AES-Telasi: Power Trip or Power Play? (A)

It would take too long to explain why there was very little electricity and no heat in Tbilisi in the winter months.…The reasons were so intertwined with Georgian networks of "patronage,", black hole, patchwork, and jerry-rig that it was impossible to separate sabotage (a strange and sudden fire at Gardabani, the country's only thermal power station) from corruption (the bungling and greedy idiots as SakEnergo, the state energy concern) from non-payment (less than 30 percent of the population in Tbilisi paid their electricity bills; Georgia owed Russia millions in electricity back debts) from theft (part of the copper transmission line between Armenia and Georgia was nicked one winter), from black clan economics (someone had the kerosene trade sewn up; it was in someone's interest to make sure there was no cheap clean alternative) from incompetence (the next winter the pride of Gardabani's brand new gleaming Unit 10, repaired with sackfuls of German money, broke down because the engineer on duty didn't know what to do when a red light on the computerized panel started to blink unexpectedly) from infrastructure deterioration (once the whole of eastern Georgia went black as the 500 kW line from the Enguri hydro plant collapsed under the weight of what one commentator described as "pre-election" abuse) from the oft-repeated worn excuse: "The Soviet Union collapsed; there was a civil war."

—Wendell Steavenson (2002), *Stories I Stole* (Grove Press, New York NY)

I INTRODUCTION

As Michael Scholey shifted his weight across the canvas bags of carrots that filled the back seat of a battered car that was half way between the Armenian-Georgian border and his destination, Tbilisi (see Exhibit 1), he wondered whether his efforts to bring power to the city of Tbilisi for the millennium celebration would pay off. His uncomfortable journey from Yerevan, which was already three hours over its forecasted five-hour length and still incomplete, had turned into a symbol of the ordeals of his first year of efforts to bring electricity to the consumers of Tbilisi.

Professors Witold J. Henisz and Bennet A. Zelner prepared this case with the research assistance of Aziza Zakhidova and Anna Kalenchits as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

On the one hand, he had successfully negotiated an agreement for 120 MW of power supply from the Armenian authorities that would provide a few hours of light to his customers in Tbilisi on New Year's Eve, 1999. On the other hand, he was far from turning the financial corner or from beating back the entrenched corruption networks stretching from Tbilisi to Moscow that presented new challenges to him almost every day.

Having missed the daily flights of both Georgian and Armenian airlines (a mixed blessing, he realized, given his past experience using both airlines), Scholey managed to hire a driver and private car to take him home. However, after a dinner in the driver's home, which turned out to be a non-negotiable part of the deal, the pair had arrived so late at the border that the driver said he feared that the Georgian police would rob him, and refused to continue the journey until morning. Recognizing this implicitly demanded bribe, Scholey exited the car in sub-zero temperatures to negotiate a ride with the next available driver (which turned out to be the carrot car). After the driver insisted on stopping in his border village for yet another non-negotiable dinner—this time close to midnight—they finally began the descent from the border back to Tbilisi. Initially, all seemed well as Scholey dozed off to sleep, but he woke with a start as the car broke down at 3:00 am. There Scholey sat, on top of several large bags of Armenian carrots in pitch darkness.

Scholey had joined AES in 1992. His prior experience included working as a geologist at British Petroleum, and as a chartered accountant on the UK electricity privatization. He started at AES in finance and accounting but was drawn to AES's projects in developing countries including Pakistan, Ukraine and Kazakhstan. He rose to Vice President of AES Silk Road in Moscow, where he led the bid for AES-Telasi in 1997-98. From the start, Scholey had felt a personal connection to the project and to the country, as well as a sense of mission in making the project a success for the Georgian people. He knew that it was not going to be easy to turn around a post-Soviet electricity distribution company serving 370,000 customers in a country with an average per capita income of $600 a year. To compound the difficulties he faced, the Republic of Georgia lacked sufficient electricity and fuel supplies, and thus needed to import up to 30 percent of its electricity and gas from its less-than-reliable neighbors, particularly during the winter season. From the first day of his management tenure at AES-Telasi in January 1999, Scholey had been improvising in order to get things done while learning the rules of the Georgian business environment on the fly. Although he realized that it would not be easy to succeed, Scholey was confident that no company other than AES was as well positioned to help meet the dire need for electricity in this culturally rich but economically impoverished post-communist state.

