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# State Weakness in Perspective: Strong Politico-Economic Networks in Georgia's Energy Sector

STACY CLOSSON

## *Abstract*

Taking the case of Georgia, this article considers the role of politico-economic networks in weakening the energy sector in a post-Soviet state. It is hypothesised that incentives, from financial gain to the provision of goods and services, encourage a multitude of actors to create an alternative system to the state. It concludes that in a weak state, networks have replaced legitimate channels of communication and no amount of foreign financial or technical assistance can make up for the lack of will among the stakeholders to develop an efficient energy system.

ONE OF THE MOST STRIKING PATTERNS IN THE POST-SOVIET space is the persistent weakness of the domestic energy sectors of many states, whether publicly or privately managed. Over the last 15 years, persistent cuts in gas and power have occurred throughout the post-Soviet states, despite the hydrocarbon and hydropower richness of the region. This has been perplexing particularly in Georgia, given unprecedented levels of financial and technical assistance provided to the government, partly in recognition of its geo-strategic positioning along a lucrative hydrocarbon transit corridor. Starting in the late 1990s, Georgia was the third largest recipient per capita of US foreign assistance in the world. In 2000, the Clinton Administration, partly in an effort to bolster the country's ability to act as a transit state for Caspian hydrocarbon export to Europe, spent \$200 per person in Georgia. This amount was six times higher than the amount spent on Ukraine and roughly 160 times more per capita than aid received by Russia (Christophe 2003). Between 1995 and 2003, Georgia received approximately \$500 million in grants for electricity production, and an additional estimated \$2.5 billion towards redeveloping its energy sector in combined international assistance, private investment, pipeline construction, and gas and electricity loans (Closson 2007). However, by late 2003, Georgia was generating electricity at only 45% of its 1989 level and was losing 365 million Georgian lari annually or approximately \$30,000 per day from technical losses (Lezhava 2006).

For a newly independent, resource deficient state such as Georgia, which saw the dilapidation of the infrastructure as a result of three wars in the early years of

independence, securing a regular power supply was paramount to the socio-economic development of the state. A regular supply of energy to operate state facilities, such as schools, hospitals and transport systems, was critical to the welfare of the population. Additionally, a regular power supply was needed to help regenerate businesses and infrastructure. Financial revenues from taxing the import and transit of electricity and hydrocarbons offered a way of bolstering state development budgets and this would be particularly relevant to Georgia in the first decade of independence. The country imported all of its natural gas supply, virtually all of its petroleum products, and most of its electricity in the winter months, as well as serving as the major transit corridor from Azerbaijan and Armenia to Europe. Ultimately, enhancing Georgia's hydro-power export potential would allow it to be less dependent on neighbours, while also offering the option of trading electricity for gas. However, rather than strengthen development efforts, the result of Georgia's handling of its energy sector was to cripple the state by 2003. A 2001 US government study estimated the losses from the energy sector for one year at \$300 million in foregone taxes, \$200 million in electricity losses, and \$100 million in natural gas losses (USAID 2001). Hence, despite following the donor-prescription for electricity sector reform of unbundling of the Soviet state run system, privatising generation and distribution, creating a wholesale market, and enacting regulatory laws, losses persisted.

Why did urgent need for reform, combined with high levels of foreign assistance, not result in a reliable and effective electricity sector in Georgia? Based on field research in Georgia from 2003 to 2007, this article considers electricity sector developments in Georgia since independence through to 2007. During field research in Georgia from 2003 to 2007, I interviewed a spectrum of society, from the elite to the unemployed, from those residing in major cities to rural areas, including the semi-autonomous regions (Adjara and Javakheti) and separatist regions (Abkhazia and South Ossetia).<sup>1</sup> This article begins by discussing reasons for Georgia's weakness presented in three strands of literature. It then introduces the idea of conceptualizing Georgia as an arena of competing networks by, first, introducing various network studies on post-Soviet states and, second, offering a framework of politico-economic networks through which to examine a weak state. This is followed by a case study of politico-economic networks in Shevardnadze's Georgia. In comparison, progress made in the electricity sector in Saakhasvili's Georgia is analysed with reference to the impact on politico-economic networks. The article concludes with a discussion of how politico-economic networks affect persistent

<sup>1</sup>Over 75 semi-structure qualitative research interviews were conducted with a spectrum of society. These interviews were conducted following the general interview guide approach in order that the same general areas of information were collected from each interviewee. Interviews were conducted in the capital and the regions with parliamentarians, heads of businesses, current and former members of the government, trade organisations, donor organisations, and non-governmental organisations. Interviews often came up unexpectedly, and many times a second or third visit with the same person or organisation was necessary to glean the information required. Due to the sensitivity of the information, none of the interviews were recorded, and some of the information obtained during interviews was 'non-attributable'. Conducting research on this type of topic meant that there were several times when I did not ask for the status of information being provided and did not take notes immediately so as not to interrupt the information flow. Naturally, however, I abided by the requests of some of the interviewees that our conversation be off-the-record.

state weakness. While progress was made during the first several years of the Saakashvili administration, some patterns of networks monopolizing decisions concerning the energy sector remained.

*Georgia as a weak state*

Why did the urgent need for reform, combined with high levels of foreign assistance, not result in a reliable and effective electricity sector in Georgia? A major element in explanations of Georgia's economic problems has focused on the weakness of the post-Soviet Georgian state. Since independence in 1991 up to the end of Shevardnadze's administration, Georgia has always been described as a weak state, sometimes teetering on the brink of failure. A leading Georgian political scientist, Gia Nodia, has argued that the disintegration of the state went further in Georgia than anywhere else in the former Soviet Union with the exception of Tajikistan (Beissinger & Young 2002, p. 412). The literature is unanimous that at least until 1994, Georgia was a failing state, if not a virtually collapsed state (Demetriou 2004). According to one analyst, 'in the winter of 1993-94, the Georgian government could not manage to defend the country, keep order on the streets of the capital, pay state workers, collect taxes, or print the currency in common use' (Fairbanks Jr 2001, p. 50). There exist three strands in the literature that attempt to explain Georgia's persistent weakness from 1991 to 2003, focusing in turn on ethno-territoriality, the role of Russia, and corruption.

