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## Ensuring the Transparency and Efficiency of Energy Subsidies in Georgia: an Agenda for Reforms

### POLICY BRIEF

#### Executive Summary

Ensuring the transparency of subsidies is a key requirement of Article 206 of the EU-Georgia Association Agreement. Subsidised energy tariffs (electricity and gas) lead to the overconsumption of energy goods and the underdevelopment of energy efficient technologies. In Georgia, electricity and gas are heavily subsidised. As a result, the country consumes 2-3 times more energy per capita in comparison with EU countries and its energy import dependence is increasing. Georgia's energy subsidies need to be reassessed in order to promote efficiency.

The Ministry of Energy of Georgia defines the subsidy schemes in the energy sector, though no reporting is provided on their amounts and efficiency. Due to the lack of transparency, it is difficult for non-governmental actors to identify and analyse the country's energy subsidy schemes.

A recent inventory<sup>1</sup> of subsidies in Georgia has identified more than 500 mln. GEL per annum of energy subsidies that need to be examined in detail and potentially phased out. Some of these subsidies are reported by public entities while a number of hidden subsidies undergo no public scrutiny. Calculated energy subsidies constitute about 6% of state budget spending. This does not include the state guarantees to hydropower developers in the sum of about 3 bln USD.

In order to ensure the transparency and efficiency of energy subsidies in Georgia, the government should: ensure the transparency of information on energy and financial flows to identify existing subsidy schemes; conduct a more in-depth study of each subsidy scheme; examine the effects on intended beneficiaries; identify other (unintended) beneficiaries and the amount of public good spent inefficiently.

Eliminating inefficient subsidies requires: an assessment based on comprehensive data; outreach to increase awareness among policymakers and civil society; preparation and lobbying of policy recommendations to phase out the most inefficient energy subsidies.

The process needs to start as soon as possible and the role of civil society is vital in ensuring the transparency and curtailing the negative effects of energy subsidies.

## **Introduction**

Promoting the transparency of subsidies is an important requirement of the EU-Georgia Association Agreement. According to Article 206<sup>2</sup>, every two years Georgia should report the form, the amount or the budget and, where possible, the recipient of the subsidy granted by the government or other public bodies. The report should be accessible on a public website.

In general, poorly designed subsidies can lead to market distortion and inefficiencies in public spending. Specifically, energy subsidies encourage wasteful energy consumption, lead to more energy dependence, undermine the development of renewable energy and energy efficient technologies and can lead to increased greenhouse gas (GHG) emissions. Energy subsidies represent a significant burden on a country's finances. Moreover energy subsidies tend to accrue to economically powerful recipients rather than to the poor and thus contribute to increased social inequality.

In many countries energy subsidies<sup>3</sup> constitute a significant portion of total subsidies and are subject to strong policy debate. In the case of Georgia, subsidised energy tariffs (electricity and gas) have led to the overconsumption of energy goods and underdevelopment of energy efficient technologies. Energy subsidies contribute to the fact that the country uses 2-3 times more energy per capita than citizens in EU countries, and Georgia's energy import dependence is increasing every year.<sup>4</sup> More than half (56%) of Georgia's national GHG emissions come from the energy sector.<sup>5</sup>

The efficiency of a country's energy subsidies needs to be monitored, since state interventions distort the proper functioning of free markets and reduce economic efficiency. At the same time, the subsidies may be missing the declared goals, thereby causing unnecessary public spending for the benefit of unintended stakeholders. In some cases, this may be a result of collusion with interest groups.

The amounts spent on inefficient subsidies could be directed to socially oriented expenditures, education, science, development and security needs of the country. Proper identification and analysis of the effects of subsidies is the first step in assessing their efficiency and determining their necessity.

The Ministry of Energy of Georgia is responsible for subsidy schemes in the energy sector, however, no reporting is provided on the subsidies issued or their efficien-

<sup>1</sup> Inventory of energy subsidies in the EU's Eastern Partnership Countries, Georgia. 2016, OECD

<sup>2</sup> Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part, Article 206, Subsidies - <http://www.parliament.ge/uploads/other/34/34754.pdf>

<sup>3</sup> Based on the IEA's latest estimates, only fossil-fuel consumption subsidies worldwide amounted to \$493 billion in 2014.

<sup>4</sup> Net energy import dependence of Georgia in 2013 was 65%, and in 2014-70%, Energy Balance of Georgia, GEOSTAT.

<sup>5</sup> National GHG Inventory Report, 2010-2013.

cy. This lack of transparency makes it difficult for non-governmental actors as well as the society in general to identify and analyse energy subsidy schemes.