Scholey was proud of what he and AES Corporation had accomplished so far: he had overcome another Russian effort to keep Tbilisi in frigid darkness; his employees were responding to his leadership and beginning to take care of their company, instead of just stealing from it; he had acquired generating facilities that would reduce AES's dependence on imported Russian electricity; and consumers, bureaucrats and politicians were increasingly sympathetic to Scholey's efforts to bring light and heat—and ultimately stability—to the country.

Yet, despite these improvements, AES-Telasi had still incurred an operating losses of $40m during its first year of operation and exceeded its ten-year investment target, and the company faced several challenges going into its second year. Scholey had not yet rooted out the corruption

networks within his firm, nor had he eliminated the influence of the "energy mafia" linking Georgian industrial interests, Georgian politicians and the Russians. He also had to find a way to improve the financial position of the firm without raising tariffs to the point that consumers would be unable or unwilling to pay. He knew that he would have to make some important changes. He would need new allies with deep pockets and local influence to help him in his efforts. Who else could he trust? Who shared his mission to provide electricity to all households that were willing to pay for it, and consequently helping to stabilize the political and economic situation in this war-torn country?

II AES CORPORATION

At the time of its acquisition of AES-Telasi in December, 1998, AES Corporation was the largest independent power company in the world. The company owned 24,076 MW of generating capacity in 14 countries and directly distributed electricity to 13.2m customers in five countries. 10,000 employees managed $12.9b assets and $5b of new projects under development. The company was in the midst of a major international expansion that would, over the next three years, see its international reach grow to 55,022MW of generating capacity in 31 countries and direct distribution to 18.4m customers in 11 countries, with a workforce of 38,000 employees [see Exhibit 2]. Throughout this expansion, President and CEO Dennis Bakke and Chairman Roger Sant strove to maintain the four organizing principles upon which they had founded the company: fairness, integrity, social responsibility and fun. Bakke and Sant had explicitly created an organizational structure and company culture that reinforced these principles at every level of operation and decision-making, even at the expense of shareholder value, creating an investment risk that the company explicitly acknowledged in its filings with the Securities and Exchange Commission [see Exhibit 3].

One important element of their management approach was the empowerment of every individual who worked with them. As explained/stated by CEO Dennis Bakke, "Everything about how we organize gives people the power and responsibility to make important decisions, to engage with their work as businesspeople, not as cogs in a machine." Chairman Roget Sant elaborated, "Our system starts with a lack of hierarchy. We abhor layers. We avoid them like the plague." The company had no corporate marketing, finance or human resources division. All of these functions were under the responsibility of local managers. There were no approvals required for purchases, no maternity or family leave policies and no bureaucratic divisions between operations and maintenance or strategy and finance. Only five layers of hierarchy separated any employee from CEO Dennis Bakke.[1] Virtually all human resource decisions were made at the plant level, and within the plant, decision-making authority was decentralized among different teams.[2]

Despite the obvious difficulties of replicating this post-modern organizational model abroad, Bakke and Sant firmly believed that AES values were universal. When asked about the challenges of international expansion, Sant replied "We haven't had the problems opening plants internationally that people predicted. For some reason, people thought that our principles and our

[1] Wetlaufer, Suzy "Organizing for Empowerment" *Harvard Business Review Reprint* 99109.

[2] Grant, Robert *AES Corporation: Rewriting the Rules of Management* http://www.blackwellpublishing.com/grant/docs/17AES.pdf).

way of doing things couldn't work overseas. But we haven't really experienced anything like that." Bakke added "In fact sometimes our non-U.S. employees 'get' AES faster than Americans do." Bakke believed that workers in post-communist societies in particular would be attracted to the change offered by AES's management style because it created "a moral dimension built upon the concepts of individual freedom and human dignity which are the cornerstones of democracy."[3] One Georgian former employee of AES-Telasi summarized, "AES was one half a major international corporation and one half a religious experience."

III THE REPUBLIC OF GEORGIA

1. Geopolitical position

Georgia's geographic position—its lies between the Black Sea, Russia, Turkey, Armenia and Azerbaijan, which borders on the Caspian Sea and Iran [see Exhibit 1]—has made control of the country's mountain passes and transit routes strategically important for centuries. One expatriate summarized the importance of this geographic position for investors: "the historical roots of Georgia lie in a mountain pass that you had to get through to go from Asia to Europe. You could just sit there and extract." As a result, Georgia was conquered in turn by Romans, Persians, Byzantines, Iranians, Turks, Mongols, Ottomans, Russians and the Soviets. In the 1990s, Georgia's strategic importance was on the rise again due to the discovery of oil and gas deposits in the Caspian Sea and a need to transport these supplies to European markets.

