Russian Investments in Georgia's Electricity Sector: Causes and Consequences

By Courtney Doggart*

The aftermath of the August 2008 war between Georgia and Russia created new political and economic realities for both Georgia and Russia. One important ramification, often overlooked, is the December 28, 2008 signing of a Memorandum of Understanding (MOU) between the Russian parastatal company Inter RAO and the Georgian government over the management of the 1300 MW Enguri Hydropower Plant. This MOU effectively gave Inter RAO management over 1300 MW of Georgia's 4700 MW of generation, continuing a trend of a strong Russian presence in all aspects of Georgia's electricity sector, from generation to transmission and distribution.

This article will examine these Russian investments in light of Georgia's energy and economic vulnerabilities and explore potential causes and consequences of this situation. The purpose of the article is to raise questions about the reasons for high Russian investments on both the Russian and Georgian sides, the vulnerability of Georgia's energy system, and the strength of Georgia's institutional framework. The article will propose some thoughts on causes and implications, but in a short space, this larger topic cannot be effectively explored. Rather, the author hopes that this piece will serve as a catalyst for further investigation.

Economic Background

Though the Russian-Georgian political relationship has long been fraught with tension, their economic relationship has featured high flows of trade and foreign direct investment (FDI). Yet, the economic relationship has been largely asymmetric, with only 10% of Georgia's exports going to the Commonwealth of Independent States (CIS) and roughly 50% of Georgia's imports coming directly from Russia.[1] Furthermore, Russia's FDI inflows to Georgia have been primarily in the strategic sectors of energy, telecommunications, and banking. International economic relations impact domestic politics, shaping national interests, with this impact being more acute in countries with asymmetric economic relationships.[2] Asymmetric economic influence can manifest itself in overt coercion or influence and the effects are far more likely to be realized as influence, which is often more valuable politically, particularly during periods of political transition.[3] In short, an asymmetric economic relationship between Russia and Georgia can have political ramifications—and the relationship is particularly lopsided within the electricity sector.

Georgia's Electricity Sector

Russian companies have a presence in each major component of Georgia's electricity sector, from generation to transmission to distribution.

Generation

Georgia has installed capacity of roughly 4700 MW, of which 1300 MW are supplied by the Enguri Hydropower Plant, which is under management by the Russian parastatal company Inter RAO.[4] In addition to being under Inter RAO management but Georgian state ownership, Enguri has a further complicated structure with its dam and reservoir under control of the central Georgian authorities but its turbines and generation equipment located on Abkhazian controlled territory.[6] In addition to managing Enguri's 1300 MW, Inter RAO owns at least an additional 600 MW of thermal generation (Mtkvari power plant) and manages an additional two hydropower plants with a total of 222 MW (Khrami I and II). Taken together, almost half of all Georgia's installed capacity is owned or managed by Inter RAO, with a key portion of that located within a politically disputed territory. Furthermore, Mtkvari's contribution of roughly 11% of the country's electric consumption is gas fired, which is critical to generation supply diversification in the winter months when hydropower has weak production and Georgia's capacity is constrained.

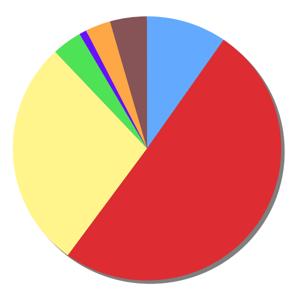

Figure 1: Ownership and Management of Georgian Electric Generation by Company and Country of Ownership

With the management of Enguri's 1300 MW, Inter RAO manages or owns almost half of all Georgia's electric generation. In addition, in 2008 roughly 400 MW of Georgia's 500 MW of imports came from Russia.[5]

Transmission

Two companies currently control electricity transmission in Georgia. The state-owned Georgian State Electrosystem (GSE) operates the 300, 220, and 110 networks and some of the 35 kV lines, which are used for more local distribution. JSC Sakrusenergo, owns the critical 500 kV line running across the country

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See footnotes at end of text.

which is used for exports. Sakrusenergo is 50% owned by Inter RAO and 50% by the Georgian State. Planned transmission lines include a 500 kV line designed for export purposes to Turkey. According to a Memorandum of Understanding signed between the two countries in 2007, this 500 kV line, as well as a 400 kV line and a substation are set to be complete by 2012.

