



**GEORGIAN NATIONAL ENERGY AND WATER SUPPLY
REGULATORY COMMISSION**

**Regulation of Rates
in the Natural Gas Industry**

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**21-25 March 2011
Kentucky. USA**



Participants in the Rates Regulation

- ❑ The Commission, whose function is to ensure that rates are fair, transparent, and efficient
- ❑ Regulated companies, which want to maximize profit, submit draft tariffs to the Commission
 - ❖ Producers
 - ❖ Transmission companies
 - ❖ Gas distribution companies
- ❑ Consumers, who want to minimize rates
 - ❖ Retail consumers
 - ❖ Direct consumers



Legal Base for Rates Regulation

- Georgian Law on the Power and Natural Gas Sectors
- Government Energy Policy
- GNERC's Rules and Methodology for Establishing Natural Gas Tariffs
- Cost of Regulation Law, which is used by GNERC to compute the cost of regulation
- GNERC's regulation entitled "On Natural Gas Tariffs"
- Tax Code
- International agreements

*GNERC received its authority to regulate the natural gas sector
In 1999*



Government Policy and Regulation of Natural Gas Rates

The Commission must take into account the government policy, which is developed and implemented by the Ministry of Energy and approved by the Parliament. The main functions and responsibilities of the Ministry are:

- ✓ **Promoting investment and developing credit resources for the rehabilitation and the development of the sector; implementing government investment policy**
- ✓ **Promoting transit and export/import operations**
- ✓ **Establishing annual balance for natural gas**
- ✓ **Authority to establish deregulation or partial deregulation in specific areas**



Deregulation and Partial Deregulation

- ✓ Deregulation is the right given to a company to operate using rates, which do not require approval
- ✓ Partial deregulation is the right given to a company to operate using marginal approved rates
- On September 25, 2007 the Ministry of Energy issued a Directive, which deregulates and partially deregulates the natural gas industry. Once the Directive enters into force, the operations in the natural gas industry will be free of rate regulation for commercial companies and partially free (approved marginal rates) for residential consumers, who had had the residential consumer status before the Directive entered into force.



Key Principles of Rates Regulation

Full cost recovery is the methodological basis for the calculation of rates:

- ✓ This method:
 - allows to recover documented and justifiable expenses (the cost of service and regulatory expenses) and receive profit on investment according to standards established by the Commission;
 - helps increase financial returns;
 - protects consumers from monopoly prices, especially in those areas of the sector, where there is no competitive market;
 - accounts for the difference in the cost of service for different types of consumers;
- ✓ Calculation of rates accounts for already made investment
- ✓ Rates Application (Required Rate of Return)

Calculating Required Rate of Return

Required rate of return is calculated based on the following:

- Operational expenses
- Depreciation
- Taxes
- Profit (profit rate is determined according to the WACC method as a weighted average cost of capital (equity and borrowed). Also, it can take into account risk factors related to the investment)



Key Principles of Rates Regulation

- ✓ Depreciation (wear) – according to existing methodology, depreciation rates are determined in accordance with the Tax Code
- ✓ Rates account for established allowable losses which, in general, amount to 5 %
- ✓ Salaries are determined according to market statistics
- ✓ Maintenance expenses – according to the Tax Code for up to 5% of fixed assets
- ✓ Other administrative expenses – according to agreements and the dynamics of similar indicators in the past periods
- ✓ Rate of return on fixed assets is currently established by the Commission at 8% to 12%
- ✓ According to existing tariff methodology, rates for distribution and supply are calculated based on pressure increments in retail customers connected to the distribution network. The distribution of cost is done in proportion to the cost of fixed assets, which are used to service consumers at a certain pressure increment



Adjustment of Rates

- ✓ Change in foreign currency exchange rates in excess of 7% in a specified period, as determined by the National Bank of Georgia
- ✓ Change in the purchasing prices of natural gas – if related cost of service, transportation, and distribution includes reimbursement of allowable losses



Tax Burden

- **Property taxes - 1%**
- **Tax on profit - 15%**
- **VAT - 18%**
- **Customs tax - none**
- **Operations involving the delivery of natural gas to TPPs are free of VAT**

Compared to other periods, the overall tax burden as reflected in tariffs has been reduced by about 8%



Rate Setting Authority of GNERC

- ✓ According to law, GNERC establishes and regulates the following rates:
 1. Marginal delivery rates (ceiling) -- only for those retail consumers, who receive gas from the gas distribution network (partial deregulation, until October 2007)
 2. Fixed delivery rates (Georgian Gas Transportation Company LLC is the operator of the Georgian main gas pipes)
 3. Fixed distribution and supply rates
 4. Marginal residential consumer rates
- Monitoring and analysis of financial reports
- Companies submit quarterly operational reports to GNERC according to the forms established by the Commission; they also submit annual audited financial reports, as well as information on investment
- The Commission has the authority to review rates on its own initiative



