

**EXTRACTIVE INDUSTRIES AND ENERGY
TRANSIT IN GEORGIA:
Background Report**





ფონდი "ღია საზოგადოება-საქართველო"

OPEN SOCIETY GEORGIA FOUNDATION

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ABBREVIATIONS AND ACRONYMS

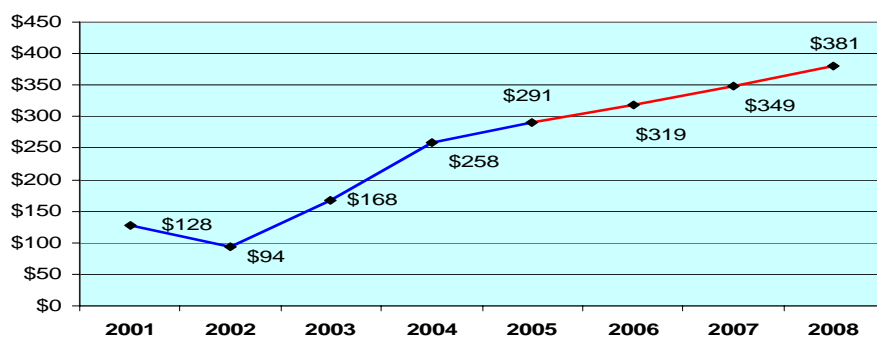
AIOC	Azerbaijan International Oil Company
bcm	Billion Cubic Meters
BP	British Petroleum
BTC	Baku-Tbilisi-Ceyhan Oil Pipeline
EITI	Extractive Industries Transparency Initiative
GEL	Georgian Lari
GG&MW	Georgian Glass and Mineral Waters Company
GGIC	Georgian Gas International Corporation
GIOC	Georgian International Oil Corporation
IMF	International Monetary Fund
mcm	Million Cubic Meters
OSGF	Open Society Georgia Foundation
PSA	Production Sharing Agreement
SAROGR	State Agency for Regulation of Oil and Gas Resources
SCP	South Caucasus Gas Pipeline
SDS	State Department for Statistics
WREP	Western Route Early Pipeline (Oil)

INTRODUCTION

After the collapse of the Soviet Union each new independent state was given an opportunity to manage the economic and political processes that shape the lives of their citizens. In Georgia, the transition from a centrally planned to a market economy and from a totalitarian regime to a democracy has been tumultuous and characterized by deep economic and social crises. Even though post-Rose Revolution government has taken decisive steps to promote good governance and economic growth, poverty rate of over fifty percent persists in the country, especially in rural areas. One of the remedies to alleviate the crises, to develop the economy and to improve people's lives is a rational utilization of the natural resources and taking advantage of the country's geo-strategic location to transport goods, especially gas and oil, from Caspian Basin to the Western markets and from the North to the East. Transparency of extractive and energy transit industries in the country, by which is meant an open public access to information on the terms under which the resources are utilized and the payments made to the state, is a necessary requirement for ensuring that the revenues are collected and deployed in the interest of the public.

This report analyses the research carried out in the framework of Georgia Revenue Watch Program, funded by the Open Society – Georgia Foundation. The report provides an overview of the extractive industries and energy transit in the country, and analyses the degree of transparency of information regarding the operations of these industries and the economic benefits accrued for the state. The primary objective of the paper is to reveal the areas where a concerted effort of civil society, with cooperation of the government and the private sector, would significantly improve the level of information transparency, and increase the accountability of companies, as well as the relevant state institutions.

Figure 1. Georgia's Past and Projected Export of Extractive Products (In million of U.S. dollars)



Sources: Georgian Statistics Department, National Bank of Georgia, IMF

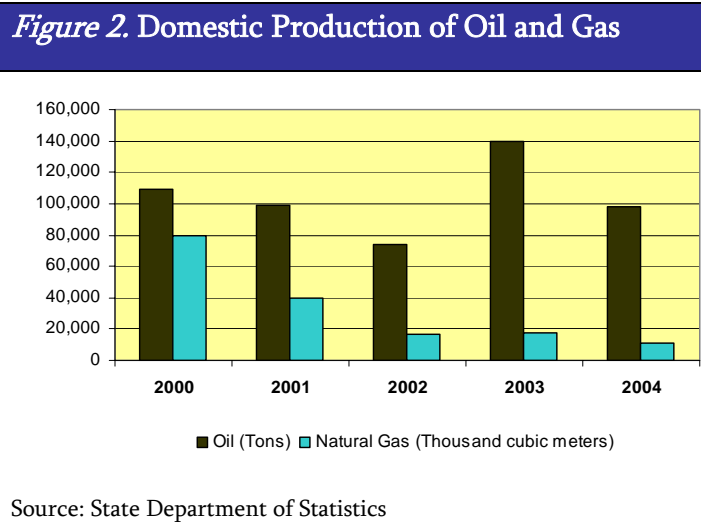
OIL AND GAS EXTRACTION

At the moment there are sixteen oil and two gas fields being jointly developed in Georgia. Oil production for 2004 was 95,596 tons, according to the government statistics. Foreign and local experts assert with reasonable confidence that this figure is expected to rise drastically to exceed several millions of tons in the foreseeable future, if even one out of several ongoing exploration activities is successful. This projection is reasonable considering that in the 80s', before the national oil industry experienced the effects of the collapsed Soviet economy, the annual oil production volume reached 3.5 million tons.

The current upstream oil and gas activities in Georgia can be divided into two types:

1. extraction from the existing oil wells; and
2. exploration for new deposits.

The primary focus of the current upstream industry is on the exploitation of the existing fields, some of which have been producing oil since early 1930's. The majority of the existing oil and gas wells in Georgia are in the last exploitation stage, meaning that the prospects of increasing hydrocarbon



production from these wells are rather limited. By the estimates of the National Oil Company, within the next two to three years, the maximum oil extraction volume from the existing wells may be 0.15 to 0.3 million tons per year, and will subsequently decrease to 0.1 to 0.15 million tons per year. Increasing the oil and gas production from the existing wells by using new technologies and innovative methods is possible. For example, in 2003, after Canargo carried out horizontal drilling in the existing vertical wells, production increased by 2.5 compared to previous year. Yet, the extraction of the remaining total oil reserves in the existing wells, which by the latest estimates equal 11.4 million tons, is technically difficult and requires considerable time and expenditures.

The drastic increase in the oil and gas extraction volume will be possible only after the discovery and exploitation of new deposits. This requires attracting foreign

investors to Georgia who will be willing to make necessary investment in exploring new prospects and to take the related risks. There are several such explorations being conducted in Georgia at the present time, most notably the exploration of hydrocarbons prospects on the Black Sea shelf.

The recent evaluation of oil resources in the country reveals significant hydrocarbon deposits. According to the latest information the total estimated oil reserves in place are 2.4 billion tons, of which 1.15 billion are projected to be in the Black Sea basin. The eastern part of Georgia holds natural gas reserves in the estimated amount of 180 billion cubic meters.

It is hard to make projections on unopened gas and oil deposits, but based on the available information, the experts of National Oil Company are estimating to make at least one discovery of oil deposit in Eastern Georgia within the next couple of years, from which the maximum output capacity of 2 – 2.5 million tons will be reached in three to five years. It is also estimated that within seven to nine years, the oil extraction from the Black Sea shelf will reach its peak of 3 to 3.5 million tons annually.¹

NATIONAL OIL COMPANY OF GEORGIA “SAKNAVTOBI”

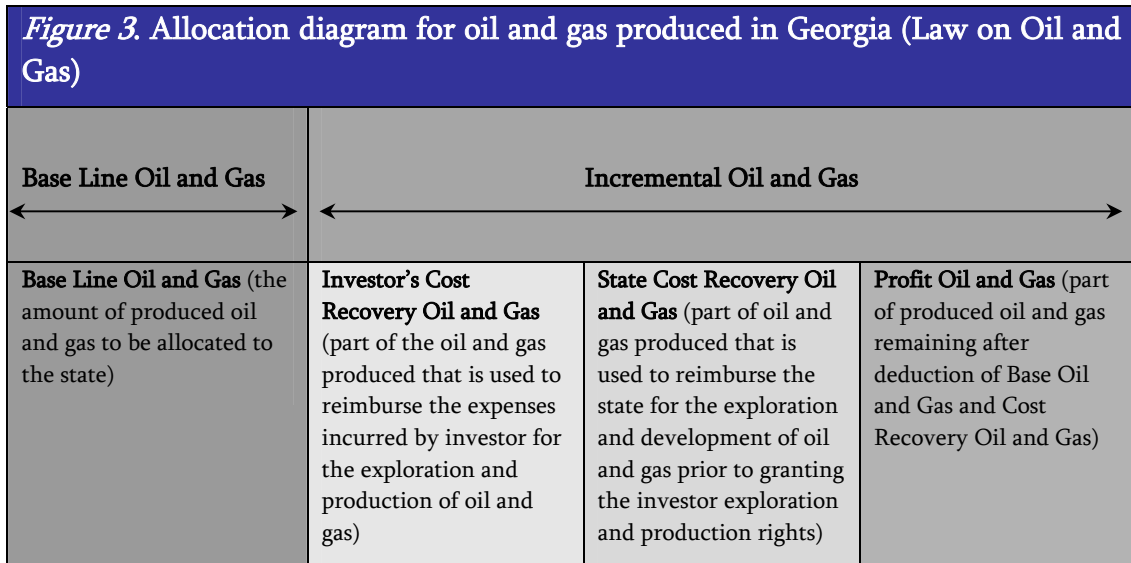
The Georgian Law on Oil and Gas established the Georgian National Oil Company – Saknavtobi – to endorse all petroleum agreements, with a primary function of serving as a commercial and operating enterprise. One hundred percent of company’s shares are held by the government. Saknavtobi serves as the Georgian side in several joint ventures established with foreign investors mentioned in this report.