The first strand in the literature attributes Georgia's weakness to the conflict between the unitary nationalist ambitions of the Georgian population and the ethnic diversity within Georgia (Broers 2003; Losaberidze & Kikabidze 1998; Nanava 2005; Panossian & Schwartz 1994; Suny 1994). This strand focuses in particular on the clash between Georgians and ethnic minority groups in South Ossetia and Abkhazia that resulted in Tbilisi's loss of control over these territories (Cornell 2002; Duffy Toft 2001). There was a fear that Georgia might not survive as a state, but rather that it would 'disintegrate into a collection of ethnic enclaves and warlord fiefdoms' (Aves 1996, p. 3). In the post-war malaise, the problems of ethno-territoriality were complicated by the after effects of 'frozen conflicts' in Abkhazia and South Ossetia. One effect was psychological and was reflected in the high levels of anti-politics sentiment that followed the failed campaigns (Fairbanks Jr 1996). Another effect was material: the chaos of war transformed into networks of profit and served as a source of strength for the institutions in the separatist states (Demetriou 2002; King 2001). Meanwhile Georgia became mired in an economy of violence (Keen 1998).

A second strand suggested that the Russian armed forces' support for the separatist fighters during the conflicts, and their role as the post-conflict peacekeeping force in Abkhazia, challenged Georgia's sovereignty (Baev 1997; Light 1996; Lynch 1998). Tension was heightened by the continued presence of Russian military bases in Georgia despite requests by the Georgian government for them to leave (Antonenko 2001). In this literature it was argued either, on the one hand, that Russian government officials had used their position of relative strength as a strategic bargaining tool to counter Georgia's Euro-Atlantic orientation (Rondeli 2003; Duffy Toft 2001), or on the other hand, that perhaps Georgia had not gone far enough in its Western orientation, while at the same time rejecting Russia as a development model (Nodia 2001).

A third approach focused on Georgia's failure to meet democratic and economic transition goals after a decade of assistance, and attributed this to high levels of government corruption. A common theme was the interweaving of 'politics, crime, and clans', which normalised the diversion of state assets for private means (Darchiashvili 2003). Fairbanks explained that the intertwining of business and politics in Georgia meant that the 'weak state' would be hard to overcome because it fed on itself (Fairbanks Jr 2001). Slow rates of growth and disparity in income levels in Georgia were blamed on the recapture of politico-economic power by personnel from the Soviet period (Gotsiridze & Kandelaki 2001). Lengthy academic studies focused on entrenched corruption in Georgia, the result of the monopolisation of the political system through such practices as clientelism, criminal activity, a weak law enforcement, and the manipulation of state resources to provide economic benefits for a privileged few (Huber 2004; Stefes 2005). Overall, the literature on Georgia's weakness is marked by well trodden paths of scholarship from historians and economists, to transitologists and international relations scholars. However, none of the explanations alone addresses persistent weakness in Georgia's energy sector.

#### *Network studies on post-Soviet states*

In parallel with the growing consensus in the late 1990s that post-Soviet states were not in transition to liberalised economies governed by the rule of law, there appeared a number of network studies to explain why this was the case.<sup>2</sup> By the 1980s, network analysis was employed in comparative politics, public administration, organisation theory, and the sociology of stronger states (Degenne & Forsé 1999; Giddens 1984; Knoke 1990; Scott 2000; Wasserman & Faust 1994). International Relations began to conceptualise relations in networks when discussing the role of non-state actors, mostly in the form of non-governmental organisations or international financial institutions and their impact on either state sovereignty or world politics (Josselin & Wallace 2001). In the post-Cold War era, the globalisation literature advanced the notion of networks in the international system, focusing on trends in networking among various societal groups (Rosenau 1995), international organisations, corporate power structures, and regional-global networks (Beck 2000), and communications and technological links (Castells 1996). An underside to the literature addressed networks of organised criminals, the mafia, arms traffickers, and terrorists (Duffield 2001; Kaldor 1999; Pugh *et al.* 2004).

In the post-Soviet studies literature, there are three major strands of network studies, most of which make reference to networks rather than applying quantitative network methodology. The first use of networks traces the reconstitution of Soviet societal formations in the 1990s including networks that exchange favours or '*blat*' (Ledeneva 1998, 2004) and networks that constitute government structures based on patrimonialism and the exchange of favours (Bremmer & Welt 1997; Cheloukhine & King 2007; Kurkchiyan 2000; Vorozheikina 1994). The second approach evaluates

<sup>2</sup>The application of networks was first used by British anthropologists, followed by American sociologists in the 1970s. For a more detailed explanation of the development of network analysis in Western social science, see Easter (1996, pp. 557–59).

whether the intertwining of business and political elites is responsible for the lack of economic development in Russia, with some determining that there has been little change from the domination of the Soviet *nomenklatura* (Khrystanovskaya & White 1996; Kirkow *et al.* 1998), while others employing quantitative methods detect the presence of new business actors, particularly in Russia's regions (Hughes *et al.* 2002), concluding that different elites form networks of distinct subgroups or factions with qualitatively different patterns of affiliation (Buck 2007). The third approach explores the role of networks as a mechanism for conducting transactions between markets and bureaucratic regulation, usurping the state. There are several studies of networks comprised of formal state actors, which use their positions to collude with transnational actors for financial gain (Cummings 2005; Jones Luong 2002; Jonson 1998; Wedel 2003), as well as studies of indigenous clan structures in the Caucasus and Central Asia that operate in parallel with the formal structures (Collins 2004, 2006; Mirimanova 2006; Ilkhamov 2006; Schatz 2004).

The conventional approach to the study of networks in the post-Soviet states has focused primarily on elites; networking is power-driven and *nomenklatura*-centred. Those studies that do broaden the scope of networks either examine the pattern of linkages between the state and societal spheres of influence at the sub-state level, or between the state and transnational actors. The studies rarely attempt either to examine a confluence of both, or to treat networks as the primary actor in inter-state relations.

