

## **Corruption, Economic Crime and Money Laundering Connected with Setting Natural Gas Tariffs**

Teimuraz Kopaleishvili

The natural gas sector is the most important part of Georgian energy sector. As is well known, Georgia has a severe lack of energy resources and imported natural gas represents the only fuel resource. Thus, natural-gas supplies represent the most important factor for Georgia's economic and societal development.

Until 1990, natural gas covered more 60 percent of Georgia's energy consumption; or, more than six billion m<sup>3</sup> of natural gas annually. Since 1990, the natural gas sector has been in a severe crisis. Natural-gas usage fell to 0.8 billion m<sup>3</sup> during the worst year's of Georgia's economic collapse. In recent years, performance has been improved a little; however, we are still rather far from the optimal level, which is considered to be 3.5 m<sup>3</sup> in Georgia annually.<sup>1</sup> Despite this clear importance, natural-gas regulations, found in the "Rules and Methodology" (hereafter, Methodology) are defined very poorly.

In the Natural Gas Tariff regulation, special importance was given to the Methodology, passed on 8 September 1999 under the 6<sup>th</sup> resolution of the Georgian National Energy Regulatory Commission (GNERC). It represented the first normative document on energy regulation in the history of independent Georgia.

This Methodology operates even now and is the methodological document for setting natural-gas regulations and tariffs. In the seven years since its establishment, changes were made four times to the resolution; however these changes did not improve the content of the document. Namely, two articles and one item were added to the Methodology and the same edition was changed three times, which includes correcting rules of gas tariff depending on exchange rate and changes in natural gas buying price.

---

<sup>1</sup> This figure comes from the Decree #3257 of the Georgian Parliament, which defined optimal usage in 2015 in its "General Directions of Georgian Policies in the Energy Sector," which was adopted on 7 June 2006.

This Methodology includes many obscure regulations of general character, the non-concreteness of which allows for various interpretations. As such, there have been negative consequences.

Following terms are used in the Methodology: “joint income,” “profit,” “separate tariffs,” “retail tariffs,” “tariffs of direct consumers,” “fees,” “normative losses,” and “permissible losses.” In a number of resolutions adopted by GNERC the following terms are also used: “wholesaling tariffs,” “distributing-delivering tariffs,” and “distributing-retailing tariffs.” It is clear the such terminology must be defined for there to be continuity in natural-gas pricing, but none of these terms are explained, and in many cases different terms as used to explain the same concept. For example,

- Article V, Item 2.V: “Tariffs should indicate the various fees in various spheres of usage.”
- Article V, Item 2.F: “Tariffs should describe the different values in different spheres of its usage.”
- Article V, Item 5.B: “Tariffs should provide with suitable level of suitable costs and profits.”

These points are not defined, and as such could the GNERC and companies great leeway to achieve personal financial goals. From a practical standpoint, the GNERC could define optimal costs and optimal profits and allow companies to set tariffs within that band. However, allowing the GNERC to set exclusive or privileged tariffs is always biased against the consumer.

These are not the only elements that could have negative consequences. For examine, in calculating transportation tariffs, Article XV requires allowing natural-gas tariffs to include fees for “normative losses,” while Article XVI allows fee for “admissible losses.” These fees are paid by the consumer. Despite this, “normative” and “admissible” are not explained in the Methodology. Moreover, Article VXII does not include allowing for losses when calculating distribution tariffs, further obfuscating tariff policies.

In 2002, Article XI, “On Natural Gas Losses,” was added to the Methodology. According to Article XI, the GNERC retains the authority to determine the admissible amount of losses that may occur during transportation and distribution of natural gas. Article XI includes terms such as “registered condition of gas-supply system” and “natural-gas purchase price,” which are established by experts in GNERC. However, Article XIX, Item 2, states that should

the wholesale cost of natural gas change, then consumer natural-gas prices may be corrected by the GNERC “as costs of transportation and distribution tariffs are indirectly reflected as a compensation for losses.” Yet there is no clear indication for how transportation and distribution costs should be determined in a timely manner, or define the relationship between the pre-determined costs and losses occurred during shipment.

Isewhere in Article XIX, correcting natural-gas tariffs is also permissible when there are changes in exchange rates. Considering that Articles XIV, XV, XVI, and XVII determine tariffs based on projected transportation, distribution, and delivery costs, it is very difficult to determine how corrections to tariffs could be carried out quickly. This is a serious gap in the Methodology.

The confused and complicated Methodology is one of the reasons why Georgia’s natural-gas system sustains large financial losses, which in turn has a severely negative impact on the development of Georgia’s energy infrastructure as a whole. Moreover, the Methodology lends itself well to those who would use it for illegal financial machinations.

The losses, which the Methodology covers, albeit poorly, are generally the result of technical failures in the gas transportation and distributions systems. These systems are old and have not received capital renovations in many years. At the same time, however, it is interesting to note that the “technical” losses sustained in Georgia exceed the losses in other similar post-Soviet, such as Armenia and Kyrgyzstan. Although natural-gas supply networks are no older in Armenia and Kyrgyzstan, the “technical losses” Tbilgazi may accrue according to current law stands at nine percent and in 2004 and 2005 stood at 12 percent; for comparison, the Armenian nation gas operator is allowed technical losses of only 4.5 percent. Thus, regardless of the actual amount of losses, Tbilgazi has the option to charge up to an extra nine percent, opening the door to many financial machinations.