The terms of the production sharing agreements (PSAs) that govern the oil and gas activities for particular license blocks vary widely, but typically they stipulate that during an initial period, one half of the extracted oil shall be used for recovery of investor’s costs and the other half is shared between the investor and Saknavtobi. For a more detailed description of the way the PSAs in Georgia divide the extracted hydrocarbon resources, please see *Figure 3*.

“Saknavtobi” has an official Web site (www.georgian-oil.com), which includes interesting narrative about the company’s origins and current operations, but does not contain data on extraction volumes or payments made to the state budget on monthly, quarterly or even annual bases. It does indicate that from its oil extraction

¹ G. Varshalomidze, “Prospects of Hydrocarbon Exploration, Extraction and Production in Georgia,” *Georgian Oil and Gas*, no. 12 2005: 146.

and refining activities, including the company’s share of joint ventures, Saknavtobi has contributed up to 46 million GEL to the state budget from 1995 to 2004.



The company can improve the transparency of oil and gas extraction sector in the country by posting on its Web site detailed information regarding:

- Total volumes of extracted oil from its own license blocks;
- Total volumes of extracted oil from the license blocks operated by joint ventures and the state share of this volume;
- Volumes and prices of crude oil sales; and
- Financial statements of the company, including information on profits and liabilities paid to the state budget.

Besides the National Oil Company of Georgia “Saknavtobi,” the following foreign companies are currently engaged in upstream oil activities in Georgia: Anadarko, Canargo and Frontera.

CANARGO ENERGY GROUP

In Georgia, Canargo Energy Group's principal activities are the exploration, development and production of oil and gas. The activities also include refining and marketing oil and gas in Georgia. The company has invested more than \$100 million over the last decade in the country, has raised a further \$57 million to be spent in 2005, and is looking to raise between \$200 to \$300 million worth of investment over the next four years.²

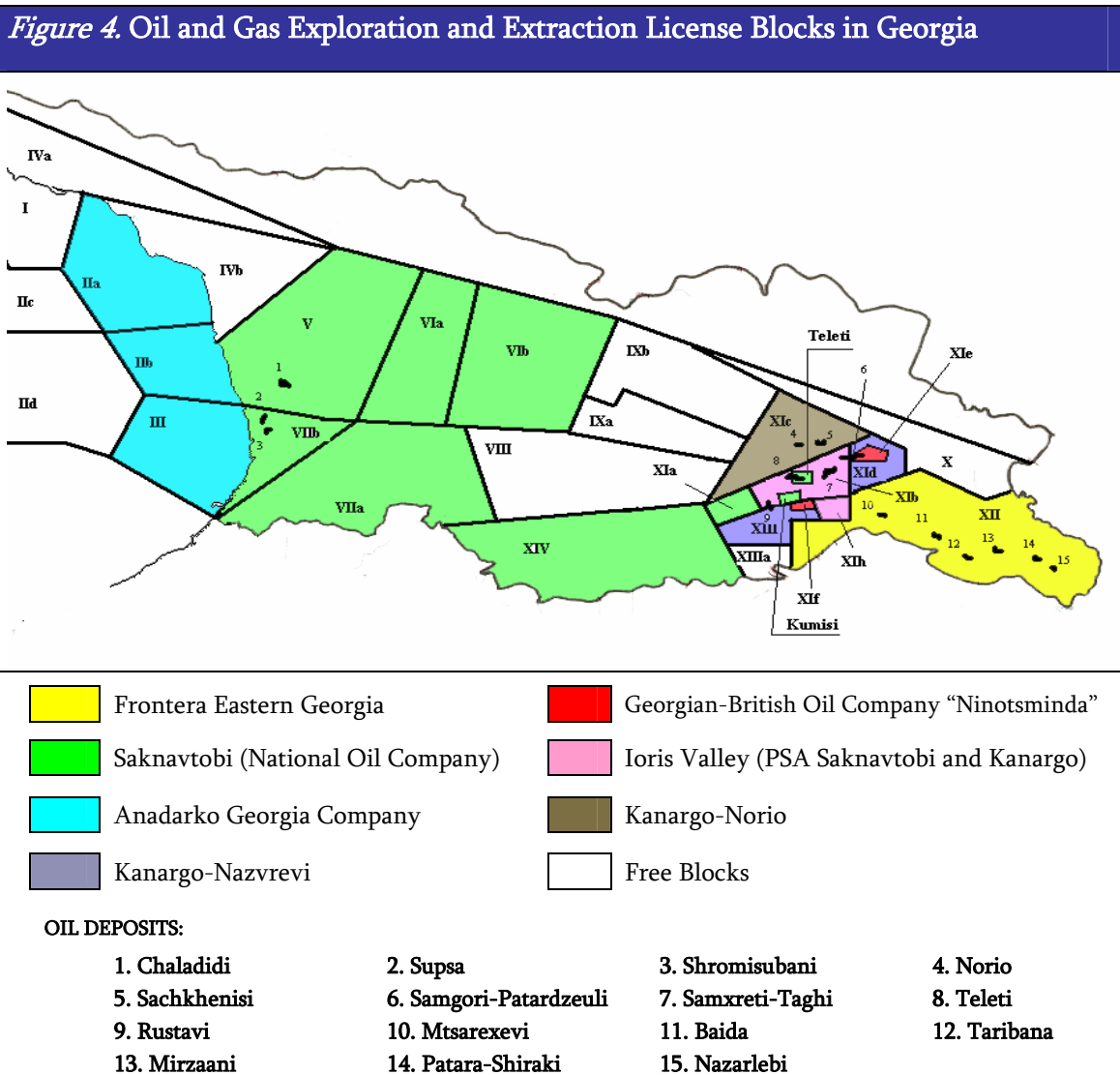
² Georgia Business Opportunities: an Investment Perspective for 2005. special advertising section, fortune magazine. <http://www.fortune.com/fortune/services/sections/fortune/intl/media/2004_10Georgia.pdf>

Canargo works on a production sharing basis whereby the government receives 70 percent of profits from Canargo’s activities, while the company can export 30 percent of its output.

The Group is a member of five production sharing arrangements:

1. Ninotsminda, Manavi and West Rustavi Production Sharing Contract;
2. Nazvrevi and Block XIII Production Sharing Contract;
3. Norio (Block XIC) and North Kumisi Production Sharing Agreement.
4. XIG and XIH production sharing contract, and
5. Samgori and Block XIB production sharing contract.

The company currently operates two fields to the east of Tbilisi, actively explores for new deposits of oil and gas, and is appraising what could be a substantial new discovery of oil at Manavi. If the estimated extraction volumes materialize, the operations at the site will significantly increase oil production in the country and contribute significantly to the Georgian budget.



Canargo has a company Web site (www.canargo.com), but it contains no information on the extraction and sales volumes, payments to the government, or the terms and conditions of the relevant PSAs.

ANADARCO GEORGIA

Anadarko signed a Production Sharing Contract with the State of Georgia to explore three blocks on the Georgian shelf of the Black Sea in June of 2000. The three blocks (IIa, IIb and III) cover approximately two million acres and extend about 50 miles offshore. Since the signing of the contract, the company has been conducting seismic surveys and other technical evaluations, while seeking partners to participate in future exploration.

Today, the production sharing contract is jointly held by Anadarko (48.0%), BP (28.5%), Turkish Petroleum Overseas Company (13.5%) and Unocal (10%), while another company, JKK retains a 4 percent net profit interest in the production sharing contract. BP and Turkish petroleum jointly hold the license in the adjoining Turkish Black Sea area and have announced plans to drill a well in mid 2005. Anadarko completed a 1,100 sq km, 3-D seismic survey in the southernmost offshore Georgia block in late 2004. The available seismic data carried out by Anadarko revealed several structures, three of which hold hydrocarbon deposits of 10 to 200 million tons each.

Anadarko has a Web site (www.anadarko.com) where it posts up-to-date operations information that includes the volumes of production from each particular well and the financial information that includes payments to the host governments. Therefore, in case the company begins extractive operations in Georgia, the payment information will be publicly available from its Web site. However, production sharing agreements are not posted. The terms of the PSA are available from the State Agency for Regulating Oil and Gas Resources of Georgia upon an official request, but they should be made freely and easily accessible to the public, preferably through the Agency's Web site.

FRONTERA RESOURCES

Frontera Resources Corporation, a Delaware corporation, and its subsidiaries are engaged in the development of oil and gas projects in emerging marketplaces. Frontera was founded in 1996 and is headquartered in Houston, Texas. Beginning in 2002, the Company has focused all of its efforts on the exploration and development of oil fields in Georgia.

