PN-ACH-510
105879

ASSESSMENT OF THE INSTITUTIONAL CAPABILITIES OF THE STATE AGENCY FOR REGULATION OF OIL AND GAS RESOURCES

Georgia Oil and Gas Sector Reform
Contract No. LAG-I-00-98-00005-00
Task Order No. 5

Final Report

Prepared for:

U.S Agency for International Development
Bureau for Europe and the NIS
Office of Environment, Energy and Urban Development
Energy and Infrastructure Division

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July 15, 1999

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TASK OBJECTIVE

The goal of Subtask E is to provide assistance to the Government of Georgia ("GoG") to improve the knowledge base of government and enterprise officials, particularly those involved or to be involved in regulating or developing rules and regulations for the oil and gas sector, and thereby support the reform of the Oil and Gas sector and the negotiation of agreements for the development of Oil and Gas pipelines and for the development of domestic Oil and Gas resources. The purpose of this report is to assess quality and quantity of resources available to the State Agency for Regulation of Oil and Gas Resources ("State Agency" or "Agency") when such Agency is created pursuant to the provisions of the recently enacted Georgian Law on Oil and Gas ("Oil and Gas Law" or "Law").

REPORT BACKGROUND

Until the early 1990's, Georgia was a modest producer of oil (3,500 barrels/day, 1993 estimate) and natural gas (1.4 billion cubic feet/year). However, over the last several years, production declined due to depletion of existing fields and the lack of exploration and development of new fields. In 1993, the Georgian economy consumed hydrocarbon energy at the rate of 16,000 barrels of oil per day and 128 billion cubic feet of natural gas. Most of this energy was imported.

Over time, the business climate for oil and gas investment in Georgia improved. By the summer of 1996, Georgia had begun to attract the interest of foreign investors in the exploration, refining, and transportation sectors of the oil and gas industry. Saknavtobi (the state-owned oil and gas entity) had entered into several production sharing contracts for the exploration and production of oil and gas. Currently, a modest amount (3,500 barrels/day) of relatively high quality crude is being produced under two of these agreements. In fact, exploration activities in one Concession Area have resulted in indications of significant commercial quantities of very dry gas.

The need to reform the oil and gas sector of the Georgian economy has been recognized by the GoG. From the earliest days of the energy sector reform program, USAID identified the enactment of a law to govern the exploration and development of Georgia's oil and gas resources as a legal reform priority. To that end, USAID and other donor agencies have worked with Georgian counterparts on passage of an Oil and Gas Law for almost two years. Hagler Bailly has provided technical support for this effort, beginning under Delivery Order 16 and continuing under Task Order 5. The trials and tribulations attended the legislative history of the Oil and Gas Law are chronicled in Hagler Bailly's previous reports. Suffice it to say that President Shevardnadze signed the Oil and Gas Law into law on 3 May 1999.

SUMMARY OF THE OIL AND GAS LAW

The Oil and Gas Law represents a significant step forward in the process of the legal reform of an important segment of the Georgian economy. Prior to adoption of the Law, investors faced a number of difficulties: a vacuum of government policy respecting oil and gas exploration and development; the existence of several, sometimes conflicting, legislative acts purporting to regulate the oil and gas industry; the absence of any law or regulation whatsoever with respect to certain important areas; the absence of a legislative basis for production sharing agreements; and a dual system of contracting and licensing which potential investors found confusing, because the existing law did not clearly identify who was authorized to negotiate on the State's behalf.

By and large, the Oil and Gas Law addresses the legal deficiencies experienced by the petroleum sector, noted above. Additionally, it sets out the basic principles needed to support oil and gas exploration, development, and production. In brief, the principal features of the law are:

- Creation of a single competent authority within six months of enactment (or by November 3, 1999) to act on behalf of the State for the negotiation, signing, and administration of oil and gas contracts (the "one-stop shop").
- Separation of the State's sovereign and regulatory authority from its commercial interests.
- Establishment of a small State Agency (with a staff not to exceed 25 persons) accountable directly to the President.
- Recognition of the legality of Production Sharing Contracts concluded by or on behalf of the State and investors prior to the effective date of the law (the "grandfather" clause).

- Allowance of international arbitration as a method for resolving legal disputes in cases involving investors who are not residents of Georgia or who are not legal entities registered in Georgia.
- Privatization of the National Oil Company (Saknavtobi).