Distribution

Georgian electricity distribution consists of five main companies of which three are owned by Energo-Pro (Czech) for a total of 46.5% of Georgia's distribution. Inter RAO (Russia) owns 75% of Telasi, which accounts for 33.6% of distribution. The final company is the state-owned Abkhazia Energy Company, which makes up the remaining 19.9% of distribution. However, the latter is currently outside of state control.[7]

Furthermore, though the Electricity System Commercial Operator (ESCO) is currently owned by the Georgian state, the government plans to privatize it in the coming years by distributing the shares among the electricity sector licensees, with 30% going to distribution companies, 35% to generation companies and the remaining 35% becoming the property of the dispatch licensee. Under the current ownership structure, Inter RAO will have a large stake.

Inter RAO

Of the Georgian electricity assets owned by Russian companies, Inter RAO, the international division of Russian company behemoth RAO UES, is the biggest investor in Georgia. As of December 2009, Inter RAO was 57.3% owned by Rosatom State Nuclear Energy Corporation and OJSC Energoatom Concern, both state-owned and operated. In addition to heavy Russian state representation in ownership, the state is well represented on Inter RAO's board of directors. The Chairman of the Board of Directors is Igor Sechin, First Deputy Prime Minister and staff member of Russian President Putin for almost two decades, who was singled out in a 2007 *Economist* article about the strong ties between the FSB (successor to the KGB) and the Russian government.[8] In 2009, of the remaining ten board members, two work directly for the government (Minister of Energy and State Property Management), two work for Rosatom, (Inter RAO majority shareholder and state nuclear energy corporation), four work for other state owned enterprises or subsidiaries with an international presence (VTB and its subsidiary Russische Kommerzial Bank AG, Gazprom, Rosneft-Energo, and Transneft-produkt). The final board member represents Inter RAO. Inter RAO cannot be seen as anything other than a state controlled company with the ability to pursue state interests, be they economic, political, or both.

Figure 2: The dam of Enguri Hydropower Plant

Reasons for Russian Investment

Investment patterns such as the ones seen in Georgia occur as a result of both external reasons (such as motivations of investors) as well as internal ones, namely the legal, institutional, and regulatory framework governing investments. An examination of Georgia's investment framework reveals that the country's investment-friendly laws coupled with a strengthened presidency and reduced independence of the electricity regulator have resulted in a lack of transparency in the electricity sector. The resulting framework likely corresponds to Russian investment interests while failing to attract large-scale interests from other investors, either because of lack of opportunity or fear of unhealthy risk.

In 2006, Georgia astounded readers of the World Bank's Doing Business Report by jumping 75 places—from 112th to 37th—in the span of one year. This was the biggest jump made by any country since the World Bank started the rankings four years previously, and is indicative of Georgia's pace and determination to create markets favorable to investment.[9] As of March 2010, Georgia is 11th on the list. Changes in licensing, enforcing contracts, and employing workers all helped Georgia to jump to nearly the top of the rankings. Yet, other factors, such as the country's Foreign Direct Investment (FDI) and anti-monopoly laws have also helped create particular factors that tend to encourage foreign investment.

Foreign Direct Investment in Georgia

The abandoning of restrictions on FDI has been cited as reason for the tremendous global growth of the past decades, as countries worldwide abandoned restrictions on foreign investment and reaped the benefits of capital inflow,[10] with Georgia no exception. Georgia's 1996 Law on Investment Activity Promotion and Guarantees provides the basis for foreign investment in the country. With its short foreign company registration turnaround time and limited list of sectors requiring explicit government permission, Georgia's active promotion of FDI inflows has it jumping from 15th to 9th between 2006 and 2007 in an inward FDI performance index measuring the three-year moving average of 141 countries' inward

FDI performance.[11] Georgia is clearly actively promoting inward FDI, and one of the largest contributors to that is Russia. In 2007, stocks of Russian FDI in Georgia amounted to 25% of Georgia's GDP.[12]

What is unusual about the newest phase of Georgia's privatization is that Georgia is privatizing assets that a majority of countries define as strategic and typically retain under state control. These include at least 2/3 of the shares of the Georgian State Electricity Company (GSE), 24% of the Port of Poti, the Georgian Post, and several regional airports.[13] Given that restrictions are typically imposed on strategic sectors and specific countries for security reasons and that countries at war often take control of strategic sectors owned by an enemy for national security reasons, it is notable that Russian companies will likely be main investors, particularly in the electricity sector.[14] Though Russia was roundly criticized by the G7 and NATO for using excessive force during the August 2008 war over Georgia's breakaway enclave of South Ossetia and had, as of mid-December 2008, continued to violate the European Union-brokered cease-fire following the 2008 conflict,[15] Georgia will still likely end up selling some strategic assets or management rights to Russia. This does not mean that there is a direct threat of supply cut-off—there was no interruption to electricity supplies within Georgia aside from expected damage during the 2008 war, for example. Yet, it does mean that Russia will wield influence in Georgia .