In June 1997, the company entered into a twenty-five year production sharing agreement with the Ministry of Fuel and Energy of Georgia and the National Oil Company of Georgia “Saknavtobi,” which gives Frontera the exclusive right to explore, develop and produce crude oil in a 5,500 square kilometer area in eastern Georgia known as Block XII. Under the terms of the Block XII PSA, the Company is entitled to conduct exploration and production activities and is entitled to recover its cumulative costs and expenses from the crude oil produced from Block XII. Following recovery of cumulative costs and expenses, the remaining crude oil sales, referred to as Profit Oil, are allocated between Georgian Oil and Frontera in the proportion of 51 percent and 49 percent, respectively. Frontera Eastern Georgia began commercial production of oil from Block XII in April of 2000.

As of the end of 2004, according to the company, it has invested approximately \$70 million in its research and operations in Block XII. With this investment, Frontera has undertaken series of studies, geologic field work and operational work programmes that has resulted in the identification of two major geologic plays within the block that contain significant reserve potential that the company intends to pursue to commercial production. The reservoir engineering firm of Netherland, Sewell and Associates, Inc. has assigned unrisks resource potential in excess of 1 billion barrels of recoverable reserve potential to two exploration prospects within Block XII.

The company has a Web site (www.fronteraresources.com), where it posts information for potential investors, including the consolidated financial statements. The company received the revenues of approximately \$1.04 million in 2004 from the Georgian crude oil sales. Considering the terms of the PSA (the company retains the entire oil profits until the total costs and expenses are recovered, and the company is exempt from any tax liability), and the stated investment volume of \$70 million, the company will not be making payments to the state for a foreseeable future, unless the production of oil raises sharply. The company does not publish information on the volume of the extracted oil. The monitoring activities of the company’s operation in Georgia should focus on the size of the actual investment in the country, and the volume of the extracted oil from each field. The PSAs of the company should be made publicly available, as well as the documents related to the tender process that granted the company such advantageous terms and conditions for extracting Georgian gas and oil.

OVERSIGHT OF OIL AND GAS EXTRACTION IN GEORGIA

The main legal instrument that regulates the extraction of hydrocarbons in Georgia is the Georgian Law on Oil and Gas, adopted in 1999 and subject to numerous modifications. The draft revision of the law is currently under deliberations in the Parliament. The law creates legal basis for state supervision and control of oil and gas operations in Georgia and determines general principles of agreements made between the state and the investor for the exploration and production of oil and gas. The law also determines the functions of the National Oil Company of Georgia.

State Agency for Regulating Oil and Gas Resources

The state management of oil and gas operations is performed by the State Agency for Regulation of Oil and Gas Resources (SAROGR). The agency selects areas to be offered to investors, prepares rules and conditions for tenders and auctions, negotiates and concludes all agreements on behalf of the state, issues licenses, supervises and controls the implementation of agreements, and carries out other tasks. Two statutory functions stand out for their relevance for the transparency of information. The first one is the mandate to create and manage a centralized information bank in respect to all data on oil and gas resources and operations in Georgia. The other is the mandate to observe the principle of transparency, including the publication of annual report on performed activities and public consideration of auction and tender terms and conditions.

The status of the SAROGR is expected to be significantly altered if the Parliament passes the suggested changes to the Law on Oil and Gas. The agency will assume a legal status of independent regulatory commission, with three commissioners appointed by the president. The new law also envisages separation of the licensing function into exploration and extraction licenses. Today, the license for oil and gas issues by SAROGR entails the rights for both exploration and extraction stages. The new law will require separate licenses for these two stages of oil and gas operations in

The Functions of the State Agency for Regulation of Oil and Gas Resources Include:

Creation and management of a centralized information bank in respect of all data and information Oil and Gas Resources and Oil and Gas Operations in Georgia (collection, systematization, analysis and storage of information and data).

In performance of its functions, observance of the principle of transparency; including public consideration of auction and tender terms and conditions in the process of preparation and their further approval, publication of annual report on performed activities, etc.

Source: Georgian Law on Oil and Gas

Georgia. The law also introduces the concept of “general license for using oil and gas resources,” which enables investor to carry out explorative, as well as extractive operations. Most importantly, the responsibility of gathering, analyzing, and publicly reporting the information regarding the exploration for and the extraction of oil and gas resources in Georgia is transferred to the new Commission.

To this date, SAROGR has not fully met its mandate of insuring transparency of oil and gas related information. The agency holds the following information that is essential for conducting monitoring of oil and gas extraction related operations in the country:

1. The terms and conditions of all tenders and auctions that resulted in granting of exploration and extraction rights to investors.
2. The production sharing agreements that specify (a) how the extracted volumes and earned revenues are distributed between the state and the private companies, and; (b) what types of payments will the government be receiving from the private companies, including bonuses, and when.
3. The volume of oil and gas extracted from each well.
4. The volume of oil and/or amount of money each operating company owes to the State.

However, the information is not systematized, and is not available in an easily accessible format. The agency has a functioning Web site (www.sarogr.ge), but it does not contain statistical information. The agency produces annual reports, which contain information regarding oil and gas revenues, and are available upon request. It would be desirable for the Agency to ensure timely and accessible provision of information, for example, by posting monthly updates on volumes of extracted hydrocarbons on its Web site.

HARD SUB-SOIL RESOURCES

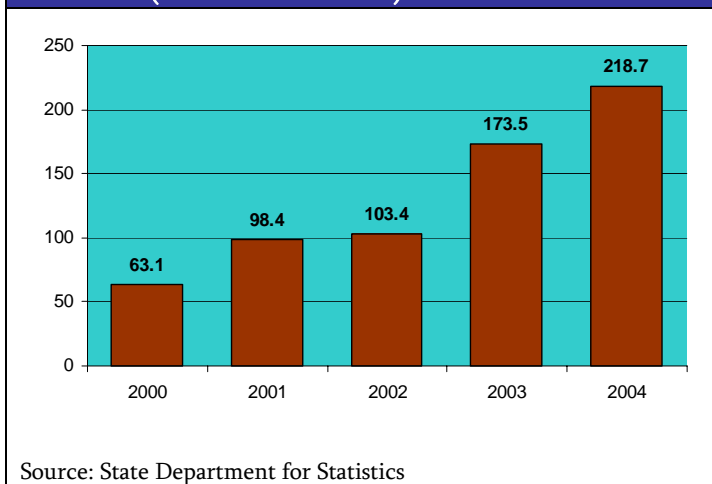
Georgia has a diverse mineral industry, producing ferrous and nonferrous metals, ferroalloys, and industrial minerals. Most important of these are: (1) production of manganese for the Chiatura deposit; (2) production of copper, barite, and a range of byproduct minerals, including gold and silver from Madneuli complex; and (3) production of commercially marketed mineral water products from natural springs in various regions of Georgia.

The government receives two major streams of revenue from the exploitation of these resources. The first is the profit tax, together with other applicable taxes that the companies engaged in extractive activities pay to the state. The second is the special duties levied on companies for the usage of natural resources. The amount of duties is determined by the 2004 Law on the Duty Imposed on the Use of Natural Resources. For example, a company must pay 0.12 GEL to the state for every ton of extracted manganese, and 0.9 GEL for every gram of extracted gold.

MAGNESIUM

Georgia is endowed with one of the largest magnesium deposits in Europe. In Chiatura – the magnesium-mining town of Georgia, the estimated reserves of magnesium are around 215 million tons. Chiaturmanganese, up until recently owned by the state, is one of Georgia's best known companies. It extracts manganese from six shafts. Founded in the 1920s, it supplied steel mills across the Soviet Union and Eastern Europe during the Soviet times. Although it is a significant magnesium deposit in the region, Chiaturmanganese has suffered a heavy slump in recent years, producing only 219,000 tons of manganese in 2004 –

**Figure 5. Extraction of Manganese in Georgia
(thousands of tons)**



less than a third of its historical production volume.

The plant was subject to numerous privatization efforts since 1993, all of them without success. Before the privatization of the plant, Chiaturmanganese filed for bankruptcy in order to enable the government to sell its assets, and use the money raised to cover its obligations

to creditors, including the wage debt, and the debt to the government. Chiaturmanganese has about 80 million GEL in debt, including 53 million GEL owed to the government.

Evrax Holding, Russia's largest steel producer, won a tender for 80 percent of Chiaturmanganese and all of the shares in the Vartsikhe cascade in January 2005, bidding \$132 million for the assets, which were offered in a single lot. However, in June 2005, Evrax Holding decided to pull out from a privatization deal as a result of falling manganese prices, which, according to the company, no longer justify the refurbishing of the Chiatura factory. The ownership of the manganese extraction industry in Georgia is still undecided. When the privatization process is complete and the final owner of Chiaturmanganese complex is revealed, it will be an important task to work with the company on the issues of transparency, to achieve publication of the extraction volumes, as well as the financial flows to the state budget through an easily accessible channel, preferably a Web site.

GOLD AND COPPER

Copper ores and concentrates, and unwrought and semi-manufactured gold, are among the major Georgian export commodities (see *Table 1*), and are expected to experience growth in production.

