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Complaint on incompatible State aid for the Nenskra hydropower project, Georgia

Disputed decision: The Implementation Agreement for the Nenskra Hydroelectric Project dated by 31 August, 2015 and amended and restated on June 16, 2017 between the Government of Georgia, JSC Electricity System Commercial Operator (ESCO), JSC Georgian State Electrosystem (GSE), JSC Partnership Fund, and JSC Nenskra Hydro. The Implementation Agreement includes a section on the project related Power Purchase Agreement as well as other obligation of the parties such as energy rates, guaranteed generation, put and call options etc.

We strongly believe that the Government of Georgia as well as 100% state owned companies such as the JSC Partnership Fund, GSE and ESCO have breached the Energy Community Treaty for the reasons laid out below.

Introduction

The planned Nenskra hydropower project consists of a 280 MW plant with a proposed 130 metre high asphalt face rock fill dam on the Nenskra River, flooding up to 267 ha of forests and communal lands. Additionally, an 8.7 metre high dam and 12.4 kilometre diversion tunnel will be built to bring water from the Nakra river to the Nenskra reservoir.

The project is planned to be implemented by JSC Nenskra Hydro, a joint venture between the state-owned Partnership Fund (10%) and the Korean K-Water company (90%) under a BOT scheme (Build-Operate-Transfer). International Financial institutions such as the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB) and the Asian Infrastructure Investment Bank (AIIB) are considering loans for the project. In January 2018 the EBRD approved 214 mln¹ and a USD 15 million equity investment² for the Nenskra HPP project followed by the EIB approving 150 mln USD in February 2018.³ The ADB⁴ and the AIIB⁵ have not made decisions yet.

¹ <https://www.ebrd.com/work-with-us/projects/psd/nenskra-hpp.html>

² <https://www.ebrd.com/work-with-us/projects/psd/nenskra-hpp-portage.html>

³ <https://www.eib.org/en/projects/pipelines/all/20150670>

⁴ <https://www.adb.org/projects/49223-001/main>

⁵ <https://www.aiib.org/en/projects/proposed/2017/280-mw-nenskra-hydropower-plant.html>

Problem overview

The Government of Georgia, the state-owned Partnership fund and the Korean company K-Water signed a confidential BOT contract on August 31st, 2015. Part of the contract was disclosed in November 2017 by the Ministry of Energy without key parts⁷. However, information related to the financing plan, energy rate, tax implications, and put and call option have never been released officially. Additionally, the guaranteed power purchase agreement (PPA) is fully confidential, although it will have significant consequences both for individual consumers as well as generally for the planned reforms in the energy sector. On February 4, 2019, high level officials of the Korean water company visited Georgia and signed an additional Memorandum with the Ministry of Economy and Sustainable Development for acceleration of the construction works.

Recently, in June 2019, Rustavi 2 TV released a leaked version of full contract which we assume to be genuine. Where the information from the contract is corroborated by other publicly available sources, we also note this below.

Before the contract was leaked, the Environmental and Social Impact Assessment (ESIA) had already revealed some alarming details about the project. According to the ESIA, the power purchase agreement signed by the state and the investor is based on the 'take or pay' model. It guarantees purchase of 1,196 GWh, which equals the Nenskra dam's proposed average annual production and 9% of total annual generation of Georgia in 2018⁸. This means that the project will have preferential treatment over other Georgian electricity producers, including the state-owned Enguri dam. The Georgian government will be responsible for the construction of the related infrastructure, including high voltage transmission lines, raising the questions about the project's hidden costs for the public⁹. Moreover the Government is obliged to purchase the electricity from the company for 36 years.

It is also notable that so-called Cost Benefit Analysis that was disclosed by the Government in 2017¹⁰ just analyses the benefits of the project while costs are omitted, including depreciation cost, fiscal cost, environmental and social costs, impacts on the economy of Georgia etc.