DISCLAIMER

In early 1999, several months after Hagler Bailly commenced work under Task Order 5, the contract was amended to remove references in Subtask E to training and institutional development of GoG agencies to prepare them to negotiate transit pipeline issues, and to focus instead on providing support, technical and otherwise, to an agency to be named in the oil and gas legislation. At the time, all parties, including USAID and Hagler Bailly, assumed that passage of oil and gas legislation was imminent. On that basis, the amended scope of work for Subtask E provided that Hagler Bailly was to:

> Prepare a needs assessment, not to exceed fifteen pages in length, of the institutional capabilities of the soon to be formed "State Agency on Oil and Gas" under the Oil and Gas Law, once enacted, to determine the legal, regulatory, and administrative expertise of the "State Agency on Oil and Gas" in the areas of oil and gas exploration, production, and transportation.

The facts failed to reward the parties' optimism. Far from the "soon to be formed" anticipated in the contract, the State Agency has yet to be formed, and it may be some months before the President begins even to appoint the Agency's management. For that reason, Hagler Bailly has not been able to assess the "Agency's" capabilities. We have, instead, evaluated the capabilities of the GoG institutions possessing some experience and expertise respecting the matters to be regulated under the new law, principally the Ministry of Environment and Natural Resource Protection, the Ministry of Fuel and Energy, and Saknavtobi.

INTERVIEWS

In preparing this report, Hagler Bailly met with the organizations thought to be pivotal to the workings of the Georgian oil and gas sector. Specifically, we interviewed representatives of the Ministry of Environment and Natural Resources ("MENR"), the Ministry of Fuel and Energy ("MFE"), and Saknavtobi to determine the level of competence existing in Georgia and available

to the State Agency to fulfill the Agency's functions. We also interviewed a producer, JKX, was to obtain an investor's perspective.[1]

The Ministry of Environment and Natural Resources is not enthusiastic about the Oil and Gas Law in its final form. The Ministry expressed the concern that, under the new Law, the inter-ministerial council, of which MENR was the chair, will be dismantled in favor of the new State Agency, and that the functions of issuing and administering new oil and gas contracts will be transferred to this new Agency. Given that the Law limits the staffing level of the new Agency to 25 persons, MENR seriously questions whether the State Agency will be able to carry out its duties.[2]

There allegedly exist within MENR formal written procedures which pertain to the application for and the grant of a license/contract for petroleum operations. Hagler Bailly has made repeated requests for a copy of these procedures. Although the Ministry promised to provide a copy was to Hagler Bailly, it never did. We are, therefore, unable to evaluate whether these procedures might usefully serve as an appropriate basis for licensing or contracting by the new State Agency.

The Oil and Gas Law requires all governmental entities to provide support to the State Agency. We doubt that MENR will do so enthusiastically.

The Ministry of Fuel and Energy, for its part, is very pleased with the provisions of the Oil and Gas Law. MFE does not believe that the staffing limitations placed on the State Agency will pose a problem. MFE advised us that Saknavtobi would be formed as a joint stock company in the near future. This Ministry stands ready to assist the State Agency, and MFE expects to nominate several individuals to the supervisory council of the Agency. The only observation

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[1] Hagler Bailly attempted to meet with other producers, but they declined to be interviewed in connection with this assessment.

We make an observation respecting our interviews. The comments of all individuals with whom we met, particularly representative of Ministries and State-owned enterprises, were guarded. Some of the reticence of the interviewees may have been due to concern for the future and a reluctance to speculate on matters political in nature. Whatever the reason, the interviewees' lack of candor interfered with our ability to gather facts for the assessment.

[2] During the development of and debate over the Law on Oil and Gas, MENR strongly contended that it should have jurisdiction over oil and gas regulation. After spirited debate, the Ministry lost, which may help to explain its current comments regarding the new State Agency.

offered by MFE regarding the State Agency was that the new Agency will need funding to set up and begin operations.

The Georgian National Oil Company, Saknavtobi, believes that the new Oil and Gas Law will have little impact on its operations. While Saknavtobi acknowledges that the sovereign governmental functions have been removed from its sphere of activity, it is still firmly in control of the commercial functions having to do with oil and gas operations. The Law grants to Saknavtobi a significant voice in the manner in which petroleum operations are conducted in Georgia. Saknavtobi will continue to act as the liaison between the investor and GoG. Furthermore, so long as the State owns 75% or more of Saknavtobi, Saknavtobi expects to be an active participant in advising and assisting the State Agency.