The deposits of copper and gold in Georgia have been exploited from the ancient times. Starting in 1975, the Madneuli Mining-Concentration Enterprise in Bolnisi supplied gold-copper concentrates and gold-bearing ores to the

Table 1. Volume of Georgian Copper and Gold Export (million U.S. dollars)

	2002	2003
Copper ores and concentrates	\$13.16	\$23.44
Gold unwrought and in semi-manufactured form	\$28.58	\$20.33
Source: State Department for Statistics		

gold mills and copper smelting plants throughout the Soviet Union. In 1994, Joint-Stock Company "Madneuli" was founded on the basis of the enterprise, with the controlling interest belonging to the state. A gold recovery mill was constructed and commissioned at the Madneuli deposit by joint Georgian-Australian enterprise "Quartzite" in 1997, which uses the method of heap leaching of gold-bearing secondary quartzite, with an annual production capacity of 2 tons of gold (unverified company data).

The Madneuli Company has been notorious for alleged misappropriation of funds owned to the state budget. In 2004, the ex-president of the company was arrested in Switzerland and charged with misappropriating the company's funds. The government has had several attempts to improve the management of the company and to promote transparency.

Georgia's three-year Poverty Reduction and Growth Facility arrangement with the IMF mandated the Georgian government to appoint new supervisory board for the Madneuli mining company. The board is supposed to be guided by performance-based contracts, which will require it to exercise effective oversight of management to ensure improved transparency in the operation of the state enterprise. Even though the supervisory board has been appointed, the performance-based contracts for the board have not been issued. The IMF also mandated public posting of the Madneuli mining company's audit (on the official Web sites of the Ministry of Finance and the Ministry of Economy). As of November 2005, the audit had not been finalized due to payment dispute with the auditor. The unverified financial statements of the company are posted on Madneuli's official Web site (www.madneuli.ge), which indicates that company's total sales were close to 60 million GEL in 2004, but the data comes into contrast with the information available from the State Department for Statistics.

In November 2005, the London-based Stanton Equities Corp. won a tender on the privatization of 97.25 percent shares of the Madneuli mining company and 50 percent shares of Trans Georgian Resource Ltd - which focuses on exploration of ore - after offering \$51.1 million. Out of this sum, \$35.1 million will be paid for the 97.25 percent shares of Madneuli, while \$16 million will be paid to the state budget to cover the company's debts. Madneuli itself owns 50 percent of shares of the Georgian-Australian joint gold mining company Quartzite LTD.

After the legal transfer of ownership of Madneuli to the new company, it will be important to work with the new owner to achieve a high degree of transparency of information regarding extraction volumes and transfers to the state budget.

MINERAL WATERS

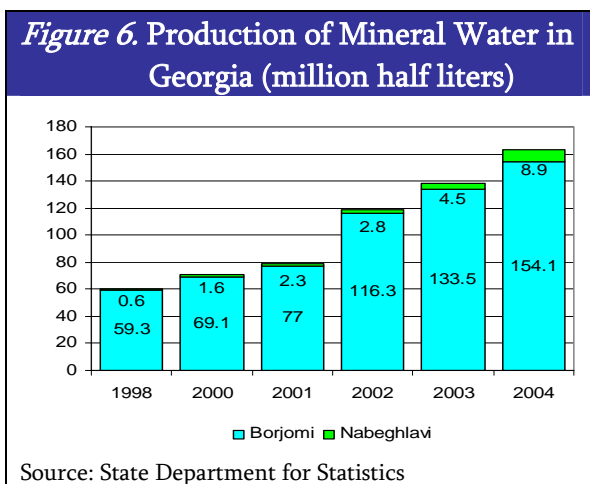
Georgia is known throughout the former Soviet Union for its abundant mineral water resources. Today, there are up to 2,300 registered mineral springs, with total reserves of 130 million liters per year.³ Only several of these springs are under commercial production.

The Borjomi brand of mineral water has been distributed throughout the region for over 100 years. The brand name "Borjomi" remains widely recognized in the former Soviet Union and is often associated with medicinal qualities. After the dissolution of the Soviet Union and during the subsequent civil unrest in Georgia, much of the country's industry, including mineral water operations, was almost stalled. However, starting from mid 90's, the bottling operations started to increase

³ State Department for Statistics.

considerably and today the mineral water represents around 5 percent of total exports.⁴

The international holding, Georgian Glass and Mineral Water Co. (GG&MW), was founded in 1997 by European investors, international financial institutions, and Georgian representatives, and holds the official license to extract and bottle Borjomi natural mineral water. Today, the company owns two mineral water bottling factories. The primary markets for the bottled Borjomi water are the countries of the former Soviet Union, but it is also exported to many foreign countries, including the United States, Israel and Germany, where they are gaining popularity.



Another increasingly popular and fast-growing mineral water extractive company is “Healthy Water” Georgian mineral water company, which extracts and bottles “Nabeghlavi” water.

The state receives several significant revenue streams from the extraction, bottling and the sale of mineral waters of Georgia. One obvious revenue stream is the profit tax levied on the

companies. Another important source of revenue for the government is the duty imposed for using natural resources, which includes mineral waters.⁵ The 2004 Law sets specific duties for different mineral waters: 10 GEL for one cubic meter of “Borjomi” mineral water, 6 GEL for one cubic meter of “Nabeghlavi” and “Sairme” mineral waters, and 4 GEL for “Utseri” mineral water. The amount of duty liability for a company is based on the volume of water that the company is allowed to extract annually, as specified in the natural resource usage license.

Even though both companies have Web sites, neither the information on production volumes nor any financial statements indicating transfers to the state budget are available. Considering the symbolic value of mineral waters for Georgia and the economic benefit associated with their sale both domestically and abroad, the inclusion of the major mineral water extractive companies in the revenue transparency initiatives is crucial. Monthly, quarterly and annual disclosure of the production volume information, and the payments made to the state budget would improve the image of the mineral water companies and enable civil society groups to monitor their activities.

⁴ State Department for Statistics.

⁵ Georgian Law on the Duty Imposed on the Use of Natural Resources

TRANSPORTATION OF ENERGY RESOURCES THROUGH GEORGIA

The strategic location is among Georgia's most important economic assets – it is a vital part of the East-West energy transit corridor that brings gas and oil resources from the Caspian basin to the Western energy markets. Even at times as distant as the end of the nineteenth century, up to 20 percent of the world's oil production flowed from oil fields near Baku to world markets through the Georgian Black Sea port of Batumi.

Table 2. Oil and Natural Gas Pipelines in Georgia

Pipeline	Operator	Maximum Capacity	Tariff	Georgian Agency Responsible for Transit Revenue Collection
Baku-Supsa (WREP)	BP	5.75 million tons per year	\$0.18 – \$0.20 per barrel	GIOC
Baku-Tbilisi-Ceyhan (BTC)	BP	50 million tons per year	\$0.12 – \$0.14 per barrel	GIOC
South Caucasian Pipeline (SCP)	BP	7.4 bcm./per year (Phase I) 20 bcm./per year (Phase II)	5% of previous year's throughput	GIOC
North-South Gas Pipeline	GGIC	16 bcm/per year	10% of previous year's throughput	GGIC

There are three ways of transporting hydrocarbon resources through Georgia – through pipelines, via railways and by trucks. The newly constructed pipelines will bear the major share of the transshipment volume (please see *Table 2*), but the railway shipment volumes are also substantial and expected to grow. The transit of energy resources through the country contributes to the state budget three major revenue streams:

Transit Fees – the major income for the government from energy transit operations, charged per barrel for pipeline transit and per ton for railway transit. Pipeline transit fees vary and usually are indexed to inflation. For instance, Georgia received transit fee of \$0.18 per barrel of crude shipped through Baku-Supsa pipeline until the fee increased to \$0.19 in 2001. BTC transit fees will be \$0.12 per barrel until 2010 when it will increase to \$0.14. Georgia does not receive monetary transit fees from the two major gas transit pipelines crossing its territory. Rather, the government has opted to receive the percentage of the total transported gas volume as transit fee (5 percent from SCP and 10 percent from North-South pipeline).

Profit Taxes – companies that operate the pipeline are subject to Georgian Tax regulations and have to pay profit tax on the profits they generate as the result of their activities in the country. BP, for instance, will make the first

profit tax payment in April 2006, covering the second half of 2005 transportation. From currently committed volumes (the Azeri-Chirag-Guneshili fields) total profit tax payments will be around \$575 million between now and 2025, peaking at more than \$50 million for 2010-2011.⁶

Special Contributions – companies constructing and operating the pipelines have made financial commitments to support various social, economic and cultural programs in the country. Even though these grants are as a rule used to fund projects undertaken by NGOs and do not represent a direct revenue for the state, often they still effect the budget by freeing up the public funds that would have otherwise been spent on similar social and economic programs. Good examples of similar special contributions are the various social investment programs funded by the BTC pipeline company, including the Community Investment Program of \$5 million and the BTC Grant Program in the amount of \$40 million.

BAKU-SUPSA PIPELINE (WREP)

The Baku-Supsa pipeline, also called the Western Route Export Pipeline (WREP), has been operating since 1999. Operated by the British Petroleum company, it is the harbinger of modern pipeline systems that transship Caspian hydrocarbons through Georgia. Initial line capacity is 5.75 million tons per year (115 000 b/d), but with the additional pumping stations could increase to 10 mt/year (200 000b/d).