Delivery Rates

- ✓ About 99% of natural gas is imported to Georgia from Russia and Azerbaijan
- ✓ The volume of imported gas is unlimited
- ✓ As we noted above, beginning in October 2007, the delivery of gas has been deregulated with the exception of consumers, who use gas for non-commercial purposes (residential consumers) and whose relationship with the gas companies goes back before that date. For them, GNERC set marginal delivery rates
- ✓ Delivery rates do not include transportation and distribution rates
- ✓ Delivery of natural gas to various categories of residential consumers is treated the same as distribution operations
- ✓ Non-residential consumers can get natural gas from any supplier



Transportation Rates

- ✓ Transportation rates, in general, are the same for all consumers and are set 16.32 Lari per 1,000 cubic meters, including VAT (\$9.22 per 1,000 cubic meters based on local currency exchange (1 USD = 1,77 GEL))



Transit

- ✓ Transit of natural gas goes to Armenia
- ✓ Transit rates are not established by the Commission
- ✓ Profits from transit (10%) are included in the calculation of transportation rates



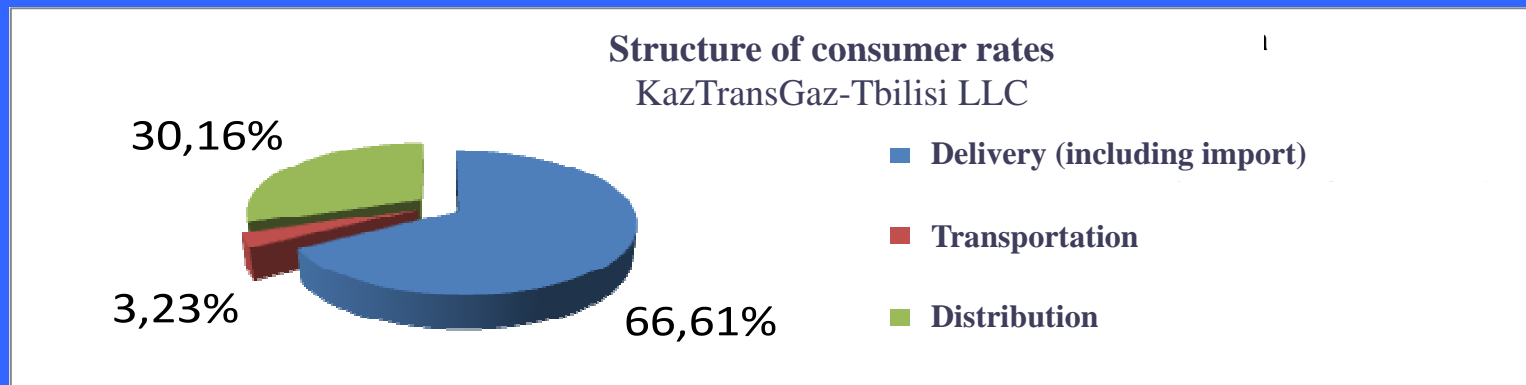
Distribution Rates

- ✓ Distribution rates are determined based on pressure (high, medium, and low)
- ✓ Distribution rates are established on an individual basis for each gas distribution company as follows:
 - for high pressure: from 0.6 tetri/m³ to 3.9 tetri/m³
 - for medium pressure: from 2.0 tetri/m³ to 12.0 tetri/m³
 - for low pressure from 10,0 tetri/m³ to 17.0 tetri/m³
- *Distribution operations include in-country transit of gas*
- *The cost of in-country transit is recaptured through rates*



Consumer Rates

- ✓ **GNERC establishes marginal consumer rates, which have the following structure:**
Marginal gas delivery rates (including import) +
Fixed transportation rates +
Fixed distribution rates
- ✓ **Consumer rates are also established separately for the consumers of high, medium, and low pressure gas**
- ✓ **The rates basket for direct consumers (i.e., consumers who get their natural gas directly from the transportation pipelines), whose delivery rates are deregulated, consist only of delivery and transportation rates.**





Stimulating Factors of Regulation

- ✓ **Marginal rates – companies can establish their own rates within the limits defined by GNERC**
- ✓ **GNERC can allow a company to keep, for a certain time, the savings realized as the result of a decrease in losses**
- **According to Georgian Law on the Power and Natural Gas Sectors and the current government policy, GNERC can establish long term tariffs, effectively extending the period when the rates have to be reviewed. This reduces expenses, while the rate adjustment itself only affects those factors, which cannot be controlled by the companies, and also takes into account the expected results (X is the consumer price index)**
- **Today GNERC is working on a long term tariff methodology. It is very important for us to learn about the experience of our international partners in this area.**



Questions to KPSC

Rate regulation

- Is the national policy taken into account in ratemaking?
- What is the legal (regulatory) basis for ratemaking and its practical application?
- What methodology is used for reviewing rates?



Thank you for your attention!