Anti-Monopoly Laws

In addition to its unusually open FDI laws, Georgia also has weak anti-monopoly laws. Characteristics of strong competition law include provisions for a well-funded and staffed independent regulatory commission with enforcement capabilities, non-discrimination in law and enforcement, realistic thresholds of merger notification, transparency, a clearly defined review period, an appeals process, and the establishment of channels of communication for enforcement and evidence gathering. Challenges to the implementation of a strong competition law are lobbying by interest groups, weak regulatory systems, and abuse of competition laws in a protectionist manner.

Georgia's experience with competition law has gone through several stages, the most recent being the adoption of the "Law on Free Trade and Competition" in 2005. This law superceded the previous anti-monopoly legislation, which was more in line with U.S. and EU competition laws. The current competition law has come under fire from critics for lacking sufficient clarity and creating a "hazardous legal vacuum."[16] Unlike previous legislation, the new legislation does not address the traditional fields of competition law, such as agreements restricting competition, concerted practices, abusing dominant position in the market, takeovers and mergers, state enterprises and so-called natural monopolies.[17]

In addition, the new Agency for Free Trade and Competition lacks the independent status of the earlier competition regulatory body, The State Antimonopoly Service. Instead, the Agency for Free Trade and Competition is located within the Ministry of Economic Development and has limited investigative powers.[18] President Saakashvili threatened to close the Agency in October of 2007, following rapid price increases, particularly in the foodstuffs sector. The Agency still appears to exist, but as a sub-division of the Ministry of Economic Development, lacking its own website.

Both the FDI and competition laws indicate that Georgia's priority is investment and the shape of that investment is not of paramount importance. Furthermore, the openness to foreign investment and lack of regulatory oversight for monopoly behavior leaves Georgia susceptible to abuse of market power. This scenario of open investment environment with little oversight is one that has been known to deter strategic investors and encourage others. This is a theme that continues in the structure and regulation of the electricity market.

Consequences

It should be acknowledged upfront that Russian investment in Georgia's electricity sector is not inherently bad for Georgia. In fact, it can be argued that without it, the electricity sector in Georgia would not be functioning nearly as well as it is currently, though a comprehensive study on this and the impact of EU/U.S. support would clarify these assertions. However, there is reason to believe that the results of the Georgian-Russian investment relationship have contributed to reinforcing a cycle of corruption, weakened regulatory oversight and loss of strategic investors.

Increased corruption is a danger of foreign investment inflows, and its likelihood is dependent on both the host country's political and economic environment, as well as the transparency of the investor.[19] An ideal political environment includes strong institutions that provide necessary checks on government officials wishing to make illegal profit. Competitive political environments, for example, provide a greater check on public officials, more easily calling them to task for misbehavior and more easily providing alternative candidates. A free press, active civil society, and trustworthy judiciary all contribute to these checks. Georgia's current political climate leaves it ripe for increased corruption, particularly given the lack of transparency in Inter RAO, the leading investor in Georgia's electricity sector.

For example, the June 2008 "Governance Matters" report put out by the World Bank shows that between 2006-2007 Control of Corruption and Voice & Accountability both declined in Georgia, with the latter returning to 2004 levels.[20] In the World Economic Forum's 2008 Global Competitiveness Report, Georgia shows a competitive disadvantage in its judicial independence, favoritism in decisions of government officials, transparency of government policy making, organized crime, ethical behavior of firms, and strength of auditing and reporting. Similarly, Russia's own democracy indicators have continued to worsen in all areas from corruption to independent media. Furthermore, Russia is unwilling to ratify international treaties that would increase transparency in the energy industry, such as the Energy Charter Treaty. Both Georgia and Russia's weak democratic environments taken together indicate that FDI inflows from Russia are likely to continue the cycle of weakening institutions, rather than strengthening them as would happen with strategic investors.