#### *The weak state as an arena for competing networks*

In contrast to the approaches reviewed above, this article introduces a fourth approach to network studies, based on a critical reading of stateness (Holsti 1996; Linz & Stepan 1996) that reconceptualises the weak state as a space for the activities of a confluence of state and non-state and global and local actors traversing territories in a complex of networks. Over time, these networks have replaced legitimate channels of communication. Thus, transposing networks onto Clark's 'glocal' medium (1999) reconstitutes the 'idea' of the state as an arena of conflicting groups and issues, providing a departure point from which to understand the causes of persistent state weakness. This begins with a re-examination of the actors operating within the state and asks to what ends the state serves their objectives (Smith *et al.* 1996).

The collapse of the integrated Soviet system, followed by military conflict in Georgia, created new arrangements based on revised ownership and the inclusion of new economic actors. Field research revealed that transactions in the energy sector were monopolised by politico-economic networks comprised of state and non-state stakeholders, locked in a struggle for resources. Alongside the state was another ordering of actors, a second if not substitute economy, and an unwritten but understood set of rules that served the interests of those in power and sustained the livelihoods of the rest. Most transactions were made with the complicity of the state, between official and unofficial markets, traversing recognised and unrecognised territories, expanding the depth and breadth of their operations over a decade. The ineffectiveness of the energy system was not necessarily about a failure to develop, as it was a tool to strengthen those operating within an alternative system of networks, and these networks served as the basis of power in governmental and business structures. Thus, no amount of foreign

assistance or investment could overcome the lack of will to develop an effective energy system. To the contrary, external financial assistance only strengthened these networks, defeating the purpose of external donors and investors.

The networks examined in this study are composed of stakeholders from four groups: the elite (the ruling family, key power ministers and international partners), the bureaucracy (state and local), business groups engaged in unregulated or illegal operations (including peacekeepers, paramilitary groups and criminals), and consumers (the marginalised majority). The Shevardnadze family was at the nucleus of the energy elite in Georgia. They included the president's daughter's father-in-law, Guram Akhvlediani (whose daughter Nino was married to Shevardnadze's son Paata), the president's nephews Nugzar and Ceasar Shevardnadze (sons of his deceased brother) and Gia Jokhtaberidze, who was married to his daughter Manana Shevardnadze. The elite extended beyond Georgia's borders to former communist *nomenklatura* and new partners in neighbouring states. The bureaucracy consisted of the 'Red Directors' (former heads of the Soviet state-owned firms) and the managers of the State Trade Organisation who maintained their hold over the energy sector after independence. District level political bosses also converted their positions into profit through informal control over business jurisdictions (Metreveli 2004). The business groups dominated smuggling and financial transactions across official and unofficial borders in Georgia. The consumers were by far the largest group (roughly estimated to be 70% of the population) and included the most disenfranchised members of society due to their unemployment (or under-employment) and lack of access to state goods and services. They sought to gain employment or pay lower rates for services.

The networks featured in this study are semi-permanent, set up for one operation or a fixed period of time and then disbanded. This makes them unique; their configurations and rules are dependent on their mission. Every network's operation is sponsored, usually by someone in the elite or bureaucracy. The networks are also non-transparent, governed by a set of unwritten and yet binding rules. The stakeholders in the networks are multi-sectoral, covering a variety of state and non-state offices, as well as crossing physical and financial boundaries. Finally, the networks operate according to a certain logic—for the accumulation of profit or welfare maximisation. The relationships within the networks neither resemble a hierarchical nor a horizontal pattern, but are more likely to form web-like heterarchical structures. The system is neither directly sponsored as an official state function, nor is it part of an unofficial or shadow economy, but instead comprises the grey market. Finally, all actions are conditioned by current socio-political and economic factors and their combined activity eventually create an alternate force, which challenges governmental institutions as the primary inter-state actor.

The next two sections will explore the relations of politico-economic networks in the politics of energy in Georgia, first under the presidency of Edvard Shevardnadze, and then under Mikheil Saakashvili.

#### *Politico-economic networks in Shevardnadze's Georgia*

In order to demonstrate how the combined activities of stakeholders in politico-economic networks undermine the state, a case study of the demise of a foreign

investor in Georgia's electricity sector—American Enterprise Services Corporation (AES)—is presented below. The series of events described do not tell the whole story; plenty of criticism was levelled at AES for how it conducted business in Georgia, including an unpopular management style, too much focus on raising rates, and investing too much too soon.<sup>3</sup> Moreover, between 2000 and 2002, AES stock lost more than 90% of its value as a result of the convergence of several global events: the 2001 California power crisis, residual financial losses related to altered business practices after the Enron electricity scandal in the US, lost profits in Latin American business in Argentina, Brazil and Venezuela due to political and financial crises, and uncertainty in the markets following the terrorist attack on America in September 2001.<sup>4</sup> What the case study is meant to demonstrate is how a series of actions by various intersecting politico-economic networks, whether orchestrated or not, undermined the ability of the company to provide the capital Tbilisi and major business with a reliable supply of electricity over a five year period.

In summer 2003, the Georgian parliament was told by the government that Unified Energy Systems Nordic, a subsidiary of the Russian Joint-Stock Company Unified Energy Systems of Russia (RAO-UES) under the directorship of Anatoly Chubais, had already bought a 75% controlling interest in the Tbilisi electricity generator Telasi for \$26 million (Bit-Suleiman 2003). The biggest foreign investor—American Enterprise Services Corporation (AES)—had pulled out of Georgia, after almost five years of negative returns and a deficit expenditure of \$190 million. AES paid \$34 million to leave the country and an additional \$60 million to cover past loans. In addition to Telasi, RAO-UES purchased the ninth block of the Gardabani thermal power station (the only one in working condition) from AES, as well as the right to manage the hydroelectric power stations, Khrami-1 and Khrami-2, on a 25-year lease. Through its 50% shares in the Sakrusenergo (a Georgian–Russian joint venture), RAO-UES also acquired ownership of half of all the high voltage power lines in Georgia. Thus, given that Georgia's primary transmission line, Kavkasioni, originated in Russia, that the capital residencies and major state agencies (one million customers, or 30% of the population) were now served by RAO-UES, and that a critical winter thermal power generator was owned by RAO-UES, by 2003 Russia dominated a major share of Georgia's electricity market.