<i>Table 3. Transit Revenues from the Baku-Supsa Oil Pipeline</i>						
	1999	2000	2001	2002	2003	2004
Volume (million barrels)	24.8	36.6	43.3	45.9	46.0	47.1
Fee (Per barrel, U.S. dollars)	0.18	0.18	0.18-0.19	0.19	0.19	0.19-0.20
Transit Revenue (in million U.S. dollars)	4.5	6.5	8.5	8.7	8.7	9.3
<i>of which</i> transferred to the state budget (\$ million)	0.7	1.4	3.8	4.3	6.6	6.9
<i>of which</i> used to cover expenditures, meeting Georgia's obligations under international agreements (\$ million)	3.8	5.1	4.7	4.4	2.1	2.4
Source: Georgian International Oil Corporation (GIOC)						

The pipeline mainly accommodates the “early oil” from the Caspian Sea region operated by AIOC consortium off the Azerbaijan coast. In addition, the pipeline transships Kazakh oil, which is produced by the Chevron-led consortium at Tengiz oil field. Kazakh crude oil is transported by barge across the Caspian sea to Dupendi (near Baku), and then moved by a combination of railcars and pipelines to Supsa.

⁶ BP Georgia Office.

BTC AND SCP PIPELINE SYSTEMS

The BTC pipeline is designed to transport Caspian oil: up to one million barrels of Azerbaijani crude per day (bpd) – 50 million tons per annum, via Georgia to the Turkish port of Ceyhan on Mediterranean. The pipeline was commissioned by a consortium of energy companies led by British Petroleum, which has a 30.1 percent stake and is the operator of the pipeline. The other members of the BTC consortium are:

- SOCAR (the state oil company of Azerbaijan) 25%;
- TPAO (Turkey) 6.53%;
- Statoil (Norway) 8.71%;
- Unocal (USA) 8.90%;
- Itochu (Japan) 3.4%;
- Amerada Hess (USA) 2.36%;
- Eni (Italy) 5%;
- TotalFinaElf (France) 5%;
- INPEX (Japan) 2.5%; and
- ConocoPhillips (USA) 2.5.

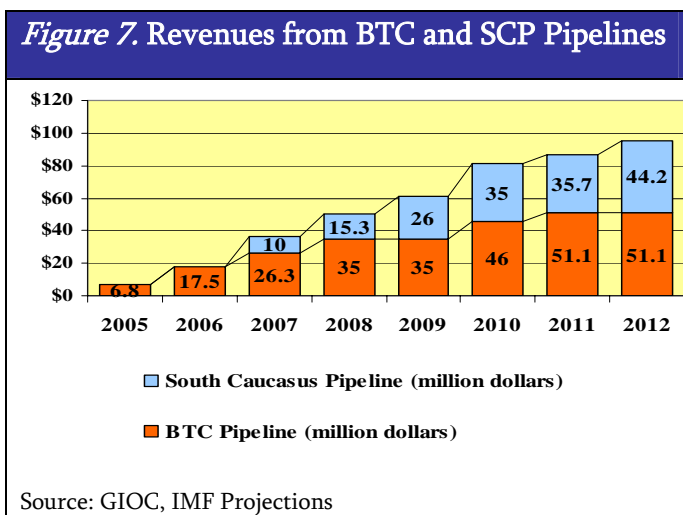
Georgia will receive a transit fee of \$0.12 for every barrel transported through the pipeline. As the *Table 4* shows, the revenues for the state are expected to start at \$6.8 million and increase drastically to reach \$51 million by 2011. The total transit revenue for Georgia from the BTC pipeline is expected to be over \$700 million.

Table 4. BTC and SCP Oil and Gas Transit Volumes and Revenues								
	2005	2006	2007	2008	2009	2010	2011	2012
BTC Revenues:								
AIOC oil production (million barrel)	114.6	192.0	265.0	338.0	338.0	374.5	411.0	411.0
exported using Baku-Supsa	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
exported using BTC	56.3	146.0	219.0	292.0	292.0	328.5	365.0	365.0
BTC transit fee (US\$ per barrel)	0.12	0.12	0.12	0.12	0.12	0.14	0.14	0.14
BTC transit fee (US\$ million)	6.8	17.5	26.3	35.0	35.0	46.0	51.1	51.1
BTC transit fee (percent of GDP)	0.12	0.29	0.41	0.52	0.49	0.60	0.63	0.59
SCP Revenues:								
Gas sales to Turkey (bcm)			2.0	3.0	5.0	6.6	6.6	8.0
Georgia's 5 percent (in-king fees) (bcm)			0.100	0.150	0.250	0.330	0.330	0.400
Assumed sales price (US\$ per tcm)			100	102	104	106	108	110
SCP transit fee (US\$ million)			10.0	15.3	26.0	35.0	35.7	44.2
SCP transit fee (percent of GDP)			0.16	0.22	0.36	0.46	0.44	0.51
BTC Plus SCP transit revenues (\$ million)								
	6.8	17.5	36.3	50.3	61.1	81	86.8	95.3
BTC Plus SCP transit revenues (percent of GDP)								
	0.12	0.29	0.57	0.74	0.85	1.06	1.07	1.11
Source: GIOC, IMF Projections								

The practical maximum pipeline capacity of SCP is around 20 bcm per year but would require construction of five additional compressor stations. The current capacity is 7.4 bcm and plateau deliveries under the existing sales contracts are expected to be achieved in 2009.

If Shah Deniz/SCP partners are able to identify new markets in the future, they will consider investing in the second stage development of the field and the pipeline to increase capacity for new gas sales. This could not come on stream before 2012 due to the long lead times in making the necessary investments. Until a decision is made on Stage Two and new gas sales agreements entered into, it is not possible to project throughput on the gas pipeline beyond 2012, as it is very customer dependent.

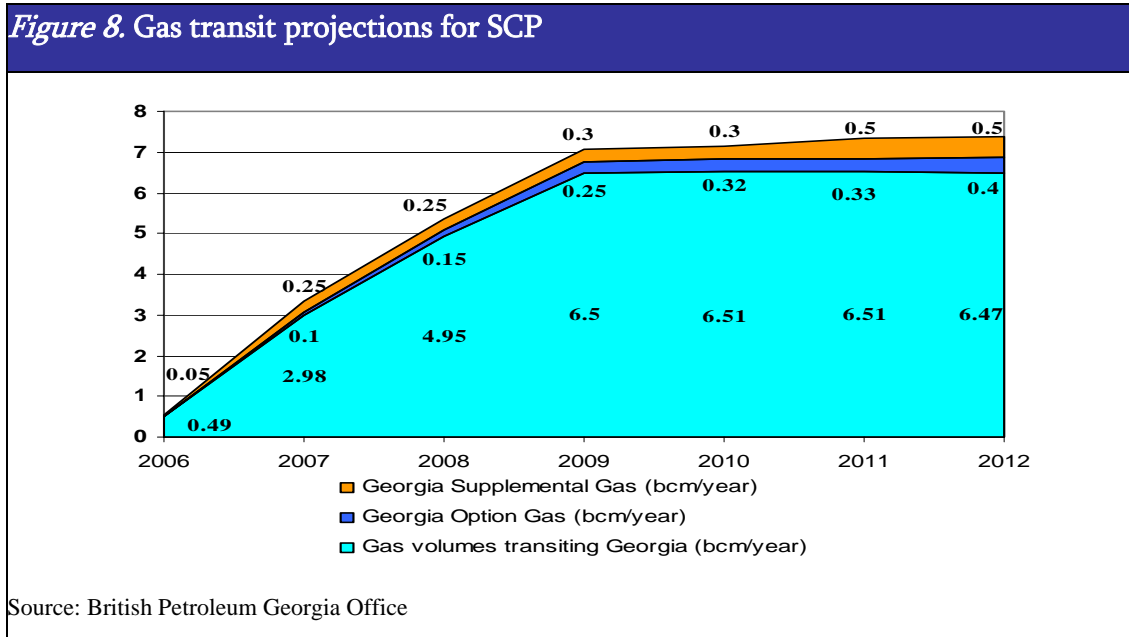
Georgian government had a choice of accepting either money or the natural gas as a transit fee for SCP. Based on the energy security strategy of the country to diversify the energy supply sources, the government agreed to accept the natural gas option. The volume of the so called "Option Gas" is based on five percent of the previous year's throughput. As the projections in the *Figure 9* indicate, the volume of gas given to Georgia as a transit fee will increase from 0.1 bcm in 2007 to 0.4 bcm in 2012. The monetary value of the Option Gas is harder to estimate, because the true value depends on the price at which this gas can be "monetized," or sold. The break even price at which it makes sense for the State to take the gas, rather than the cash alternative, is \$50 per thousand cubic meters. At \$50, the value of the gas at plateau is around \$18 million per year. Of course, if the gas can be sold at \$100 - which is



perfectly possible in the current gas price regime - then this value would double. Georgian government also has a right to purchase additional gas transported through SCP at a discounted price (Supplemental Gas).

The Georgian International Oil Corporation (GIOC) was established to rehabilitate oil pipelines and other means of oil transport in the territory of Georgia, as well as carry out the related finance, banking investment, insurance and other financial activities. GIOC is responsible for the implementation of the Host Country Agreement on behalf of Georgia regarding the Baku-Supsa Oil pipeline and collecting the revenues from the pipeline operation and transferring it to the state

budget. GIOC also represents Georgia in implementation of the BTC and SCP pipelines in the country.