International Monetary Fund assessment of Nenskra

The International Monetary Fund in November 2017 in its assessment¹¹ "Fiscal Transparency Evaluation" for Georgia considers the Power Purchase Agreement for the Nenskra hydropower project as a unique case that exposes the state budget to additional fiscal risks.

It turns out that the government guarantees an internal rate of return (IRR) of 12.5 percent on equity investments (In USD), "which if not paid for could result in the government terminating the contract, at a total cost of USD 800 million plus the IRR on USD 180 million of equity (6.2 percent of GDP plus the IRR)".

⁷ <http://www.energy.gov.ge/projects/pdf/pages/Nenskras%20Hidroelektrosadguri%201764%20geo.pdf>

⁸ Total generation in 2018 was 12,148.6 mln kwh <https://esco.ge/en/energobalansi/by-year-1/2018-energy-balance>

⁹ <https://www.ebrd.com/cs/Satellite?c=Content&cid=1395257113529&d=Mobile&pagename=EBRD%2FContent%2FContentLayout>

¹⁰ <http://www.energy.gov.ge/projects/pdf/pages/Nenskras%20Hidroelektrosadguris%20Proektis%20Ekonomikuri%20Sargeblanobis%20Analizi%201787%20geo.pdf>

¹¹ <https://www.imf.org/en/Publications/CR/Issues/2017/09/27/Georgia-Fiscal-Transparency-Evaluation-45274>

Moreover the government provides a three level guarantee of ensuring income for the company, namely, if project revenues fall short the government agrees:

1. To adjust regulated prices in the year following any shortfall (which would cost consumers, but not the government);
2. To cover the shortfall from the Partnership Fund¹² up to a maximum of USD 54 million (for which it receives a guarantee fee of USD 2.5 million per year from the project); and
3. If the government cannot top up any payments itself, it will be obliged to buy out the equity in the project (USD 180 million) and the debt (USD 620 million). This exposure is subject to exchange rate risk too, not discussed in the paper.

It is notable that unlike most other PPAs on hydropower plants in Georgia, the government agrees to take construction (up to 30 mln USD) and hydrology risks (uncapped).

World Bank Experts' assessment of Nenskra

The IMF report was followed by a World Bank study on "Assessment of Fiscal Costs and Tariff Impacts of Power Purchase Agreements"¹³ in February 2018, prepared by World Bank experts with external contributions. It is notable that the analysis was undertaken in response to a request from the Ministry of Finance of Georgia.

The World Bank report reveals and assesses even more details of the contract than the IMF one. The study directly states that the fiscal cost from Nenskra hydropower plant is the largest among the PPAs of other large hydropower projects because it has the highest indicative PPA tariff "starting at 7.55 USc/kWh with 3% annual escalation, off-take liability of 34¹⁴ years, and estimated annual generation of 1.2 billion kWh per year, which is 9 percent of projected total domestic demand in 2023".

Table 1: Estimated Annual Fiscal Cost under PPAs (million GEL).

	2022	2023	2024	2025	2026	2027	2028	2030	2032	2034	2036	2041	Total for 2022-2041
Nenskra	-	225	231	238	250	252	260	276	293	310	329	382	5632
Namakhvani	39	36	37	38	38	39	41	43	47	44	48	0	631
Koromkheti	18	18	18	18	18	18	18	18	18	18	18	0	268
Total	57	280	286	294	306	309	319	337	358	372	395	382	6531

Source: World Bank team estimate.

The report also says it can be reduced to "GEL 611 million (US\$247 million) in present value terms, through exports of electricity (assuming that the surplus energy is exported at 85 percent of the prevailing market price in Turkey). However, the fiscal cost cannot be eliminated entirely because the average wholesale electricity market price in Turkey is about 4.5 USc/kWh whereas the PPA tariffs for these projects are higher (starting from 6.2 USc/kWh)".