The UK company, JKX, was the only investor that made itself available for an interview. JKX takes a "wait and see" approach to the Oil and Gas Law and the new State Agency. JKX confirmed that each investor's contract contains a number of provisions which are regulatory in nature. Because Georgia lacks a formal regulatory mechanism to provide governmental oversight of the investor's operations, the "regulations" are contained in the petroleum agreement between the state and the investor. These contracts are not available to the public, and conceivably, each contract may contain different provisions.

JKX appears to be satisfied with the status of its and its relationship with GoG. Expressing a "less-is-better" philosophy, the company does not wish to be burdened with more regulation. JKX suggested, however, that the State Agency adopt rules to regulate the transmission, storage, use, and release of the confidential information which the new Agency is charged with handling.

REGULATORY NEEDS OCCASIONED BY THE OIL AND GAS LAW

The functions of the new State Agency are enumerated in Article 8 of the Oil and Gas Law. The Law obligates the new State Agency to regulate the exploration and development ("upstream") sector of Georgia's petroleum sector. The Law also empowers the Agency to prepare "rules and conditions of tenders and auctions" for awarding petroleum agreements to investors. (Article 8 (b).) The Agency also has the function of preparing and proposing to the President of Georgia for his approval "normative acts required to establish a clear stable non-discriminatory and effective legal and regulatory project for performance of Oil and Gas Operations based on market principles and operating in the national interest." (Article 8 (h).)

The State Agency is the "one-stop shop" to act on behalf of the State in matters concerning the upstream oil and gas business. The Agency is responsible for identifying areas of the country to

be offered to potential investors and consulting with "relevant state bodies" on the areas so selected. (Article 8 (a).) The Agency also makes decisions regarding the form of the offer (tender or action), prepares the rules and conditions of such offers, and conducts the bid tender or auctions. (Article 8 (a), (b), and (c).) Further, it is the function of the State Agency to prepare, negotiate, and conclude all petroleum agreements with successful bidders "on behalf of the State." In the fulfillment of these duties, the Agency "is entitled to request for, and shall receive, assistance form any governmental body, state organization and enterprise." (Article 8 (d).) Presumably, the bodies, organizations, and enterprises alluded to by the Law are Saknavtobi and the inter-ministerial counsel, referred to above.

Previously, the inter-ministerial council handled some, but not all of these functions. Supposedly, this council had written rules by which it has operated. Whether and to what extent these rules are sufficient for use by the State Agency is problematic. At the very least, these rules must be updated to make allowances for the requirements of the new Law. They must also be modified to establish procedures for the issuance of any other permits and licenses required by other governmental entities. Regulations and normative acts should be drafted to effectuate these provisions of the new Law.

Under the Law the State Agency is charged with the preparation of model form contact language (Article 8 (a)) covering a long list of issues relevant to upstream oil and gas operations. (Article 12.) Unfortunately, these issues are stated as "bullet points," and no attempt is made to flesh out or develop these points. For example, the Law simply states that the maximum term of an oil and gas agreement is 25 years, divided into separate exploration and production periods. It does not, however, establish any maximum term for the duration of the exploration period. Investors will likely attempt to extend the exploration period for long as possible, many years beyond what is reasonable. This is not in the best interests of the State. Hagler Bailly counseled GoG to set five to seven years as the maximum period for the exploration phase. Regulations should be adopted which establish a maximum limit on the length of the exploration period. Additionally, regulations should be adopted to establish minimum and maximum limits and requirements for other issues, such as insurance, accounting procedures, methods for calculating oil and gas reserves, and rules for measuring and reporting production. Heretofore contract and regulatory drafting expertise in these areas has not been evident in GoG Ministries and personnel. The Agency needs technical assistance in drafting such regulations and model form contract language.

Another function of the State Agency is to establish and maintain a confidential data bank of geologic, seismic, and other petroleum related data. This is data which is accumulated during oil and gas operations. The Law does not clearly provide for the handling of the data which has been collected in the past. Regulations should be promulgated to clarify this point and to provide

for the collection, preserving, and use of this information and any data produced in the future. These regulations must also insure that the confidentiality of this material is maintained.