The GIOC, as the central repository of data regarding volumes of hydrocarbons shipped via the pipelines and transit fees accrued to the state, should adhere to high standards of transparency of this information. The company has been keeping data from the operation of Baku-Supsa Oil pipeline from 1999 to this date. According to the company spokesperson, the data is transparent and free to access for any interested person. However, the company has no operational Web site, and the information regarding revenues from Baku-Supsa pipeline operation is published once a year in a single issue of a local newspaper. Even though the information might not be deliberately concealed from the public, it is certainly not easily accessible. It would be desirable for the company to set up a Web site for regular and timely posting of the information regarding the operation of all three pipelines – Baku-Supsa, BTC and SCP.

NORTH-SOUTH GAS PIPELINE

The North-South Gas Corridor is spread from Georgian Russian border to Georgian Armenian and Georgian Azerbaijan borders with total length of 235 km. The highest point of the system is 2420 meters at the Caucasus mountains and the lowest point at 290 meters above the sea level. The system supplies gas to Georgia and also serves as the only gas supply route to Armenia. The natural gas is supplied by Gazprom, and the national operator of the gas pipeline system is Georgian Gas International Corporation (GGIC). Georgia receives 10 percent of the gas supplied to Armenia as the transit fee.

The GGIC has a web site (www.ggic.ge), where the company posts information on transit volume, and the monetized value of transit revenues. However, much of the information necessary for transparent functioning and public monitoring of the corporation, such as the receipt, realization and losses of transit gas, and budgetary transfers, is not available.

Table 5. Gas Transit through the North-South Pipeline		
	2003	2004
Transit Volume (million cubic meters)	1,200,945	1,332,570
Transit Tariff (percentage of annual transit volume)	10%	10%
Transit Revenue (million cubic meters)	120 094	133 257
Transit Revenue in USD (calculated based on gas price at Russian/Georgian boarder - \$60 per 1000 c.m.)	\$7,205,670	\$7,995,420
Source: Georgian Gas International Corporation		

RAILROAD OPERATIONS

In the 90's Georgia experienced a dramatic decrease of oil transit volumes through the railways. Lack of cooperation between the participants of the Georgian oil transit corridor, lingering historical corruption on the route, and a growing competition from the oil terminals in the neighboring countries had a negative impact on the attractiveness of the Georgian oil transit railway services. This resulted in a significant reduction of oil volumes and a financial loss for the Georgian Railways, Georgian oil terminals, and the economy of Georgia as a whole.

The country is steadily regaining its status as a key railway transit link for Caspian oil. Naftrans, the member of the Greenoak Group and the owner of Batumi Oil Terminal in Georgia established in 2004 a new company – Pertotrans to provide integrated oil forwarding and transshipment services from Gardabani to Batumi. Petrotrans Limited is promising to provide customers with a new integrated transportation service, including handling crude oil and refined products from Gardabani on the Azeri-Georgian border to their transshipment and loading on tankers in the port of Batumi.

Considering the projected increases in the oil production volumes in Azerbaijan and Kazakhstan, the utilization of Georgian railway system for oil transport is expected to also increase significantly. Even with the construction of the BTC oil pipeline, it is foreseen that about 80 million tons of additional export capacity will be needed by 2020 to meet current production plans. ExxonMobil, which has the rights to export Azeri oil, announced its decision not to use the BTC pipeline and instead signed a five year contract with the Azpetrol Company to export 10 million tons of

Azeri oil by rail from Baku to the Georgian port of Batumi. The transshipment began in July of 2005.

Kazakhstan transported a total of 332,800 tons of oil through the Georgian railway in 2004, and the figure is expected to double in 2005. A new oil terminal in Kulevi, which is currently under construction, will further increase the capacity of Georgian Railways to accommodate the transit of Kazakh oil. Currently, Batumi Oil Terminal is the only terminal on the Georgian Black Sea coast that the railway system can use to transship oil. After the completion of Kulevi oil terminal, expected to take place within a year, the Georgian Railway's oil transshipment capacity will significantly increase (please see *Table 6*).

The Batumi Oil Terminal

Batumi Oil Terminal has been operating for over 120 years, and now represents a key petroleum transshipment facility on the Georgian Black Sea coast. Historically a state-owned enterprise that was virtually inoperative by the late 1990s, the Terminal was sold to Naftrans, a company of the Greenoak Group in August 1999. Greenoak Group consists of several companies, including Naftrans, which in turn owns Batumi Oil Terminal, Petrotrans and Alegratrans.

The Terminal has been completely rebuilt and modernized at a cost of more than \$60 million, and now handles 56 percent of the country's oil transshipments. The Terminal transships crude oil and oil products exported by regional producers in Kazakhstan, Azerbaijan, Turkmenistan and Georgia. The range of handled products includes 8 types of crude oil⁷ and 15 different refined oil products⁸. The Terminal's transshipment capacity is currently 12 million tons per annum, and close to 9 million tons were transshipped in 2003.

Table 6. Gas and Oil Terminals on Georgian Black Sea Coast for Railroad Transit		
Terminal	Description	Transshipment Capacity (million tons per annum)
Batumi Oil Terminal	Handles 56% of the country's transshipments of oil and oil products. Will accommodate ExxonMobile shipments of 10 million tons of oil in 2005-2010.	12
Kulevy Oil Terminal	Currently under construction, the terminal is scheduled to open by the end of 2006.	6 (expected to increase to 10 following second stage of construction)

⁷ Crude Oil types are: 1. Kumkol Crude Oil; 2. Urals Crude Oil; 3. Cheleken Crude Oil; 4. Okarem Crude Oil; 5. Keimir Crude Blend; 6. Azeri Crude Oil; 7. Shirvan Crude Oil; 8. Tengiz Crude Oil.

⁸ Refined oil products are: 1. Fuel Oil (Fuel Oil M-40 and Fuel Oil M-100); 2. Light Gasoil; 3. Furnace Oil; 4. Diesel Fuel; 5. Kerosene (Kerosene KO-20 and Technical kerosene); 6. Jet Fuel TS-1; 7. Naphtha; 8. Gasoline (A-76, A-80, A-92, A-95); 9. LPG (Propane and Butane).

Kulevi Terminal

The Kulevi Terminal represents another private venture in the area. It is being constructed at a site located between Poti and Analkiya. The Georgian-Austrian company Terminal 2000 launched the construction of the terminal in April 2000. The throughput capacity of the Kulevi terminal will be around 6 million tons of liquid hydrocarbons and is expected to rise to 10 million tons following the second stage of construction. The project also envisions constructing an oil storage farm with a capacity of 300 thousand cubic meters, two 250 meter piers and laying pipelines with pumping stations.

It should be noted that information regarding railway transit of oil is among the hardest to obtain. Neither terminal has a Web site, and the site of the Georgian Railways (www.railway.ge) contains no information regarding the volumes of transported oil, nor the transit fees collected and transferred to the state budget. It is desirable for the Georgian Railway company to publish this information, which would make it possible to conduct cross-comparison of data obtained from the railway, the oil terminals and the shipping companies.

TRANSPARENCY OF REVENUE INFORMATION: CURRENT SITUATION

The citizens' right to access public information is acknowledged by the Constitution of Georgia adopted in 1995. In 1999, the Parliament of Georgia adopted a General Administrative Code of Georgia, third chapter of which is dedicated to the freedom of information. The Administrative Code regulates periods of time necessary for the release of public information, types of classified information and general criteria for their definition, and the identification of persons responsible for the release of public information. The freedom of information provision of the General Administrative Code of Georgia will serve as the key legal instrument in promoting free access to the information regarding revenues from extractive and transit industries in Georgia.

Additional guarantees of transparency are embedded in the Law on Oil and Gas and The Regulations of Oil and Gas Operations of Georgia. The Regulations stipulate that a company engaged in oil and gas extraction must retain accurate and complete records in compliance with international accounting standards. These records include:

1. The production and disposition of oil, gas and associated hydrocarbons and other mineral substances with commercial value;
2. The sale or exchange of such substances;
3. The disposition of the proceeds of such sale or exchange;
4. Production, cost recovery and profit split report that contains information regarding quantities of available petroleum, its average price, cost recovery oil and profit oil;
5. Profit tax report that provides information regarding the company's revenues, capitalized expenditures, and taxable profit; and
6. Other reports specified in the Regulations or contracts.

Extractive companies are required by law to ensure that the State Agency for Regulating Gas and Oil receives complete and accurate information regarding oil and gas operations conducted within Georgia.⁹ The Agency, on the other hand, is required to gather and maintain all gas and oil extraction related information, and to observe the principles of transparency. Specifically, the Regulations mandate that all records in the possession of the Agency shall be open to inspection by any person

⁹ Regulations on Oil and Gas Operations, Title XII, Chapter LXIV.

during the times the Agency is open for business under reasonable rules established by the Agency to protect the integrity of the Records. Persons may obtain copies of records on request at a charge that reflects the actual cost of the Agency to make copies. A person may be required by Agency rules to provide his or her name and address and to provide identification, but the Agency may not inquire as to the purpose for which the person wishes to inspect any record.”¹⁰

Similar provisions concerning information transparency can be found in the legislation regulating licensing of mineral extraction in Georgia.¹¹ The combination of these and other relevant legal instruments can be used to demand and obtain the information regarding particular extractive companies and their activities in Georgia. This information, in turn, can be used to conduct independent monitoring of the companies’ profit and their financial liabilities to the state.