¹² In the leaked contract this clause is not visible but the IMF report mentions it;

¹³ http://greenalt.org/wp-content/uploads/2018/09/Assessment_of_HPP_Cost_2018.pdf

¹⁴ In the leaked contract and in the project ESIA it says 36 years but in the World Bank assessment 34 years is mentioned;

The analysis assesses impact of the additional financial cost for consumers arising from Namakhvani, Koromkheti, and Nenskra PPAs saying that they will result “on average for the period of 2022-2036, in a 12 percent higher annual tariff increase in nominal terms”.

In addition the report calculates the fiscal costs due to the depreciation of the GEL against the USD as the PPA tariffs are set in US cents. The analysis includes stress tests to evaluate the impacts under various assumptions for depreciation of the GEL against USD agreed with the Ministry of Finance. According to the findings of the stress tests the annual fiscal cost may increase from GEL 350 million in 2023 to more than GEL 500 million by 2026 depending on the depreciation scenario for GEL. A summary of impacts of all scenarios is presented in the Figure below.



The Nenskra hydropower project’s power purchase agreement violates EU State Aid

We strongly believe that the PPA that has been signed on the Nenskra project and the conditions defined violate Article 18(c) of the Energy Community Treaty:

“1. The following shall be incompatible with the proper functioning of the Treaty, insofar as they may affect trade of Network Energy between the Contracting Parties:

...

(c) any public aid which distorts or threatens to distort competition by favouring certain undertakings or certain energy resources.

2. Any practices contrary to this Article shall be assessed on the basis of criteria arising from the application of the rules of Articles 81, 82 and 87 of the Treaty establishing the European Community (attached in Annex III).”

Article 87 of the EC Treaty, now Article 107 of the Treaty on the Functioning of the European Union (TFEU), states:

“1. Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.”

The Nenskra PPA does not fall under the criteria of the certain cases where the State Aid could be acceptable set out in Article 107 of the TFEU.

The PPA fulfills all the four conditions to be considered State aid, as follows:

- **Aid is granted by the state or through state resources**

The special purpose company JSC Nenskra Hydro majority-owned by Korea Water Resources Corporation (90% of shares) and the state-owned Partnership Fund (10%) has been established under the laws of Georgia for the sole purpose of constructing the 280 MW Nenskra HPP. According to the contract, the state takes a number of obligations towards the company, namely, to purchase all generated electricity of the plant from the Company for 36 years whether it needs it or not; to cover any shortfall of energy generation due to hydrological events; to recognize the facility as an intangible asset (see below) during the entire Project lifecycle; granting all necessary land plots for the facility including a reservoir area for symbolic 1 USD which is more than 700 hectares of land; and to construct associated facilities such as access roads, substation and transmission lines for the project¹⁵. Therefore it is clear that aid is granted through state resources.

- **It benefits a certain undertaking**

The PPA benefits the special purpose company Joint Stock Company “Nenskra Hydro” that has been established under the laws of Georgia to construct the 280 MW Nenskra hydropower plant, and thus clearly qualifies as an undertaking.

- **It creates a selective advantage**

According to the leaked contract it becomes clear that Government agreed to treat the the project exceptionally and created an unprecedented advantageous position compared to other companies. While there are more than a hundred contracts and memorandums signed on various hydropower plants with guaranteed power purchase agreements, the Nenskra case can be assessed as unique, as only for the Nenskra project the Government:

1. guarantees highest energy rates for 36 years unlike other hydropower plants where the maximum period is 15 years;
2. Covers shortfall of electricity generation due to hydrological events by allowing the company to increase the electricity price for the State for next year. Such an approach is unique as it has not been used in any other hydropower project in the country;
3. Agreed to treat the plant as an intangible asset for tax purposes. When the Revenue Service recently issued a Tax Ruling in relation to the project that determined the facility to be treated as a tangible asset and therefore be subject to property tax, the Company requested and the Government agreed that a Change in Tax status has occurred and that the company will be eligible for reimbursement by the government of Georgia.