At the time of the Telasi acquisition in December 1998, AES was the largest independent power company in the world, operating in 14 countries, and its purchase of the Georgian company was part of a major expansion to 31 new countries (Henisz & Zelner 2006, p. 3). In Georgia, AES had offered \$25.5 million for 75% of Telasi (the remaining 25% belonged to the state and to employees of the company) and an additional \$10.35 million for partial debt repayment to the government, with a commitment to invest \$22.6 million in the first year and \$84 million over 10 years (Henisz & Zelner 2006). Subsequently, AES invested \$275 million, including over \$200 million towards upgrading the Tbilisi electricity grid and installing meters in

<sup>3</sup>Interview conducted off-the-record with former employee of AES Telasi, Tbilisi, April 2005.

<sup>4</sup>R. Grant, 'AES Corporation: Rewriting the Rules of Management', *Cases in Contemporary Strategy Management*, Case Seventeen, Blackwell Publishing, available at: <http://www.blackwellpublishing.com/grant/4thedition/default.asp>, accessed 24 February 2008.



households in the capital. In October 1999, AES purchased recently refurbished units nine and ten of the Gardabani power station for \$16.5 million plus a commitment to pay \$2 million in back wages and invest \$100 million. AES TransEnergy was established with the Georgian Ministry of Fuel and Energy to gain the rights to export electricity from Gardabani to Turkey. Finally, in 2000 AES gained a 25-year lease over the management of the hydroelectric power stations, Khrami-1 and Khrami-2.

Given the dire situation in Georgia's electricity sector at that time, problems were expected. In the winter of 1998–1999, the capital Tbilisi had only four to six hours of electricity per day while the rest of the country received an average of three to four hours (IMF 2000, p. 67). However, from the outset, the operation was riddled with difficulties. In the first year, the company incurred operating losses of \$40 million per year, and after 16 months the company was losing \$120,000 per day and only managed to collect payment from 10% of its customer base. Mikheil Saakashvili, then a leading member of the president's ruling Citizens of United Georgia party (*Gaertianebuli Sakartvelos Mokalakeebi*), appeared on Georgian television accusing the Minister of Fuel and Energy of obstructing the ability of AES to operate effectively.<sup>5</sup> Partly as a result of AES's difficult first year, the Minister, Temur Giorgadze, was forced to resign in November 1999.

Semi-permanent arrangements of stakeholders operating in networks mounted challenges on at least six issues that ultimately undermined AES's operations in Georgia. First, prior to the company's entry into the Georgian market, the government had accrued massive debts for electricity from neighbouring countries, some of which refused to supply AES until debts were paid. As of February 2002, the Government of Georgia was in debt to its neighbours for electricity supplied since 1998. These debts had arisen as a result of bartering arrangements among former Soviet elites across newly delineated state borders. As a result of the non-transparent arrangements, Georgia owed \$4 million to Russia, \$4.5 million to Armenia, \$6 million to Azerbaijan, and 1.5bn kilowatt hours of electricity to Turkey.<sup>6</sup> This impacted on AES's negotiations with these states for the necessary import of electricity and was particularly damaging after units nine and ten in Gardabani suffered an explosion in December 2001, crippling their ability to generate electricity, and necessitating the import of power in the winter months.

Second, the authority's protection of big business from paying for electricity (owned in part by members of the Shevardnadze and other ministers' families) put AES's accounts in arrears. Georgia's Azoti chemical plant, in which Gia Jokhtaberidze had a stake, used \$6 million worth of power in 2001, but did not pay AES for this supply. According to Michael Scholey, General Director for AES in Tbilisi, if Azoti had paid its bills, the funds would have been sufficient for power generation for all of Tbilisi for one month.<sup>7</sup> This lack of government initiative in assisting AES to rectify this problem was also due to the fact that the government billed companies for value-added taxes based on the quantity of electricity distributed, as opposed to the quantity actually

<sup>5</sup>'Energy Crises as well as Search of People Guilty in it Continued', *Sarke Information Agency*, 15 November 1999, available at: <http://www.sarke.com>, accessed 15 May 2005.

<sup>6</sup>'IMF Urges Georgia to Sort Out Energy Debts', *Prime-News BBC Monitoring*, 7 February 2002.

<sup>7</sup>P. Devlin, 'Power Trip', 2003, 85 minutes (United Kingdom, BBC).

paid for by recipient companies.<sup>8</sup> Thus, it was not in their interests to encourage collection of fees for power usage.

Third, when AES did attempt to work through the government to raise rates to its customers, it faced a network of stakeholders from the bureaucracy and consumers. By 2001, AES faced a trial in Georgia's constitutional court and was under scrutiny by a parliamentary commission for raising rates to its customers. Eventually, parliament, Tbilisi City Council, and the executive branch joined forces in opposition to AES's policy of raising rates and punishing non-payment with disruptions to supply. In early 2003 the Georgian Constitutional Court, on appeal, reversed a decision to raise electricity rates, and enforced price cuts, further undermining AES's financial position. AES refused to lower rates and threatened to sue the government for breaking the conditions of the contract.<sup>9</sup> At the same time, the Georgian Ministry of Finance seized AES's bank accounts and arrested the company's financial manager, Giorgi Gvichiani, for failure to pay taxes amounting to \$1.2 million. Following this, AES halted the import of electricity from Armenia, claiming it no longer had sufficient funds.<sup>10</sup>

Fourth, collectors working for AES and their customers formed informal business groups to increase the profits of the employees and reduce the amount customers paid. Various tactics were employed, including tampering with the meters, under-reporting usage, or selling equipment belonging to AES and declaring it stolen (Henisz & Zelnor 2006, p. 13). It was aided, in part, by the Georgian government's continued practice of paying low salaries to employees at the National Dispatch Centre. To compensate, the employees resorted to taking bribes from customers to redirect supply to them, despite non-payment, at a loss to the company.<sup>11</sup> Another compounding issue was the Soviet legacy of low or no utility bills. Previous to AES's arrival in Georgia, collection rates were between 20% and 40%. As the General Manager of AES in Georgia explained:

Our biggest problem here is that we are working in a place that has no culture of paying for utilities. Also people of all backgrounds are experts at stealing electricity including climbing poles and diverting the flow or simply rigging their meters at home . . . We are trying to change all this.<sup>12</sup>

Fifth, AES became embroiled in political conflict between Russia and Georgia. In 2001, Russia cut gas and electricity supplies to Georgia as part of a dispute regarding allegations that Georgia was allowing Chechen guerrillas to operate out of its Pankisi Gorge. Tensions peaked in October of that year when ethnic Chechen fighters residing in Georgia launched an assault on breakaway Abkhazian forces in the Kodori Gorge. Some alleged that the Georgian Ministries of Internal Affairs and State Security had arranged to ferry the Chechen fighters from the Pankisi Gorge in north-eastern

<sup>8</sup>'September 11 Report', Black Sea Press, 1999, available at: <http://www.econews.bspress@caucasus.net>, accessed 20 April 2006.