The Georgian National Electricity and Water Regulatory Commission

Indicative of this trend is the case of the Georgian National Electricity and Water Regulatory Commission (GNEWRC). One key component of a functioning competitive electricity market is an independent regulator who oversees the sector, typically distributing licenses and setting tariffs. Though GNEWRC is well-designed, several changes in the past several years have threatened the independence of the regulator or worked to undermine its effectiveness.

In the past several years GNEWRC has been moved from Georgia's capital of Tbilisi to Kutaisi, a city roughly a three hour drive away, has been understaffed from the commissioner level and under-trained at all levels, and has seen key duties moved from its jurisdiction to the Ministry of Energy. Since 2004, GNEWRC has lacked political support and has been undermined, possibly the result of parts of the Georgian government believing that independent regulators are not necessary.[21] The reasons for GNEWRC's destabilization are several, including a strengthening of the Presidency at the expense of checks on central government power. In all likelihood, Russian FDI in the electricity sector does not play a direct role. However, the weakening of GNEWRC is symptomatic of larger policy problems—problems that are fed by investment from non-strategic sources.

As a result, Georgia is able to neither attract strategic investors nor position itself for entrance into Europe's Energy Charter Treaty (ECT), which would require Georgia to maintain a strong, independent regulator. Strategic investors are typically defined as those that have cash and access to debt financing—a characteristic that is most common in investors from the U.S. and Europe.[22] In addition, strategic investors can also be considered those that enhance a country's transparent operating through the adherence to international best business practice standards. Georgia's inability to attract these strategic investors to its electricity sector is most likely due to the returns from investment not being able to outweigh the risk. The result is a reinforcing feedback loop where lack of transparency in the deal-making process attracts Russian investors, which in turn decreases transparency, which in turn increases the risk. Encouraging a competitive environment in the electricity sector requires most market participants to have confidence that their offers will be given a fair and objective review, to be assured that there will not be breaches in confidential information, and that open access to adequate information that would affect the resources they choose to offer would be given.[23]

Georgia has made tremendous gains in encouraging investment, working to streamline and open the process. However, given the deals made behind closed doors and the complaints surrounding several privatizations, it seems unlikely that the Georgian government is able to provide confidence in a fair and objective review process. For investors that require such an open review process, Georgia's lack of ability to provide this is a huge deterrent.

As mentioned before, other investors may see this lack of transparency as an asset. By not providing a transparent investment process in practice, Georgia is weeding out strategic investors from the others, and it is the others that will invest in the sector. As a result, these non-strategic investors could contribute to the further marginalization of regulatory measures as well as to corruption within the country, creating at best the loss of best business practices that could be gained from strategic investors and at worst a cycle of corruption.

Conclusion

Georgia's current energy security is dependent on Russia, from gas imports to fuel the thermal power plants, to the high percentage of ownership and management rights of electricity sector assets. In order to create a situation that allows for necessary investment but takes preventative protection measures Georgia should:

- Strengthen independent regulatory bodies such as GNEWRC and make others, such as the Agency for Free Trade and Competition an independent body.
- Reduce dependence on Russian gas during the critical winter thermal generation period. Bilateral contracts with Azerbaijan and the creation of gas storage can reduce the potential for dangerous price fluctuations.
- Reevaluate FDI laws to protect strategic assets. Removing the tender for the GSE privatization is a helpful first step. However, a formal legislative approach will be more effective than a case-by-case evaluation.

In sum, the Georgian-Russian relationship is one in which politics and economics intersect in a potentially destabilizing fashion, aided by Georgia's domestic policies that create a feedback loop reinforcing this lopsided relationship. However, with an institutional framework that provides the proper safeguards against corruption through independence and transparency, as well as preventative measures that provide a buffer against gas prices, Georgia will be able strengthen its position vis a vis Russia's role in its electricity sector for the future, while allowing the investment necessary for a developing country recovering from war.

Footnotes

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[3] Ibid.

[4] Inter RAO UES OJSC (Inter RAO) was formed in the spring of 2008 as a successor to Inter RAO UES CJSC as part of the reforms of its founder, RAO UES. All of Inter RAO's assets are international. The paper has tried to be consistent in its references to Inter RAO. However it may occasionally refer to UES ownership, keeping in context with the earlier ownership.

[5] European Union, INOGATE. Georgia Country Overview. http://www.inogate.org. Accessed March 27, 2010.

[6] Abhazia is a breakaway region from Georgia that is not under central state control and which Russia recognizes as an independent country. The region is still a conflict zone.

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