- **It has the potential to distort competition and trade.**

¹⁵ <https://www.ebrd.com/cs/Satellite?c=Content&cid=1395273895489&d=Mobile&pagename=EBRD%2FContent%2FContentLayout>

The contract on Nenskra defines a long term (36 years) guaranteed power purchase agreement for whole generated electricity (9% of total generation), the price of which is more than twice the existing wholesale price (4.9 USc). According to the contract, the Government is obliged to purchase electricity for around 10.6 USc during the first 13 years and for 12.7 USc for the remaining 23 years. It is notable that this price is not only significantly higher than the existing price within the country but it is more than three times higher than Georgia can export electricity to neighbouring Turkey where in 2018 the export price was just 3 USc.

It is also notable that the contract defines the amount of electricity that the plant will supply to the Georgian system month by month. According to these data during the 3 winter months (the main deficit period for Georgia) the plant is contributing by only 260 mln kWh while main generation falls in the other 9 months when existing hydropower plants are producing electricity at least 10 times cheaper.

Therefore it is clear that promotion of the Nenskra hydropower project together with other projects with PPAs will distort competition and trade on the electricity market that is in the process of creation in Georgia. Moreover such projects limit the development of competitive new renewables in Georgia too.

The Energy Community has already recognised that Georgia's PPAs constitute a "major concern for the development of a competitive market and price deregulation in Georgia" in its Annual Implementation Report 2018.

Transparency of information on aid is one of the key principles defined under the EEAG. Energy Community Contracting Parties are required to disclose the full text of the approved aid scheme or the individual aid granting decision and its implementing provisions as well as the form and amount of aid granted to each beneficiary. Taking into account the fact that Georgia's aid scheme for renewable energy is not set out in any legislative act or implementing act or decision, but appears to be decided on a case by case basis, that no decision about the conditions for contract of the Nenskra project, or the PPA, financing plan, energy rate tax implications, put and call option, and so on have been disclosed, and that they are considered confidential, it is clear that the transparency principle is being violated. The Energy Community has already recognised that "there is no single legislative act on renewables, Georgia lacks a systematic approach towards regulation of the field"¹⁶, and this in reality means that there is not a level playing field for different renewable energy companies.

The primary objective of aid in the energy sector should be "a competitive, sustainable and secure energy system in a well-functioning Union energy market"¹⁷¹⁸. Therefore the energy sector aid measure should define precisely the objective it pursues and explanation of the expected contribution of the measure towards this objective. In the case of the Nenskra project, no justification that could substantiate the need for using such a support scheme for the project has been provided in any publicly available document.

Negative impacts of hydropower plants on water systems and biodiversity (Paragraph 117) are recognised by the EEAG State aid rules. The EEAG permits aid to hydropower plants only if the State respects Directive 2000/60/EC that lays down criteria in relation to allowing new modifications of bodies of water. Article 4(7)¹⁹ of this Directive underlines that the above-mentioned Directive will not be breached only if a) All

¹⁶ <https://www.energy-community.org/implementation/Georgia/RE.html>

¹⁷ [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0628\(01\)&from=EN](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014XC0628(01)&from=EN)
3.2 General compatibility provisions;

¹⁸ "Guidelines on State aid for environmental protection and energy 2014-2020"

¹⁹ https://eur-lex.europa.eu/resource.html?uri=cellar:5c835afb-2ec6-4577-bdf8-756d3d694eeb.0004.02/DOC_1&format=PDF

practicable steps are taken to mitigate the adverse impact on rivers; b) the reasons for those modifications or alterations are specifically set out and explained in the river basin management plan; c) the reasons for those modifications or alterations are of overriding public interest and/or the benefits to the environment and to society; and d) the beneficial objectives of these modifications or alterations of the water body cannot be achieved by other means²⁰, which are a significantly better environmental option.

The above-mentioned conditions have not been fulfilled in the case of the project as Georgia still lacks an Energy Development Strategy, claims of overriding public interest and benefits to society and environment have not been substantiated; assessment of the alternatives is lacking in the project documentation; and there is not any river basin plan for the Enguri river.