A recent inventory<sup>6</sup> of subsidies in Georgia by the International Institute of Sustainable Development and WEG has identified more than 500 mln. GEL per annum of energy subsidies that need to be examined in detail and potentially phased out. Only some of these subsidies are reported by public entities while others are not available for public scrutiny. As a result, there is potentially a large amount of public spending that could be inappropriately allocated and about which the public is unaware.

## Forms of Energy Subsidies in Georgia

Properly defining subsidies is the first step toward their identification and elimination. Georgia joined the World Trade Organization (WTO) in 2000, signing the Agreement on Subsidies and Countervailing Measures (ASCM) that defines subsidies. Therefore, the ASCM definition of subsidies is fully applicable to Georgia. All the main components of the WTO definition have been incorporated into the national legislation.<sup>7</sup>

According to the Georgian Law on Competition, a subsidy is defined as “state aid (a subsidy) - decision with respect to an economic agent that includes tax exemption, tax reduction or tax deferral, discharging of debt and its restructuring, loan on preferential terms, transfer of operational assets, financial aid, giving assurance of profit, privileges, etc.”

The recent inventory of energy subsidies<sup>8</sup> has indicated that decisions on energy subsidies are made on an ad hoc basis without analysing the impacts and efficiency. More specifically, the following schemes are active:

- Provision of natural gas below market value to thermal power plants (TPPs) and gas distribution companies in order to make electricity and gas tariffs more affordable for residential customers. The estimated amount of subsidy due to tariffs set at below-market rates is more than 350 mln. GEL annually. It provides more benefit to larger consumers rather than the poor who consume less.
- VAT exemption for imported natural gas used as feedstock in TPPs. Because of this subsidy scheme the government forgoes 30 mln. GEL in revenue annually. This amount could otherwise be used for financing education, science and other development and security needs.
- About 5 mln. GEL is being spent from the state budget annually on the gas provided free of charge to households of Kazbegi and Dusheti municipalities in winter. About 25 mln. GEL from the municipal budget is spent on electricity vouchers for consumers in Tbilisi Municipality. Moreover, electricity<sup>9</sup> is provided free of charge in the Svaneti region. The quality of service (capacity and voltage) is very poor since the state and distribution company are not interested in improving

<sup>6</sup> With the support of the OECD, the International Institute of Sustainable Development along with experts from WEG and Global Subsidy Initiative conducted the first inventory of energy subsidies in Georgia during 2015-2016. Inventory of energy subsidies in the EU's Eastern Partnership Countries, Georgia. 2016, OECD.

<sup>7</sup> Global Subsidies Initiative (GSI) provides comprehensive guidance on energy subsidies – Available at: <https://www.iisd.org/gsi/subsidy-types>

<sup>8</sup> With the support of OECD, International Institute of Sustainable Development with WEG and Global Subsidy Initiative experts conducted the first inventory of energy subsidies in Georgia during 2015-2016.

<sup>9</sup> Amount of electricity provided to Svaneti region is unknown from public sources.

the service and providing more electricity. This significantly diminishes the benefit from free use of available electricity. These subsidy schemes lead to increased consumption in an unproductive sector instead of supporting economic development.

- Supply of electricity to the Russian occupied region of Abkhazia is free of charge. This can hardly be called an intended subsidy, since the powerhouse of the Enguri hydroelectric power station is on Russian occupied territory and Abkhazia's consumption cannot be controlled. However, the fact is that the Georgian central government is responsible for maintaining and operating the power plant and providing the region with electricity. As a result, the estimated amount of subsidy is more than 130 mln. GEL per year with electricity consumption in the region increasing significantly every year.<sup>10</sup> This causes an increase in the country's power deficit in winter months, which is then being covered by imports from Russia.
- Sovereign guarantees for power purchase agreements with the developers of new hydropower plants amount to 3 bln USD with the present value of about 1 bln. Thus the state is taking on the market risks instead of investors. The tariff levels provided to developers are much higher than current market prices.

The above subsidy schemes are summarised in the table below.

<b>Subsidy Scheme</b>	<b>Objective of the Subsidy</b>	<b>Amount of Subsidy</b>
Market price support and regulation, Regulated prices set at below-market rates	Provision of natural gas below market value to TPPs and distribution companies in order to make electricity and gas tariffs affordable for residential customers	2012 – 350 mln. GEL 2013 – 314 mln. GEL 2014 – 367 mln. GEL
Government revenue foregone, Tax breaks and special taxes, Tax expenditures	VAT exemption for imported natural gas used as feedstock in TPPs	2012 – 30 mln. GEL 2013 – 22 mln. GEL 2014 – 30 mln. GEL
Direct and indirect transfer of funds and liabilities	State budget spending on gas supplied to households of Kazbegi and Dusheti municipalities in winter	2012 – 4.3 mln. GEL 2013 – 4.8 mln. GEL 2014 – 6 mln. GEL
Direct and indirect transfer of funds and liabilities, Direct spending, Earmarks	Electricity vouchers for consumers in Tbilisi Municipality	2012 – 6.4 mln. GEL 2013 – 24 mln. GEL 2014 – 25 mln. GEL
Provision of goods or services below market value	Supply of electricity to Abkhazia for free.	2012 – 130 mln. GEL 2013 – 138 mln. GEL 2014 – 160 mln. GEL
<b>Total</b>		<b>2012 – 521 mln. GEL</b> <b>2013 – 503 mln. GEL</b> <b>2014 – 588 mln. GEL</b>