After gaining its independence in 1991, Georgia attempted to protect itself from a reassertion of Russian influence by using American interest in its strategic location to its advantage. Although Georgia's efforts were rewarded with substantial inflows of foreign aid (in 1996, Georgia was the third largest recipient of US Aid on a per capita basis after Israel and Armenia), Russia continued to flex its military and economic power in an effort to prevent Georgia from attaining full membership in the American orbit. Russian peacekeepers were active in both Abkhazia (in the northwest) and South Ossetia (in the northern center). As of 1998, 4,000 – 5,000 Russian troops remained in two military bases in Batumi, capital of the autonomous Republic of Adjari, and Akhalkalaki, a small city in the predominantly Armenian southern region of Samtskhe-Javakheti, near the Turkish border. The Russians also maintained an active military interest in the Pankisi Gorge area, which was linked to smuggling and terrorist interests in nearby Chechyna, and Georgian authorities could not confirm that the Russians had vacated a third military base (Gudauta) in the breakaway province of Abkhazia. The expression of Russian interests extended into the economic sphere as well, via offshore shell companies that funneled money into competing local mafia clans. Peter Mamradze, a top advisor to the Georgian president, lamented that "living next to Russia is like living on the slope of a volcano".[4] One expatriate explained:

> "everything that [the Russians] do is based on keeping Georgia unstable: Ossetia, Abkhazia, and foreign direct investment in Georgia and in neighboring countries. They just want to blackmail Georgia. They want to control infrastructure, especially to

[3] Bakke, Dennis (2005) *Joy at Work* (PVG, Seattle, WA) pp. 239-240.

[4] Stern, David *Financial Times* 11/22/99 p. 1.

Armenia and Turkey. It's not about profits. It's about what Georgia is in between. Russian firm strategy in this part of the world is just an extension of Russian foreign policy."

2. Economic situation

Georgia offered substantial economic potential, at least in comparison to the other post-Soviet republics, which lacked substantial oil or gas supplies. It had abundant hydroelectric power sources, forests, minerals and rich agricultural land including fine vineyards. The population was highly educated, was well exposed to Western culture, had a firm sense of national identity, and possessed strong family and kinship ties. However, Georgia's ability to realize its potential was hamstrung by the forced severance of economic ties to Russia, the devastation of three military conflicts and, most importantly, by endemic corruption.

Historically, corruption and thievery had emerged as a survival mechanism against foreign oppression, but in the post-Soviet period, corruption had come to undermine Georgia's own quest for stability and national identity. Georgia's problem of corruption was among the most serious in the world[5] and pervaded virtually every aspect of daily life. Two-thirds of economic transactions took[6] place in the gray or black market (as compared to 21 – 30 percent in other post-Soviet states). As a result, the World Bank estimated that in 1998, an amount equal to 75 percent of the government budget was lost due to nonpayment of taxes. Non-payment was able to occur not only economic activity went unreported, but also because tax collectors who had purchased their position for $5,000 used their power to grant exemptions to those who paid sufficiently high bribes. Senior government officials were also in on the game through their involvement in smuggling cigarettes, fuel and alcohol; the looting of 160kg of gold from the State Treasury; and, in the case of Former Prime Minister Sigua, the embezzlement of $15m from the state budget.[7] Unsurprisingly, lower-level government officials and the population at large replicated this behavior:

- Georgian police routinely extorted money from drivers on the highway between Tbilisi and the airport, and had been involved in organizing kidnapping rings.
- Eighty percent of students in the University system paid bribes for admission, exam grades and dissertations.
- Seventy percent of the population was willing to "give up basic moral values," paying or receiving bribes to solve their problems.[8]
- Eight-seven percent of Georgians believed that unofficial payments were either an essential or a useful part of doing business.[9]

[5] Georgia ranks among the most corrupt ten countries in the world on Transparency International's Corruption Perception Index.

[6] Estimates range from 64 percent (IMF) to 67 percent (Schneider 2001).

[7] Freedom House Country Report 1998

[8] Anzaparidze 2002 cited in Godson, Roy, Dennis Jay Kenney, Margaret Litvin and Gigi Tevzadze (2003) *Building Societal Support for the Rule of Law in Georgia*, National Strategy Information Center, Washington DC.