<sup>9</sup>'US Firm Accused of Defying Georgian Constitutional Court Over Electricity Price', Rustavi-2 TV, *BBC Monitoring*, 2003.

<sup>10</sup>'Finance Ministry Seized AES-Telasi Accounts', *UNA-Georgia Online Magazine*, 4 January 2003, available at: <http://www.civil.ge>, accessed 8 July 2006.

<sup>11</sup>P. Devlin, 'Power Trip', 2003, 85 minutes (United Kingdom, BBC).

<sup>12</sup>'Distributing Energy and Cultural Change', *InternationalReports.net*, 2002, available at: <http://www.internationalreports.net/cis/georgia/2002/1/distributing.html>, accessed 26 February 2008.

Georgia to the Abkhaz–Russian border. In the following six months, Russia violated Georgian airspace twice, bombing three villages and killing civilians. The international community was not immune to this violence—in October a UN Observer Mission in Georgia (UNOMIG) had been struck by a missile over the Kodori Gorge, which killed nine people.<sup>13</sup> Russia's irregular supply of gas and electricity and the unstable situation in northern Georgia resulted in unpredictable levels of electricity transmission, undermining AES's ability to enforce the collection of payments. When the company could find an alternative supplier, it was often at a higher price.

Sixth, the aforementioned AES TransEnergy became embroiled in a network of Russians, Georgians, and Turkish stakeholders from the elite and bureaucracy. Georgia owed Turkey for oil imports. Sakenergo, the Georgian government's electricity regulatory body, headed by Emzar Chachkhiani, and the Georgian–British offshore registered firm, Anglo Oil, headed by Levan Pirveli (also a Member of Parliament), signed an agreement with the head of the state-owned Turkish Electricity Generation and Transmission Corporation. In 1998, Raiffeisen Bank provided a loan for \$46 million to Anglo Oil, guaranteed by the Minister of Fuel and Energy, Teimuraz Giorgadze. This loan was to be spent on equipment for the Gardabani thermal power plant to export electricity to Turkey under the management of Sakenergo.<sup>14</sup> Experts investigating IFI loans to Georgia report that officials at AES TransEnergy together with the Georgian government made an illegal profit by importing electricity from Russia for \$0.23 and reselling it to Turkey for \$0.345 per kilowatt (Kochladze 2000).

However, a Georgian newspaper reported that the scheme was much more complicated. Georgia sold electricity to Turkey at \$0.35 per kilowatt and Turkey paid Anglo Oil \$0.7 per kilowatt, generating the first illegal profit. Then, if Georgia was delayed in providing electricity to Turkey, it was liable to pay a 10% fine, rendered through 'in kind' electricity. In reality, Georgia's system was not technically able to provide the agreed volume of electricity to Turkey from Gardabani. Meanwhile, despite laws to the contrary, Anglo Oil took over temporary management of the Tbilisi–Rize (Turkey) power line that supplies electricity from Russia to Turkey.<sup>15</sup> Several months later, Anglo Oil suspended operations of the Tbilisi–Rize power line, making Sakenergo liable for a fine worth \$4 million to Turkey, as well as being liable to Russia for suspending its use of the power line. In order for the troika of stakeholders to make such illegal profits, Sakenergo banned AES from importing electricity for the first three months of their initial contract in relation to Anglo Oil's operations, hampering the American company's ability to deliver electricity to its Georgian customers. For four years, the Georgian MP, Levan Pirveli, managed this operation and allegedly made \$43 million profit.<sup>16</sup> The head of the Turkish company was eventually convicted for engaging in this scheme.<sup>17</sup>

<sup>13</sup>Human Rights Watch, *World Report Georgia*, 2002, available at: <http://hrw.org/wr2k2/europe9.html>, accessed 5 March 2006.

<sup>14</sup>Raiffeisen Zentralbank to Acquire up to 40% of Georgia's ...', *Central Asia & Caucasus Business Report*, 26 February 2001.

<sup>15</sup>*Dge*, 31 March 1999.

<sup>16</sup>Interview with Givi Targamadze, Parliamentary Chairman of the Defense and Security Committee, Tbilisi, April 2005.

<sup>17</sup>Interview with Levan Ramishvili, Director, Liberty Institute, Tbilisi, April 2005.

The AES story is particularly interesting as there are multiple layers of intersecting politico-economic networks of elite, bureaucracy, business groups and consumers undermining the effectiveness of the company's operations. As one business case study concluded, 'Scholey [Director of AES in Tbilisi] had not rooted out the corruption networks within his firm nor the influence of the "energy mafia" that linked Georgian industrial interests, Georgian politicians, and the Russians' (Henisz & Zelner 2006, p. 2). At the top of the network were the directors of the state-owned companies who formed networks with fellow elites in Russia and Turkey to undermine the supply of gas and electricity to AES for generation and distribution. A second level of networks consisted of members of the bureaucracy—state officials and directors of the largest state plants—who avoided paying for the supplied electricity. Stakeholders included the Ministry of Defence, Shevardnadze's security forces, and Tbilisi airport, among others (Henisz & Zelner 2006, p. 13). The bureaucracy, in particular the electricity regulating agencies, the Justice Ministry and parliamentarians, also worked to ensure that AES could not legally raise prices in order to compensate for the funding shortfalls experienced from non-paying customers and cuts in supply from neighbouring states. Employees of AES and their customers formed business groups to make a financial gain from their transactions. An unidentifiable network was responsible for 15 attacks against the offices and personnel of the company, including a threatening letter to the then-director, Igancio Iribarren. Further, Niko Lominadze, the Chief Financial Officer and highest-ranking Georgian employee at AES Telasi, was found dead in his apartment. He had been tied up and killed by a gunshot to his head in August 2002.<sup>18</sup> Despite assurances from the Georgian Interior Minister, Koba Narchemashvili, none of these cases was ever solved during Shevardnadze's presidency.<sup>19</sup>

After the departure of AES from Georgia in 2003, pressure from parliamentarians and Georgian non-governmental organisations resulted in the resignation of Energy Minister Mirtskhulava. However, President Shevardnadze quickly named him the head of the Georgian National Energy Regulatory Commission (GNERC). In his new position, three Western energy companies operated under his supervision: Georgian United Distribution Energy Company run by American PA Consulting; Energy Wholesale Market run by Spanish Imiard; and the Georgian United State Electricity System run by Irish ESBI. It became Mirtskhulava's responsibility to balance these three companies and prevent UES from monopolising the energy sector.