The total calculated energy subsidies constitute about 6% of state budget spending, which is a very high number.<sup>11</sup> There are also other energy subsidy schemes which cannot be properly assessed due to the lack of data.

<sup>10</sup> During 2014-2015 electricity consumption in Abkhazia increased by 9.6%, ESCO.

<sup>11</sup> State Budget – 8 billion GEL in 2014 <http://www.mof.ge/4568>

## Conclusion

Energy subsidies in Georgia are not a result of planned and well thought out economic policy. They reflect a populist approach to the state's role, which is more in line with the Soviet past rather than with the principles of the liberal democracy and free market that Georgia is striving to become. Some policymakers benefit from the subsidies, making them unwilling (if not unable) to implement reforms that would ultimately lead to greater economic efficiencies. Rather, they prefer to artificially decrease energy prices, promoting inefficient energy use and stymieing the country's economic development. The net effect of the subsidies on society at large is negative.

Moreover, in most cases, energy subsidies miss their intended goals and the real beneficiaries of these subsidies are different from the intended ones. Frequently, the declared beneficiaries of subsidy schemes are getting either insignificant or even negative net benefits from these subsidies. In reality, the funds for subsidy schemes are taken away from budget and accrue mostly to the rich and business and financial groups, thus depriving the poor of the opportunity to receive more socially oriented benefits from the same budget.

The subsidies are comfortable to policymakers unless their inefficiencies and negative impacts become very obvious. Therefore, state officials may be reluctant to raise the issue of reviewing the existing subsidies and diverting the existing flows of public good to more productive and socially oriented use. There is a need for civic actors and specialists to put the issue of subsidies on the political agenda.

Most of the subsidies identified in the energy sector of Georgia should be assessed and analysed in more depth. The adequacy of subsidy schemes and their efficiency in achieving the declared goals needs to be studied and most of the subsidies will need to be removed to allow for more efficient economic development.

Increasing the transparency of energy and financial flows is a condition for better understanding and phasing out energy subsidies. This will be an important step for the rationalisation of energy policy in Georgia and compliance with EU Association Agreement requirements.

The positive outcomes of energy subsidy reform can be multiple. These can include among others:

- Fiscal gains for government (fiscal savings or reducing debt);
- Reallocating public funding to more productive sectors and for social services to vulnerable groups of the population;
- Savings in energy use, improving energy efficiency and energy security.

Civil society's role is vital in guaranteeing the transparency of energy subsidies and limiting their negative effects as well as to contribute to increased transparency of energy subsidies and build political support for their reform.

## Recommendations

The requirements of the Georgia-EU Association Agreement provide a good opportunity to revisit the subsidy schemes in the energy sector and bring them in line with the country's interests and sustainable development objectives.

The provisions of Article 206 of the Association Agreement should not be taken lightly. Instead of a superficial approach to reporting only the officially recorded subsidy amounts, a more in-depth approach should be taken to identify and report on hidden subsidies not directly reported in the state and public budgets.

In order to ensure the transparency and efficiency of energy subsidies in Georgia, the following steps are recommended:

- As a part of wider transparency initiative in Energy Sector, ensure the transparency of information on energy and financial flows, in order to identify the possible subsidy schemes;
- Conduct a more in-depth study of each subsidy scheme identified, examine the effects on intended beneficiaries and identify the other beneficiaries and the amounts of public good spent inefficiently. Assess the efficiency of subsidy schemes and the potential for their elimination.
- Conduct an outreach campaign to raise awareness among policymakers (Ministry of Energy, Ministry of Finance, Regulatory Commission) and civil society in Georgia on existing energy subsidies and their economic, social and environmental impacts;
- Prepare recommendations for phasing out the most inefficient energy subsidies.

Initiating the discussion with the government authorities and stakeholders in reforming Georgia's energy sector is the main goal of this policy brief.

<sup>7</sup> Available at: [http://www.gse.com.ge/new/wp-content/uploads/2015/05/TYNDP\\_GE\\_2015-2025\\_ENG.pdf](http://www.gse.com.ge/new/wp-content/uploads/2015/05/TYNDP_GE_2015-2025_ENG.pdf)