[9] World Bank, 2000.

The problem of corruption grew so severe that, in December 1998, the International Monetary Fund suspended Georgia from its membership and limited government access to multilateral funds.[10]

3. The Case for Investing in Georgian Electricity

At the moment the IMF was walking away from Georgia, the need for investment in the Georgian electricity system was becoming increasingly desperate. The sector ran financial deficits that swamped Georgia's otherwise improving fiscal position; undermined the development of private sector enterprise[11] in general, and foreign direct investment in particular; and, each winter, contributed to political and social instability, as the hours with power supply dwindled to the low single digits. As a result, foreign and domestic actors seeking to stabilize the Georgian economy had a joint interest in power sector reform, including private participation.

Financial Strain of State Ownership

The financial losses of the electricity sector totaled between $250m and $400m annually, which was equivalent to 7.5 – 15 percent of gross domestic product in 1995 – 98, as compared to a government budget deficit excluding the sector of 5 – 7 percent (i.e., in the absence of the power sector financial deficit the Georgian government would have had a fiscal surplus). Nominal revenue per kilowatt-hour was below $0.005 cents/KWH of electricity generated, well below 50 percent of the cost of generation.[12]

These financial losses had several causes. Multilateral donors and the government officials implementing reform believed that the involvement of a private investor could help to address these problems.

- One problem was delayed maintenance and repairs that the government lacked the financial capacity to undertake. At best, 42 percent of installed capacity was available for generation.[13]
- Reported collection rates ranged from 20 – 40 percent because much of the population stole electricity using illegal lines tapped into the low-voltage transmission system.[14] The government could not terminate supply to non-payers because it lacked information on individual consumption, and did not possess the funds to invest in metering equipment.
- Corruption played a substantial role. Diesel fuel meant to run peak power plants in the winter months was routinely sold on the black market by Ministry officials.[15] Of the $82m in

[10] LeVine, Steve New York Times 2/7/99 p. 15 c1

[11] The International Monetary Fund's 1998 Article IV Consultation for the Republic of Georgia stated that "A major obstacle to private business development in Georgia has been the poor state of the energy sector. Power cuts are common and the added cost of generating one's own electricity supply (through the use of power generators) remains a cost burden to many enterprises." (p. 9)

[12] Lampietti, Julian (2004) *Power's Promise* (World Bank, Washington DC).

[13] Lampietti, Julian (2004) *Power's Promise* (World Bank, Washington DC).

[14] LeVine, Steve New York Times 2/7/99 p. 15 c1.

[15] Reuters, 4/13/98.

foreign aid received for power sector reform, $15m was unaccounted for.[16] The rate of theft of domestic funds was far greater, with as much as $300m misappropriated from 1988 – 1998. Privatization of hydroelectric facilities occurred at token prices to firms in which senior government officials had hidden stakes, often in conjunction with Russian interests. According to one observer, "a small number of families controlled everything in the energy sector… They were go-betweens for the Russians and the Turks making big money on transiting electricity across Georgia. Turkish Ministers went to prison for this." An expatriate observer recounted, "Everyone in the Georgian energy sector is corrupt, and that is from the very bottom to the top of all aspects of the energy sector, including people working on the wires, managers, executives, government ministries, regulators and parliamentarians." Multilateral donors hoped that private investors would be less beholden to networks of corruption.

- The sector suffered from a shortage of fuel, particularly during the winter and in years with below-average rainfall (over 80 percent of Georgian power was hydroelectric). Due to the weak fiscal situation of the government, neighboring states were unwilling to supply electricity or fuels to the government. In November 1994, Turkmenistan, which the Georgian government owed $400m in overdue bills for natural gas and electricity, severed supplies.[17] Four years later, the Russians claimed unpaid debts of $500m for fuel oil, gas and electricity imports.[18] Once again, it was hoped that creditworthy private investors could improve the situation with suppliers.