#### *Politico-economic networks in Saakashvili's Georgia*

After the falsified November 2003 parliamentary election, the subsequent protests across the country and the eventual resignation of President Shevardnadze named the 'Rose Revolution', the January 2004 election brought leading opposition politician Mikheil Saakashvili to power. In his 2005 State of the Nation address, the new

<sup>18</sup>P. Devlin, 'Power Trip', 2003, 85 minutes (United Kingdom, BBC).

<sup>19</sup>In August 2006, the former Tbilgaz General Director, Georgi Gvichiani, was sentenced to life in prison in connection with the murder of Niko Lominadze, formerly of AES. The motive is thought to be an effort to cover-up financial mismanagement within AES, uncovered by Lominadze. Refer to 'Georgian Interior Minister Steps in Over Attacks on Power Company', *Prime-News BBC Monitoring news agency*, 9 September 2002.

president named the power supply as ‘the biggest failure of our government’ and there was hope that 2006 would be the first year since 1992 with uninterrupted supply. However, a combination of attacks to the main gas pipeline and electricity line from Russia, aging technical equipment, and continued manipulation of distribution in Georgia’s regions prevented the government from achieving its goal (Rimple 2006). In his 2006 State of the Nation address, President Saakashvili explained that in the Kakheti province of Georgia, there had been no electricity for several months only because

one swindler appropriated the Kakheti [electricity distribution] system and then sold it to another person who was not interested in this system at all. As a result, Kakheti was in darkness for several months and we were unable to sell the system because of legislative barriers created by ourselves.<sup>20</sup>

Were politico-economic networks still undermining the Georgian electricity sector three years after the ‘Rose Revolution’?

The Russian company’s management of the power sector in the capital had improved the reliability of supply. Since 2004, RAO had brought in Russian engineers to rehabilitate the facilities, continued metering customers, and hired responsible management, most of whom were Georgians.<sup>21</sup> And, when issues arose, such as RAO’s complaint of the lack of reliability of the wholesale energy market to supply electricity or the necessity to raise rates, high level talks between Russian and Georgian officials resolved the matters (Ulushadze 2005). As a result, Telasi’s profits increased from \$4.1 million in 2005 to \$27.8 in 2006 on a turnover of \$105.6 million, resulting from higher rates for electricity and higher collection rates. To address the rest of the country’s problems with electricity supply, President Saakashvili, assisted by a grant from USAID, hired a management company, PA Consulting, to reform the United Distribution Company (UDC), which oversaw the management of most electricity distribution outside the capital, making up 70% of the Georgian population. Throughout Georgia, efforts were undertaken to place meters at power purchasing points, restructure management, launch investigations into fraud, place strict penalties on those who did not comply, and move to a direct payment system at the banks. As a result, consumer bill collection rates nationwide rose from 20% to 44% in the last half of 2004, from 44% to 70% during 2005, and from 70% to 85% by December 2006.<sup>22</sup>

The electricity sector reform was part of a government strategy overseen by a prime ministerial coordination committee with the goal of attracting foreign investment and diversifying suppliers (Government of Georgia 2006). The unofficial line was that Georgia needed to be less reliant on Russia, as its supply remained vulnerable to sabotage and could fall prey to both geo-politics and ethno-politics. In January 2006, two blasts hit the Mozdok–Tbilisi gas pipeline and the reserve pipeline on the Russian

<sup>20</sup>‘President’s Annual Address to the Parliament’, February 2006, available at: [http://www.president.gov.ge/print\\_txt.php?id=1451&l=E](http://www.president.gov.ge/print_txt.php?id=1451&l=E), accessed 24 February 2008.

<sup>21</sup>Interview off-the-record with independent Georgian energy analyst, Tbilisi, July 2007.

<sup>22</sup>United States Agency for International Development, Georgia, ‘Energy and the Environment: Successes’, available at: [http://georgia.usaid.gov/index.php?m=17#3\\*](http://georgia.usaid.gov/index.php?m=17#3*), accessed 12 December 2008.

territory of North Ossetia. This, coupled with Russian demands for a doubling of the price of gas to Georgia, left Georgia without gas for several of the coldest months of the year. Meanwhile, Georgia's import of electricity from Russia on the Kavkasioni line through the Kodori Gorge in Abkhazia remained prone to sabotage and general poor maintenance, leading to frequent problems with supply (Chkhartishvili *et al.* 2004, p. 129). By late 2006, Georgian–Russian relations were the worst they had been since the early 1990s. The Russian government imposed an embargo on Georgian wine, spirits and water. This was followed by the arrest of four alleged Russian GRU spies in Tbilisi in September 2006. Russia responded by withdrawing its ambassador from Tbilisi, imposing a total economic blockade of Georgia, and implementing a systematic programme of checking all Georgians residing in Russia and immediately deporting those with inadequate documentation.