As the State's representative in upstream oil and gas matters, the State Agency has oversight responsibilities for the petroleum activities of all investors, including Saknavtobi. The Agency is charged with the obligation of "Supervision and control of implementation of provisions and activities envisaged in Agreements made and Licenses issued under this Law. Provision of conditions required for implementation of Oil and Gas Operations under the Agreement and the License." (Article 8 (f).) To discharge its duties as stated in the first sentence of this Article 8 (f), the Agency will require production and other operational information from investors. The meaning of the second partial sentence contained in this sub-article is unclear. Regulations should be promulgated to advise investors of the amount and kind of information which must be reported and frequency of these reports. Regulations should also be promulgated in an attempt to clarify the meaning of the second part of this sub-article.

The Law specifically delegates to Saknavtobi "all operational or commercial tasks under Agreements . . . until the State ceases to be its (Saknavtobi's) owner or owns more than 75% of its (Saknavtobi's) shares. . . ." (Oil and Gas Law, Art. 8 (i).) That same article also assigns to the State Agency as one of its functions "the supervision and control of implementation of all operational and commercial tasks under agreements delegated to" Saknavtobi.

Article 9 of the Law establishes the functions of Saknavtobi. Citing Article 8(f), the Law provides that Saknavtobi will "participate in the course of drawing up of, and negotiations on the Oil and Gas Agreement and initial the Agreement prior to official signing by the Agency." (Oil and Gas Law, Art. 9(2)(a).)

Prior to passage of the Oil and Gas Law, it was Georgian practice for Saknavtobi to handle all contractual relationships governing the upstream oil and gas business. However, Saknavtobi lacks legal standards for the contents of such contracts. Hagler Bailly has never been permitted to review any of the existing petroleum contracts, but we believe that they were negotiated on an *ad hoc* basis with the result that these contracts contain various, possibly inconsistent or conflicting, privileges and responsibilities. Thus, under prior practice, the government's sovereign, regulatory, and commercial interests were unavoidably and inappropriately intertwined. Furthermore, in accordance with the Subsoil Law, before petroleum activities could commence, investors were required to obtain a separate license from MENR. This presented investors with the "dual contracting" dilemma described on numerous occasions in other Hagler Bailly reports.

One of the primary goals of the Oil and Gas Law was to separate the sovereign governmental functions from the business and commercial functions. Another important goal was to establish a single entity, a "one-stop shop," to be responsible for handling all governmental and regulatory upstream petroleum issues. During the discussions leading up to the passage of the Oil and Gas Law, Hagler Bailly advised GoG to adopt language which called for a clearer separation of Saknavtobi from governmental/regulatory activities. We also advised that the Competent Authority (i.e., the State Agency) be given a more decisive role in upstream oil and gas matters. The Law which was finally passed by Parliament is less than optimal in these respects. The concern is that, unless the division of powers and responsibilities between the State Agency and Saknavtobi are more clearly defined and vigorously enforced, the prior practices will continue and the full benefits of the Law will not be realized. Given the small staff which the State Agency will have to carry out its duties, and in view of the provisions of Articles 8 and 9, stated above, it is absolutely imperative that the State Agency adopts regulations whereby the Agency asserts is sovereign position in the field of petroleum regulation and its primacy in the supervision and control over all investors, including Saknavtobi.

TIMING

Parliament conducted its third and final reading of the Oil and Gas Law on April 16, 1999, and President Shavardnadze signed the Law on May 3. Article 7 of the Law mandates that the State Agency "shall be created within six (6) months of the Effective Date of this Law" , or by November 3. The next several months provide a rich opportunity to assist the State Agency to organize, equip, and to begin to function as a regulator.

CONCLUSION

The newly adopted Oil and Gas Law is the first comprehensive law in Georgia to address upstream petroleum operations. This Law accomplishes three major goals: (1) it protects the legitimate interests of the State; (2) it permits investors to earn a return on and of invested capital; and, (3) it does not burden the Georgian economy with unwieldy, inefficient, and counterproductive bureaucracy. The attainment of these three objectives is a triumph for reason, logic, and persistence.

While the passage of the Oil and Gas Law was a significant step on the road to reform of Georgia's petroleum sector, it must be seen as only the first step along this path. Some of the concerns, noted above, can be overcome by the regulations that the new State Agency will draft.

By legislative fiat, commencing November 3, 1999, the State Agency will be required to regulate a vital segment of the Georgian economy. However, the Agency, when it is created, will start from a position of having virtually nothing (no staff, no expertise at oil and gas regulation, little or no existing regulatory framework, and no funds) and needing virtually everything (staff, expertise, equipment, and a suitable framework, to name a few) to begin to fulfill its functions.