Foreign Interest in Georgian Power Sector Reform

Given the importance of Georgia's power sector to the country's macroeconomic and political stability, together with Georgia's geopolitical importance, western donors attempted to rise to the challenge. Hundreds of millions of dollars in bilateral and multilateral aid flowed rapidly from the US, Germany, Sweden, the UK, Canada, Greece, the Netherlands, Turkey, the UN, the EBRD, the World Bank, the IMF, the EU, OSCE and dozens of NGOs. A substantial portion of this aid was targeted at electricity infrastructure and governance, and the resultant policy reforms closely followed the frontier of development theory at the time. Georgia was lauded for following an appropriate sequencing of reform in which the regulatory agency was established (in 1997) prior to the "unbundling" of the state-owned enterprise (in 1998), which occurred prior to the privatization of distribution (in 1998) which occurred prior to the creation of a wholesale power market (in 1999) and the privatization of generation (in 2000), both of which occurred prior to the liberalization of entry (1999 – 2000). The regulatory authority was headed by officials with fixed-term appointments, was separate from the political apparatus, was funded by the industry instead of the government, had full tariff-setting authority, followed a transparent decision-making process, and offered clear policies of appeal.[19]

[16] LeVine, Steve New York Times 2/7/99 p. 15 c1.
[17] LeVine, Steve New York Times 2/7/99 p. 15 c1.
[18] Walters, Jonathan, Privatizing Power in Georgia, Presentation to the Energy Forum 2004 conference.
[19] Lampietti, Julian (2004) *Power's Promise* (World Bank, Washington DC).

The initial results of such reforms were promising. During the period 2997 – 1998, USAID funded a pilot project, managed by the energy consultancy Hagler Bailly, "to improve electrical distribution company revenue collection from customers in the cheapest way possible to increase power supplies to consumers." The project, which involved a group of high rise apartment buildings in Rustavi, approximately twenty minutes south of Tbilisi, included four primary components.

- Distribution was expanded, from 3,500 customers to 10,000 customers.
- Meter reading was separated from billing to avoid corruption by meter readers.
- Meters were placed in locked boxes.
- Round-the-clock electricity was guaranteed to those who paid.[20]

Three months after implementation of the project's computerized metering, billing, and collections system, cash collection rates had increased from below 10 percent to 100 percent of electricity billed, and daily power supply had increased from less than six hours a day to nearly 24 hours a day. Commercial and technical losses together amounted to less than five percent of collected revenues."[21]

IV AES ENTERS GEORGIA: AES-TELASI

1. The Business Case

The government's decision to privatize Telasi, an electricity distribution company serving approximately 370,000 households in and around the capital city of Tbilisi, and AES's interest in participating in the tender, were both understandable given the mission of AES Corporation, the poor performance of the Georgian state in providing reliable and affordable electricity, the perceived importance of such supply for Georgian stability, and the interests of Western actors in such stability. AES Director General Paul Stinson first formally raised the prospect of AES's entry into Georgia (along with the hopes of Tbilisi residents) in October 1998, when he described a future in which "residents will have personal electricity meters, and pay for electricity in banks. Collectors will check the tickets… consumers won't have any claims. If we win the tender, we will make our best effort to supply the residents with electricity this winter."[22] This optimism was echoed by President Shevardnadze in his December 21 radio address that year when he proclaimed, "Electricity will be supplied to the population 24 hours a day, in the event that payments are made promptly."[23] Irma Kavtaradze, the First Deputy Minister for State Property Management, who negotiated the privatization, claimed that, "By selling Telasi to the US Company AES, there will be an end to the dark nights in Tbilisi."[24]

[20] Black Sea Press 3/19/98.
[21] http://georgia.usembassy.gov/releases/release19981103.html
[22] Prime News 10/7/98.
[23] BBC Monitoring 12/21/98.
[24] Black Sea Press, 12/29/98.

AES offered $25.5m for 75 percent of Telasi (the remainder would stay in government or employee hands) plus $10.35m for partial debt repayment to the government, with a commitment to invest $22.6m in the first year and $84m over ten years. Under the deal, all meters would be replaced, and a computerized collection system would be installed, allowing consumers to pay their bills through local banks or payment offices rather than to meter readers.[25] The government, in turn, would meet virtually every one AES's contractual demands.

- Any investments or other costs, including the opportunity cost of capital deployed, input costs including those due to changes in exchange rates could be passed through to customers as rate increases within four years.
- AES would be compensated for any change in law that increased taxes, required additional capital expenditures or which otherwise:
    - "either materially increased the annual costs of performing the [Telasi] obligations or the AES obligations,"
    - "materially decreased the annual returns (other than as the result of a decrease in the demand for Energy or Energy Services) of [Telasi] and/or AES.
- Tariffs would be indexed to take into account inflation and exchange rate movements.
- Any disputes would be arbitrated in London, in the English language, using the English text of the agreement.

