure on the business environment in Georgia.

In its development, the EITI project in Georgia has reached its logical concluding phase, when most, if not all means and efforts were exhausted. In its own lifecycle, project has performed around numerous challenges and obstacles. At times, expectations were high, resources and efforts were commensurate, and in many ways, the project repeated the pattern of EITI initiatives in other membership-aspiring countries: similar resistance and/or reluctance from authorities and market players, society's mixed understanding of the relevance of the matter and generally absent conditions to facilitate the process in an expedient way.

Having said that, it is worth mentioning that the project achieved some tangible results in advocacy and outreach. Thanks to the activities – Project Team has managed to maintain the momentum between several stages of the project. Project staff even attempted to reinvigorate advocacy efforts after the major change in the government (2012 elections completely replaced governing elites in the country), and successfully kept up critically important interaction with key decision-makers and industry players in Georgia.

All key stakeholders and potential beneficiaries of EITI in Georgia have rhetorically embraced the value of the initiative. However, political will to translate such intention into substantive decision was (so far) absent. Current Administration's affirmed commitment to open government and its adherence to structural reforms gives grounds for cautious optimism. Discussions about the future of EITI in Georgia retain its relevance and significance for the country's political agenda. Constructive dialogue between parties and Georgia's aspiration to join European family makes the initiative appear more coherent with the overall development plan, as outlined by the Government.



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