Taking into account the above-mentioned, the Nenskra hydropower project and its contract contradicts the State aid rules of the EU, and therefore Georgia by promoting the project is violating its obligations undertaken in the Treaty.

Steps taken to overcome the violation

During the years Green Alternative has actively been involved in communication with the Government of Georgia as well as with International Financial Institutions regarding the necessity of carrying out energy sector strategic planning as well as on concrete hydropower projects.

Regarding the Nenskra hydropower project we have regularly participated in official public hearing meetings as well as raising concerning issues such as contract confidentiality issues and/or Cost-Benefit analysis in various forums and events. We submitted an appeal in court as well requesting disclosure of the contract²¹. In order to influence on the process developing on the Nenskra case we have focused on International Financial Institutions such as the EBRD, EIB, ADB and AIIB. We together with our Bankwatch partners have conducted a number of face-to-face meetings with the executive directors of these Banks as well as with Management staff since 2016. Moreover we have held meetings with the US treasury, USAID in Georgia and other international donors. During this period we prepared and submitted a number of materials that can be found below:

1. Briefing on Nenskra, EBRD AGM 2016,

<https://bankwatch.org/wp-content/uploads/2016/02/briefing-EBRD-Nenskra-02Feb2016.pdf>

2. Nenskra hydropower plant project, Georgia; EBRD annual meeting; May 5, 2017;

<https://bankwatch.org/publication/nenskra-hydropower-plant-project-georgia>

3. Comments on Nenskra Hydropower Project Supplementary Environmental & Social Studies

by JSC Nenskra hydro, by CEE Bankwatch Network, Green Alternative and Balkani,

<http://greenalt.org/wp-content/uploads/2017/07/comments- Nenskra hydro20171.pdf>

²⁰ Due to reasons of technical feasibility or disproportionate cost;

²¹ http://greenalt.org/disputes_complaints/energy_projects/

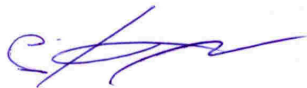
- Six reasons for not financing the Nenskra hydropower project in Georgia; December 5, 2017; It was sent to the Executive Directors of the EBRD, <https://bankwatch.org/publication/six-reasonsfor-not-financing-the-nenskra-hydropower-project-in-georgia>
- Comments on the Nenskra supplementary environmental and social studies together with the annexes related to the Bern convention were sent to the Management and Executive Directors of the IFIs; January 15, 2018; <https://bankwatch.org/publication/comments-on-the-nenskrasupplementary-environmental-and-social-studies>
- Issue paper for the EBRD annual meeting; May 4, 2018; See: https://bankwatch.org/wp-content/uploads/2018/05/Nenskra-IP-1-for-EBRD-2018.final_.pdf
- Issue paper for the EBRD annual meeting, May 8-9, 2019; See: <http://greenalt.org/wp-content/uploads/2019/05/Issue Paper new Nenskra 2019.pdf>

Conclusion

We believe that this request, which alleges non-compliance of the Nenskra project with the Energy Community rules justifies the following requests: To assess whether contract signed on the Nenskra hydropower plant and steps taken by the Government are incompatible with State aid rules under the Energy Community Treaty. If the violation is confirmed, we ultimately seek the cancellation of the contract.

We further request the Energy Community to assist the Government of Georgia in setting up an EEAG-compatible and transparent renewable energy support scheme that would level the playing field for technologies other than hydropower.

Signed:



Date: August 2, 2019

Annexes:

- 1) The version of the contract disclosed to the public – See: <http://www.energy.gov.ge/projects/pdf/pages/Nenskras%20Hidroelektrosadguri%201764%20geo.pdf>
- 2) The leaked full version of the contract - <http://greenalt.org/wp-content/uploads/2017/06/xelshekruleba.pdf>
- 3) World Bank report - <http://greenalt.org/wp-content/uploads/2018/09/Assessment of HPP Cost 2018.pdf>
- 4) IMF report - Comes attached