An analyst summarized, "*if you believed the contract*, AES was guaranteed a 20 percent return on its investment."

For the same terms, EdF offered $10.4m initially, $7m to cover debts, and a commitment to invest $25.7m in the first year and $123m over ten years.[26] The Georgian government discounted the bidders' ongoing investment commitments, and on December 22, 1998, announced that AES would be awarded ownership of 75 percent of Telasi's shares and control over the company as of January 4, 1999.

2. The Leadership Team

Consistent with AES's management tradition, control over AES-Telasi was assigned to the manager that had identified the opportunity and made the case to purchase the assets: Michael Scholey. An expatriate manager described Scholey as "a visionary guy" who "fought the good fight" and used the power of "enchantment" to succeed in getting people to "buy into a hugely appealing proposition that an American company could come into a small country and solve a big, longstanding problem." Wendell Steavenson wrote of Scholey's qualifications for this challenge:

> "Scholey was a bluff laconic Yorkshireman, intelligent and tough, with one eyebrow that went up and one that went down. He was perpetually tired because there was so much work to do. He chain-smoked. When I first met him, he was laughing about the size of

[25] Jack, Andrew *Financial Times*, 12/1/99 p. 3.
[26] Black Sea Press 10/22/98.

> the rats in the toilets at Telasi and how bringing electricity to Georgia was a challenge like climbing mountains and exploring deep Africa was a challenge a hundred years before."
> —Steavenson, Wendell (2002) *Stories I Stole* (Grove Press, New York NY)

In the words of one observer, "Scholey and his team had absolute and total control. That's the AES model: total decentralization, total autonomy." An ex-employee highlighted that Scholey replicated this model within the company: "all responsibility was pushed down. Individual employees had total discretion. There were no operating principles." The challenge was not only to make people pay, but to create a new way of thinking that rewarded individual innovation, creativity and efficiency. Scholey's mission was no less that providing the ideology to remake the country, to make people stronger, to climb mountains together.

One challenge that Scholey faced was the relative inexperience of his management team, particularly with respect to running a distribution company and operating in a post-Soviet transition state. An ex-employee recounted the downside of the entirely decentralized human relations policy:

> When AES posts an employee position in Tbilisi, who applies? We're not getting tier 1 applicants here. The company couldn't get anyone to apply. It is not part of the career track. We/the employees are not getting to schmooze in Arlington. There is no management experience on our team. If you were a superintendent (one level below a plant manager), there was no requirement for you to go abroad to be promoted plus they didn't even guarantee you a job upon your return… There was no support from headquarters for us either. There were no medical benefits or a family relocation policy. There were no school and no one to call when we were having problems."

Another ex-employee concurred, "We rather rushed into it. We didn't have the quality of the staff we needed. We lacked the right background. We weren't used to 400,000 customers."

3. Day One at AES-Telasi

> *The first six months were like a living in a shark tank.*
> —An ex-AES-Telasi employee

When he arrived in AES-Telasi's headquarters, Scholey felt as if he were under attack from every direction.

- Scholey recounted that "there was litter in the offices, the basement was flooded because there was no water run-off, and I even found a woman on the second floor who had a shop selling ice cream."
- Scholey discovered only one computer in the office, and it handled payroll alone. Furthermore, that payroll was denominated in the local currency, lari, as well as in commodities: "because of the connections of the former management to the dairy industry, wages to workers were paid partly in sour cream."

- The billing system was based solely on hand-transcribed ledgers.
- The officially reported collection rate of 40 percent turned out to be wildly overstated, with true payments equaling 4 – 10 percent of electricity supplied. Virtually every customer had an illegal second and—and often a third—line that drew power directly from a power substation or from a customer whose service could not be terminated. For example, residents living close to a hospital in the Matsminda neighborhood of Tbilisi were infamous for enjoying the most reliable power supply in the city, despite their payment rates of close to zero percent.
- The true number of customers (410,000) was more than 10 percent greater than the expected number.
- The government viewed AES as a cash cow, billing the company for value-added taxes based on the quantity of electricity distributed, as opposed to the quantity actually paid for. As a result, the government haf no incentive to assist in the collection of unpaid debts.[27]
- Due to a fire in a hydroelectric facility in late December 1998, Scholey faced a 300MW power shortfall in the first week of his management. Power was available for at most one hour a day in Tbilisi.[28]

4. Scholey's AES-Telasi Strategy

Scholey initially developed and deployed a two-pronged strategy.