To spur economic development, a Russian tycoon of Georgian origin, Kakha Bendukhidze, was appointed by the government to head the Ministry of Economy in 2004, and he later joined Prime Minister Zurab Noghaideli's coordination council. The first task was to show that they were serious about reforming the sector. As part of an anti-corruption campaign, former energy officials were fined or jailed. Then President Shevardnadze's son-in-law, Gia Jokhtaberidze, was arrested in February 2004 for tax evasion, but released in April after paying \$15.5 million; his nephew Nugzar Shevardnadze purportedly sold his assets in Georgia; and his former Minister of Fuel and Energy, Mirtskhulava, was sentenced to 12 years in prison. Next, the government implemented a strategy to draw the energy sector out of the grey market through regulatory and financial mechanisms, including the reform of licensing procedures and the tax code, and lowering the rate of value added tax in preparation for the privatisation of state assets. Georgia was ranked first in the world in making itself more 'business friendly' in 2006, leaping from number 122 to 37 in the World Bank's rankings of the ease of doing business (World Bank 2007). GDP growth increased to 11.1% in 2003, 5.9% in 2004, 9.3% in 2005, and 7.8% in 2006, averaging 7% a year for that period. The budget jumped from the level of less than \$500 million per year that it had occupied for much of the Shevardnadze era, to \$2.2 billion by 2006 (TACIS 2006).

The government next began to privatise energy assets to a mix of investors. The Kazakh state company KazTransGaz won the tender for Tbilgaz, Azoti chemical plant was transferred to a new Energy Invest Group (a joint Russian–Georgian venture with Gazprom), and Russia's Evraz Holding and an Austrian–Georgian company DCM-Ferro took ownership of the majority shares in Zestaponi metals, Chiatura manganese mines, and the Vartsikhe hydropower plant (Corso 2006a). A Georgian government study of 2006, 'The Balance of the Energy Sector', recommended strengthening hydropower capability (potentially 80% of the country's generation) and electricity import options. The government chose not to privatise the biggest electricity generator, Inguri hydropower plant, but was working with private investors from China, Europe, Turkey and Kuwait to construct over 30 new smaller hydropower stations. Upgrades to electricity lines with Armenia, Azerbaijan, Russia and Turkey were underway to increase import capability. Moreover, the rehabilitation of units three, four, and eight of Gardabani were being planned.

However, the process was not without criticism from members of the Georgian opposition and press corps. The most controversial of the sales in the electricity sector

was the \$312 million offer in September 2006 by a Czech company Energo-Pro for UDC, the Adjara region's distribution company, and six hydropower stations.<sup>23</sup> The deal reminded Georgians of the abrupt sale of AES to RAO-UES. Eight companies originally participated in the tender process and after it officially ended in June 2006, the terms of the sale changed significantly before a contract was signed in February 2007. President Saakashvili admitted that the Czech company, Energo-Pro, originally offered \$50 million to circumvent the tender process along with unspecified future investments. The Georgian government apparently rejected that offer and then the same company came back and offered \$312 million in the tender. Minister of Fuel and Energy, Nick Gilauri, explained that he had been given assurances that Energo-Pro was a reputable company, but that he had heard rumours that one possible investor was RAO (Roberts 2006). When Energo-Pro finally signed the contract nine months later, the company only paid \$132 million for all assets, as well as gaining access to export markets in Turkey and Russia. The government explained that Energo-Pro had promised to invest an additional \$185 million in infrastructure upgrades (Corso 2006b).

The perception of collusion among elites was deemed by one long-time energy consultant to Georgia to be the result of a rushed privatisation process in which transaction advisors were not sought and a combined approach of negotiation, conference and consensus was used by the Georgian government, rather than a strict 'blind' tender process. The Georgian government, in fact, was hoping that PA Consulting would bid on the package and Energo-Pro would bid high in the first round in order to beat them. Then, when the process of due diligence did take place, Energo-Pro found the assets to be in far worse shape than they originally thought, so they lowered the offer. And, as far as the newly appointed head of Energo-Pro in Georgia was aware, it was strictly a Czech company with experience in running power stations at home and in Bulgaria, backed by the Czech government.<sup>24</sup>

Another controversial issue was the government's handling of the construction of a gas turbine power plant. In March 2005 the prime minister expressed interest in the project, and within a little over a month the government had put together a financing scheme and announced two potential constructors. Normal project development takes 12 to 18 months, including a feasibility study, drafting the initial project design, identifying the technical parameters and possible sources of funding, selecting a consultant, inviting tender for design, and award. Land allocation for such a project then involves environmental permits and licenses and equipment procurement.<sup>25</sup> Additionally, there were questions regarding the necessity of such a project given priorities for hydropower and upgrades to power lines, which would cost less and provide more affordable electricity. There were exchanges of opinions on these topics between the Georgian Minister of Energy, Archil Mamatlashvili, and an independent energy analyst, Murman Marbvelashvili, in the Georgian newspaper '24 Hours' (Margvelashvili 2005). In response to the experts' expressed concerns, the Ministry told the newspaper that the selection of the gas turbine was not their responsibility,

<sup>23</sup>'Georgia Weekly Stock Commentary', *Galt and Taggart Securities*, 26 June 2006.

<sup>24</sup>Interview with Dean White, General Manager, UDC, Tbilisi, July 2007.

<sup>25</sup>M. Margvelashvili & T. Mikiashvili, 'How to Build a Gas Turbine?', *World Experience for Georgia*, available at: <http://www.weg.ge/publications.htm>, accessed 20 July 2007.

but that they believed the American produced Pratt & Whitney gas turbines were selected over others based on price and a shorter installation period. There were suggestions that Bendukhidze had promoted this project because he had financial interests in a company affiliated to Pratt & Whitney.<sup>26</sup> The Georgian–Russian company Energy Invest Group built the plant with a loan from United Georgia Bank, a daughter company of the government of Russia’s Vneshtorbank. When the plant was opened in January 2006, President Saakashvili held a live press conference on Georgian television and proclaimed:

You know a few days ago we opened a gas turbine plant ... I started building such a plant a year ago. It was built in record time. Such a plant has never been built in such a short time anywhere else. This was done because we needed it for the resilience of the system.<sup>27</sup>

It is too early to fully analyse the effects of the Saakashvili administration’s reforms and privatisation drive on the Shevardnadze-era networks. However, it does appear from a much improved supply of electricity to the majority of paying Georgian customers in 2007 that the destructive forces of much of the networks had been curtailed. For the largest and most marginalised group, the consumers, the networks were temporarily disrupted, but not blocked entirely. Several measures taken by the Saakashvili government probably diminished the activities of business groups as a result of the government’s efforts to legitimise business practice through new incentives such as lower taxes, decreased rates, and improved licensing procedures. Additionally, reforms in the law enforcement agencies, tax administration, prosecutor’s office, and financial regulations resulted in a more transparent system. However, in some of Georgia’s regions, particularly in western Georgia, the staffing policy was chaotic and this allowed for the continuation of activities within networks. The so-called ‘commercial lines’ established for businesses were still diverted for private sale with the participation of officials (Rimple 2006).