The situation becomes even more difficult when considering the so-called “commercial” losses of natural gas. Commercial losses come mainly in the form of theft or non-registration of full gas usage. In recent years, the level of commercial losses Tbilgazi has experienced has equaled 60 to 70 percent of wholesale gas purchases. Interestingly enough, the natural-gas distribution networks in, for example, Gori, Kaspi, and Rustavi have experienced a relatively low level of losses.

**Losses of natural gas in natural gas supply enterprises of Georgia in 2004.**

Enterprise	Amount of purchased gas	Losses		notes
		Thousand m <sup>3</sup>	პერცენტი	
Tbilgazi	226,900	142,700	62.9	9 months
Borjomgazi	439.3	120.1	33.2	
Vanigazi	22.4	6.7	29.9	
Samtrediagazi	164.7	33.1	20.9	
Rustavigazi	1,205.6	208.3	17.3	
Gorigazi	81.6	13.1	16.0	
Kaspigazi	130.3	7.6	5.8	
Kutaisigazi	1,088.5	352.5	32.4	

To the extent of our knowledge, no other country has achieved such a high level of gas losses. Is it possible that 30 or 60 percent of gas leaks from gas networks, and no one in the city notices hundreds, if not thousands, of square meters of gas in the air? Naturally, other than that widespread anecdotal evidence of theft, this paper does not present concrete cases of criminal activity. That said, it is impossible not to conclude that if customers did not have corrupt dealings with authorities of gas-distribution enterprises, then losses on such a scale could not occur. It is worth noting that each management change, including changes in 2004 and early 2006, has been followed with a near complete turnover in bill collectors.

From our perspective, natural-gas thefts reflect a failure of society to fight crime as well as a failure of the Georgian government to reform regulations and laws governing the Georgian energy sector. Reforms should focus on clarifying the Methodology as well as developing sensible policies for defining natural-gas tariffs.

The consumer price of natural gas in Georgia is based on three components: the actual price of natural gas, taxes, and profits. Taxes and profits, in turn, are based on legislation and

the Methodology described above. In most countries, the price of natural gas makes up 70 percent of the consumer price; in Georgia, however, the price of natural gas makes up only 43 to 45 percent of the price. For example, both Georgia and Armenia pay \$110 per 1000m<sup>3</sup> of natural gas, yet the consumer price of natural gas in Armenia is \$163 but in Georgia is \$190. While the non-gas tariffs of consumer tariffs in Georgia is far lower than Europeans face, it is higher than other countries of the CIS (e.g., \$16.7 in Ukraine) and approaches the price in the Baltic states. The consumer price in Georgia is even more interesting because the wholesale gas price actually by five dollars to \$110 on 1 January 2006, yet the consumer price stayed at \$190 without at negative financial impact on Georgian gas distribution enterprises. Thus, we have serious doubts as to whether the non-gas portion of the consumer price needs to be so high.

The GNERC has exacerbated problems in the Georgian energy sector by including questions of “strategic importance,” “national interests,” and “investment attractiveness” in setting consumer tariffs. One might argue that these are important issues for the body that oversees the Georgian energy sector, but there is no legislative basis in the Methodology or elsewhere for the GNERC to include these concepts in setting tariffs. Moreover, if the GNERC had the authority to set tariffs based on “national interests,” it would also have the authority to set privileges (i.e., discounts) for Georgia’s poor. But the Georgian government has the task of developing Georgia’s energy sector and protecting the marginalized, not the GNERC. Thus, when the GNERC establishes a macroeconomic privilege for a company or consumer discount, it is breaking the law.

Another contradictory aspect in the Methodology concerns investment in the gas network. Network investment in Georgia is undertaken either on tax dollars (i.e., government money) or the gas-supply companies’ investment (e.g., private loans from banks or saved profits). The Methodology does not differentiate the two types of investment. This is an issue because after investment, the GNERC has the right to increase energy companies’ profit (“profit from funds invested”). Unfortunately, the GNERC does not differentiate between the two types of investment, meaning that energy companies can receive higher profits from investment which is not their own. While this is not corruption, it increases societal discontent with the energy sector and should therefore be reformed.

Based on the above concerns and deficiencies, the Methodology and other legislation need serious improvement. We propose the following recommendations:

1. Methodology for setting consumer prices should be based on objective domestic and international comparisons that would examine the costs and profits in different enterprises along the same level of economic and political development;
2. Tariffs should clearly define the rule on losses. This rule should reflect only technical costs and should force enterprise to work consistently on cutting level of losses;
3. The Methodology should not permit tariff privileges to enterprises because of their “strategic importance”, “national interests,” “investment attractiveness,” or other similar factors;
4. Methodology should provide consumers with a compensation for costs in the form of cut tariffs when investment financing comes from tax monies;
5. In case of a difference between the amounts of forecasted and actually delivered natural gas, Methodology should provide with the correction of tariffs.