MINISTRY OF FINANCE

The data on company payments to the government is kept at the Tax Department of the Ministry of Finance. The Tax Code of Georgia is the legal instrument regulating access to revenue information. Chapter 122 of the Code defines a broad category of confidential information on revenues that can not be disclosed to the public. This provision prohibits the Ministry of Finance to disclose data on revenues that the state received from individual companies, unless the ministry has a written consent from the companies to do so.

One way to achieve a degree of revenue transparency without raising concerns about company confidentiality clauses is an aggregated disclosure – disclosing a single number for each benefit stream, instead of breaking down revenue payments by individual companies or license holders. Yet, the disclosure of revenues on individual company basis is a recommendation of the Extractive Industries Transparency Initiative (EITI), as well as the major international organizations, such as the International Monetary Fund.

Another possibility of circumventing the confidentiality clause of the Tax Code is the implementation of the EITI in Georgia. Through the EITI mechanism, the companies that have signed onto the initiative on a voluntary basis agree to disclose the information on all payments made to the government, thereby allowing the Ministry of Finance to disclose the corresponding information on revenues.

¹⁰ Regulations on Oil and Gas Operations, Title XII, Chapter LXVIII. Article 246. Access to Records.

¹¹ Georgian Law on Licensing Geological Activities, 8 May 2003, N2294.

STATE DEPARTMENT FOR STATISTICS

One obvious place where the information regarding natural resource extraction is being pooled and analyzed is the State Department for Statistics (SDS), under the Ministry of Economic Development of Georgia. The SDS surveys all the large enterprises (having more than 100 employees or yearly turnover of more than 1.5 million GEL), and samples the medium and small enterprises. Company-specific, monthly, quarterly and annual data gathered by the department through an established survey mechanism includes the total volume and value of production.¹² This information is valuable in monitoring revenues from major extractive and energy transit industries in Georgia.

However, the level of restriction on the access to the information is high, especially if the requested data can be used to identify a particular company. Company-specific data is considered confidential. In particular, Chapter 12 of the Law on Statistics (enacted in 1997) stipulates that data collected for the purpose of state statistics is confidential if it can be used to identify a specific entity. Dissemination of state statistical materials that contain confidential information, or that can be used to determine confidential information, is prohibited by the amendment made to the law in 2002. The SDS is allowed to use the confidential information only to prepare aggregated data, unless the submitting entity agrees for the information to be used for other purposes.

The official justification for the confidentiality clauses in the law on statistics is the need for “the atmosphere of trust” between the SDS and individual enterprises.¹³ The formal relationship between the SDS and the companies that supply it with information has been altered by a recent change in the Law on Statistics, made in July of 2005: the abolishment of the responsibility of legal entities operating in Georgia to provide accurate and timely information to the SDS. This change was a part of a series of amendments to the Georgian legislation meant to mitigate the regulatory atmosphere that was conducive to bribery and corruption. As the result, provision of information to SDS is mandatory, but the corresponding responsibility for meeting this mandate is absent, making the SDS dependant on the “atmosphere of trust” created by a high degree of confidentiality. Without the administrative sanctions for noncompliance, the only choice for the SDS to compel the entities to submit information is litigation, but this path is prohibitively time- and resource-intensive for the agency to follow.

The SDS has little capacity, legal or administrative, for verification of the submitted information. If there are logical or mathematical inconsistencies in the provided data, SDS can verify the sources of primary data, but only after obtaining permission from the court.

¹² State Statistics Survey, SDS form (N 03-01-01 monthly) for the collection of statistical information.

¹³ Interview with the Head of State Department for Statistics, Mrs. Zaza Broladze, 29 Sept. 2005.

TRANSPARENCY OF REVENUE INFORMATION: FUTURE PROSPECTS

Transparent public reporting on payments to governments by the extractive companies, and on revenues by the governments can foster appropriate use of these revenues. Publication of payments allows citizens to hold their authorities to account. Conversely, there is ample evidence of bad governance and corruption fueled by non-transparent sources of extractive resource revenue, such as oil, gas, diamonds, and gold. The Georgian government and the private companies involved in extractive and energy transit activities in the country should therefore reach a common understanding to practice maximum transparency in the reporting and utilization of revenues.

EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE

The Extractive Industries Transparency Initiative was launched by U.K. Prime Minister Tony Blair at the September 2002 World Summit on Sustainable Development in Johannesburg. Member countries of the initiative agree to abide by the EITI criteria, which guarantee a high degree of transparency of the revenue information:

1. Regular publication of all material oil, gas and mining payments by companies to governments (“payments”) and all material revenues received by governments from oil, gas and mining companies (“revenues”) to a wide audience in a publicly accessible, comprehensive and comprehensible manner.
2. Where such audits do not already exist, payments and revenues are the subject of a credible, independent audit, applying international auditing standards.
3. Payments and revenues are reconciled by a credible, independent administrator, applying international auditing standards and with publication of the administrator’s opinion regarding that reconciliation including discrepancies, should any be identified.
4. This approach is extended to all companies including state-owned enterprises.
5. Civil society is actively engaged as a participant in the design, monitoring and evaluation of this process and contributes towards public debate.
6. A public, financially sustainable work plan for all the above is developed by the host government, with assistance from the international financial institutions where required, including measurable targets, a timetable for implementation, and an assessment of potential capacity constraints.

The Georgian authorities have taken a promising first step in committing to join the EITI. The Memorandum of Economic and Financial Policies signed by the Prime Minister, Minister of Finance and the President of National Bank of Georgia, and submitted to IMF to set performance criteria for meeting the Poverty Reduction and Growth Facility requirements includes the intention to join the EITI and publish for 2004 oil and gas transit revenues, as the first step towards annual disclosure of this information. Moreover, the National Anti-Corruption Action Plan prepared by the office of State Minister for Economic Reform Issues includes a commitment to implement the EITI principles in the country. **Therefore, the government has already made the decision to participate in the initiative.**

Similarly, the key stakeholders from the private sector have expressed interest in EITI participation. The operator of the Baku-Supsa, BTC and SCP pipelines, British Petroleum has been at the forefront of promoting good governance and transparency practices in the countries of its operation, and has taken a lead role in promoting the EITI in Georgia. Most of the EITI principles and criteria are already observed by the company in its regular publication of information regarding payments to the government. For instance, the profit tax payments to the government are reported in the BP Sustainability Review. Other major companies operating in Georgia have also expressed interest to join the EITI. **Therefore, the key stakeholders from the private sector have expressed their readiness to partner with the government and the civil society in EITI implementation process.**

The civil society organizations are actively engaged in the process. Georgian non-governmental organizations have a solid experience in public finance management monitoring work, and are increasingly interested in focusing on the new major sources of revenue for the state – the pipelines. **Several prominent civil society organizations¹⁴ have recently joined forces to form an open coalition “for transparency of public finances,” a major objective of which will be to facilitate the implementation of EITI in Georgia.**

Major work lies ahead before Georgia can effectively implement the EITI. The EITI offers a set of templates for the government to report revenues received from the extractive industries, and for the companies to report the payments made to the state. An independent auditor then analyses and compares the two reports, and makes a final, publicly available conclusion. The existing EITI templates are geared towards the extractive industries, so the implementation of the initiative in Georgia will require extending the templates’ coverage to include the transit activities in the

¹⁴ Open Society Georgia Foundation, Georgian Young Lawyers Association, Association of Young Economists of Georgia, Economic Policy Research Center, and Transparency International Georgia.

country. This can be done by either drafting a separate template for the energy transit industry, or modifying the existing templates to reflect the volume of the transported oil, and corresponding payments to the state budget. Modifying the existing templates to accommodate energy transit activities should be easy, since revenues from oil and gas transit are easier to keep track of than revenues from oil and gas production: the expected revenues can be directly derived from the volume that is transited and the agreed transit fee. A recent report by the International Monetary Fund¹⁵ recognizes the need for an alternative template for Georgia, and urges the EITI secretariat to develop a modified template for Georgia. If the EITI can not commit time and resources for this purpose, the civil society organizations in Georgia, in consultation with other stakeholders from the government and the private sector, can develop a template suitable for the country.