As for the elite, the ambiguous and erratic nature of the privatisation process raises concern as to whether these deals were made for Georgia’s long-term energy security or for short-term political or personal gain. There are also concerns about Russia’s ownership of some of Georgia’s strategic assets, given Russia’s objection to Georgia’s efforts to join NATO. A small circle of the elite working for the prime minister appears to have been charged with strengthening the electricity sector as quickly as possible, and this may not have always allowed for a fully vetted and transparent process. In the long-run, this could compromise the efficiency of Georgia’s system, particularly as unemployment and inflation rises, and customers are unable to pay rising electricity rates. Additionally, as consumers and district level bureaucrats lose faith in the promises of the Saakashvili government to fully enact reforms, they may return to relying on the alternative system of networks. Their frustration with the economic and political situation has already been seen in

<sup>26</sup>Interview off-the-record with energy analyst, Tbilisi, July 2008.

<sup>27</sup>Rustavi-2, ‘President Says Georgia Emerging Stronger from Energy Crisis’, *BBC Monitoring Service*, Tbilisi, 30 January 2006.



street demonstrations in early November 2007 that were quelled with force, resulting in the government imposing a 15-day state of emergency, and calling early presidential elections.<sup>28</sup>

*Politico-economic networks and persistent state weakness*

Within less than a decade, Georgia went from independently managing its electricity infrastructure in 1991, to being heavily in debt to numerous neighbouring states for gas and electricity by 1995, and ceding control of much of its electricity supply and distribution system to state controlled Russian companies by 2003. Georgia's relationships with neighbouring states were based on the knowledge that a significant percentage of the energy sector was relegated to the grey market, and that many of the business relationships were non-transparent and semi-permanent. In Georgia, the politico-economic networks started out as diffused as a result of the war and the elite was only able to partially gain control of business in the energy sector. There was a self-perpetuating symbiosis among the various stakeholders in networks. In the early 2000s, the interests of individual stakeholders, whether it be for personal or group gain, were overtaken by the alternate force of networks. That is, new members received the same benefits as others who were already participating in the networks. Government positions were sought in order to participate in the networks and not to serve the state. In Georgia after the 'Rose Revolution', however, a major shift took place in the management and financial structures of the electricity system as a result of the central government regaining power and authority. As a result, many of the district based networks were debilitated and only a very few elite networks survived, mostly overseeing the privatisation of assets to foreign investors. AES invested in Georgia at a time when there was little control by the centre over the periphery, when operations within networks were the primary legitimate medium for transactions, and when everyone from the elite to the consumers were participating in an alternate system. Conversely, RAO came at a time when a new president was re-establishing control over the state and taking measures to diminish the need for networks.

It would appear important, therefore, to determine the point at which networks go from being a hindrance to becoming a benefit to the state. Politico-economic networks also operate in strong states. For the most part, they conduct business within legal parameters as defined by the state and international law. Thus, stakeholders operating in networks do not *per se* cause state weakness; it is non-transparent networks operating in the grey market that do this. This is compounded by the lack of will on the part of the authorities to regulate the system and from this comes a cascade of actions taken by various stakeholders within and beyond the state, which combine to undermine the strengthening of the state. Eventually, there is little to distinguish between the official and unofficial sectors; the former is the basis of the strength of the latter. In stronger states,

<sup>28</sup>S. Closson (2008), 'Georgia: Facing "Beacon of Democracy"', *International Relations and Security Network*, available at: <http://www.isn.ethz.ch/news/sw/details.cfm?ID=18353>, accessed 26 February 2008.

networks are often praised for their development-enhancing capacities in terms of moving goods, people, and capital.

Invariably, it is the type of state that determines the type of networks that operate within it. In a stronger state, an effective economy and the formalisation of the role of state institutions governed by an independent and transparent rule of law create a barrier through which very few disruptive networks are allowed to penetrate. The rules of engagement for networks that wish to operate within stronger states are often strictly regulated and, if manipulated, are subject to penalties. The networks that violate the law in stronger states are aberrations, whereas in the weak state they are the norm. In addition, the incentives for participating in networks in a weak state are more urgent and personal. For consumers, the incentive is survival; networks compensate for the inability of the state to perform certain services and provide goods. For the members of the bureaucracy, the first incentive is to hold onto their positions, and the second incentive is to convert their positions as clients of the elite into financial rewards for themselves and their groups. For the elite, the incentive is to make millions of dollars in personal wealth, and to convert this personal wealth into power over the state. In stronger states, the stakeholder's incentives for participating in networks can also relate to revenue generation, both for the government and private entities. However, it is done, for the most part, with the aim of strengthening organisations for the purposes of generating even more public and private revenue in the future.

In conclusion, a weak state is an internationally recognised state in which networks have replaced legitimate channels of communication. Flows of information, finances, directives, and implementation of directives do not occur in a recognisable, transparent and logical manner. These networks infiltrate every aspect of the state to such a significant degree that decisions are taken based on the directives of the actors within the networks. Their decisions often subvert the transparent laws and procedures of enforcement, purposefully keeping the state weak. Authority rests on the accumulation of assets through the state apparatus, which validates the basis for the patron's power over clients within networks. This authority, however, is undermined by a lack of legitimacy among the population, which results in overlapping networks of marginalised members of society with non-state entities. International recognition of a state and relations of the regime with international actors, including other states and organisations, is crucial to the regime's survival. However, the actors within the state have a contrived notion of the territorial and institutional state. Territory is simply something in which to move about and beyond in the pursuit of resources. Statehood can assist (through international legitimisation) but does not prevent the network's activities. Moreover, while the government is too weak to govern effectively, individual members of the government are strong enough to grab scarce resources, to push economic activity into the shadows, and to suppress political and economic opposition questioning the legitimacy of the regime. Thus, weakness is not necessarily about the failure to develop state institutions, but it is rather a deliberately designed condition on behalf of all members of society to operate within an alternate system.

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