The steps required to complete the sign-up of Georgia to the initiative include:

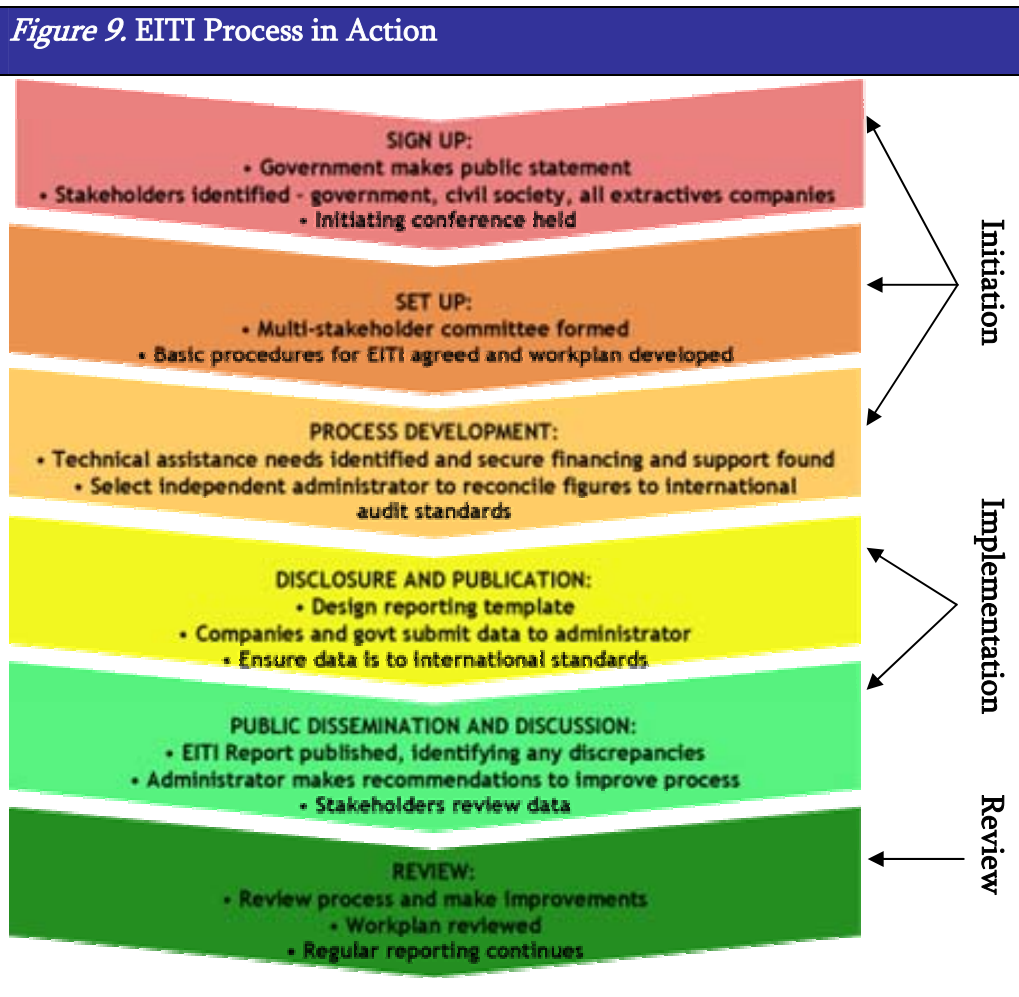
1. **Identification of the key EITI stakeholders.** This report has pointed out the major stakeholders in the extractive and energy transit industries, but the comprehensive list should be endorsed by both the government and the companies.
2. **Issuance of an unequivocal, public statement of government's intention to implement the EITI.** The government has expressed its will to join EITI both in writing¹⁶, and in public statements made by the Minister of Finance and the State Minister on Reforms Coordination.¹⁷ However, no unequivocal, public statement indicating the readiness of the government to take the necessary steps for EITI implementation has been issued yet.
3. **Review by the government of the legal framework to identify any potential obstacles to EITI implementation.** This report mentioned the Tax Code as one potential obstacle to EITI, but a more thorough legal analysis is desirable. Civil society organizations in Georgia could collaborate with the government to identify any legal obstacles and clear the way for EITI implementation in the country.

After the country is signed-up, the next stages of the initiative, as they are shown in Figure 10, can be implemented.

¹⁵ Andreas Billmeier, Jonathan Dunn, and Bert van Selm, "In the Pipeline: Georgia's Oil and Gas Transit Revenues," *IMF Working Paper*, WP/04/209, November 2004.

¹⁶ The Memorandum of Economic and Financial Policies signed by the Prime Minister, Minister of Finance and the President of National Bank of Georgia, and submitted to IMF to set performance criteria for meeting the Poverty Reduction and Growth Facility requirements; and the National Anti-Corruption Action Plan.

¹⁷ Statements made at the official launching ceremony for the NGO coalition "For Transparency of Public Finances," 28 November, 2005.



MONITORING OF SPECIAL SOCIAL INVESTMENT PROGRAMS

Besides the revenues streams that are going into the state budget from extractive and energy transit industries in Georgia, which should be comprehensively reflected by the EITI disclosure procedures, there is a significant financial assistance the country receives in the form of social assistance programs, funded by the major companies in Georgia. For instance, BP, the operating company of the WREP, BTC and SCP pipelines is funding various social investment programs in the country: Community Investment Program (\$5 million), Improved Schools Program (\$3 million), Regional Development Initiative (\$5 million per year), BP “Pledge” (\$14.5 million), and the BTC Grant Agreement (\$40 million by 2010, \$1 million per year thereafter).

Since these programs do not represent direct revenue for the government of Georgia, they may not be effectively and meaningfully included in the EITI framework. However, monitoring of how the resources within these and other similar programs are spent is crucial. Even though such programs are as a rule

designed to fund activities undertaken by NGOs and do not represent a direct revenue for the state, often they still effect the budget by freeing up the public funds that would have otherwise been spent on similar social and economic programs. For instance, close to \$2.5 million from the first, \$9 million installment of the BTC Grant was spent on increasing pensions in the Samtskhe-Javakheti and Kvemo Kartli regions.¹⁸ However, the decision on doubling the pensions was made prior to the Grant agreement, covered the entire territory of Georgia and should have been financed using the allocations from the state budget. Also, close to \$950,000 was supposed to be spent in the 3rd quarter of 2005 on student vouchers program in higher education institutions. The BTC Grant Agreement specifies the purposes for using the grant funds, which do not include higher education. By supplementing the basic social commitments of the state with the windfall financial resources such as the BTC grant, the government can free up the public funds and spend it on other priorities.

Moreover, the grant agreement clearly states that grant funds shall be used for discrete and separately identifiable projects with separate budgets and not to become, or be used as, general revenues of the government. However, the grant payments are paid to the State Treasury account at the National Bank of Georgia and are managed by the Ministry of Finance. Since the Ministry can not have special bank accounts, it is hard to track the movement of the grant funds after the initial transfer is made, or to verify whether it was indeed the grant funding that the government used to finance the activities that it claims as grant-funded.¹⁹

Therefore, it is desirable that the civil society organizations that have experience working on public finance transparency and budget monitoring issues engage in monitoring of the grants given by private companies to the government, such as the BTC Grant agreement. Monitoring should focus on:

1. The mechanisms through which the decisions on allocating the grant funding are made (do the citizens have a voice in setting spending priorities?)
2. The spending of the allocated funding on concrete programs (monitoring the financial flows, performance quality, procurement issues, etc.)

¹⁸ Official documents of the Ministry of Finance of Georgia, posted on BP website at: <<http://www.caspiandevlopmentandexport.com/ASP/LatestNews.asp?ArticleID=78&Language=English>>

¹⁹ "Establishment of a Grant Program for Georgia, Agreed Upon Procedures Report for the Quarters Ended 31 March and 30 June 2005." Available at <<http://www.caspiandevlopmentandexport.com/ASP/LatestNews.asp?ArticleID=78&Language=English>>

3. Trends in the budgetary allocations of the state in the same areas that the grant funding is targeted (is the government using the grant money to complement public spending on social programs, or is it simply shifting funds?)

CONCLUSION

This report provides an overview of the major extractive industries in the country to answer the following questions: who are the major stakeholders in the extractive and energy transit industries from both the government and private sector? What are their roles? What relative contributions do they make to the public budget? The primary focus of the report is on the degree of transparency of information regarding payments these industries make to the government. The report draws several conclusions:

- If one brings together all the major industries that extract Georgia's natural resources – oil, gas, magnesium, copper, gold, and mineral waters, it becomes evident that their aggregated contribution to the economy in general and the state budget in particular is significant. The potential for future growth, particularly for oil and gas extraction activities, and the associated growth in revenue payments for the state should not be underestimated.
- The near completion on BTC and SCP pipelines presents the Georgian society with an opportunity to earn considerable transit revenues and, at the same time, the challenge of effectively managing these revenues to promote the well-being of the nation.
- While some companies are taking initiative to disclose information on payments to the state, and post the relevant data regularly through common sources of media, others are less forthcoming. The state oversight agencies charged with insuring transparency and easy access to the revenues information face technical difficulties in gathering, analyzing, vetting and disclosing the data in an easily accessible format.
- While the Administrative Code of Georgia and the industry-specific regulations guarantee freedom of information, the Tax Code protects companies and prevents the interested person from gaining information on how much the company paid to the state, unless the company is willing to have the information disclosed. All this results in lack of transparency of the financial flows between the industries and the government.
- The implementation of Extractive Industries Transparency Initiative would provide Georgia with a useful framework for adequate reporting. Some of the initial steps necessary to join the initiative have already been taken by the government, the companies and the civil society. Significant work needs to be carried out, however, before the EITI can be effectively applied to Georgia. One of the first priorities is working with all the stakeholders to agree on how to extend the original EITI templates to allow for easy reporting by oil and gas transit industries.

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The Administrative Code of Georgia

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Georgian Law on Licensing Geological Activities

Georgian Law on the Duty Imposed on the Use of Natural Resources

For Notes