- The first prong was to invest in plant, equipment and technology to bring AES-Telasi up to the standard of other AES distribution operations. This would include the installation of meters in every household to link payment with supply. Consistent with the AES model of empowerment, line-level employees would be allowed to decide which investments were appropriate.
- The second prong was straightforward: combat corruption.

Within a year of the time that AES acquired Telasi, Scholey came to realize the importance of changing the culture among residential, commercial, industrial and government users. As a result, he bean to spend an increasing portion of his time on a new, third prong: public relations.

Investment and Empowerment

The extent of degradation of Telasi infrastructure was staggering, but with the aid of substantial cash infusions from headquarters, Scholey, his regional managers, and their subordinates made the expenditures necessary to raise local plant and equipment to world-class standards. Scholey wanted to demonstrate to Georgians in general—and to his employees in particular—what was possible if they worked together. New investments helped him not only to meet explicit financial commitments in the purchase agreement, but also to generate revenue, improve electricity supply and, perhaps most importantly, create goodwill.

[27] Black Sea Press 9/11/99.
[28] Dow Jones International News, 1/11/99.

- The single largest expenditure item was imported fuel necessary to generate electricity.
- The most significant investments involved metering household consumption. Under the communist system, the amount of electricity consumed by each user was simply not recorded. In contrast, AES-Telasi wanted to bill consumers according to their consumption. The company contracted with the global engineering, consulting and construction company Black and Veatch to install individual meters. The contractor initially installed Indonesian meters in the basements of residences, but these meters were readily accessed by customers and relatively easy to tamper with. As a result, all installed meters would have to be relocated outside the home to secure boxes with. The cost of the metering program (for both relocating existing meters and installing new ones) thus increased substantially, and the installation program would not be complete until the summer of 2001.[29] By December 1999, meters were being installed at a cost of $75 apiece for 500 apartments a week, with a goal of 5,000 apartments a week by mid-May 2000, and a total of 250,000 apartments by December 2000 and 410,000 by the end of the summer of 2001.[30]
- As required by regulation, AES provided the grounding to the city's electrical system, which the state-owned company had never completed.
- AES rehabilitated 37 high-voltage substations (costing approximately ~$100,000 each), 76 high-voltage transformers (costing roughly $40,000 – $70,000 each), and 2,500 transformers (costing approximately $500 each).[31]
- In October 1999, Scholey also expanded AES's presence in the Georgian electricity sector by purchasing Units 9 and 10 of the Tbilisi State Power Plant for $16.5m plus a commitment to pay $2m in back wages and invest $100m. He also secured control of two hydroelectric facilities under a 25-year management contract. The hope was that direct control over generation could alleviate winter electricity shortages.[32]
- Additional expenses included new computers, fax machines and cellular telephones for employees.
- In an effort to maintain consistency with AES corporate values, generous severance packages were given to 700 workers. The packages included a 2000 lari cash payment, 12 or 42 months of post-termination wages (depending on time served), payment for job training courses, and cash payments for unused vacation days wage debts, including debts incurred prior to AES's acquisition of Telasi. Another 600 workers were expected to take severance packages in 2000.[33]

Scholey's strategy created costs. AES exceeded its investment commitments for the first decade in 1999 alone. However, there were also substantial intangible payoffs. Scholey was praised by many of his employees in almost reverential terms. One observer noted that "no one else who had been in Tbilisi for less than five years would have been as effective." Ex-employees reflected on life at AES-Telasi under Michael Scholey.

[29] Prime News, 5/10/99.
[30] Black Sea Press, 12/23/99.
[31] Black Sea Press, 3/12/2001.
[32] Interfax, 11/23/99.
[33] Black Sea Press 5/14/99; Jack, Andrew *Financial Times*, 12/1/99 p. 3.

- Scholey was "the best international manager that ever came to Georgia. One of the greatest men I have ever met."
- "Working for AES-Telasi was very fun and every one of us felt that we were doing something important. AES's attitude to business and employees was very different from many other companies, and because of it, most of us remember this period as one of the best in our life."
- "Scholey [was] seen as a savior… as a hero… He brought a new management style. The population hated the corruption in the power sector and viewed Scholey as an island in the sea that tried to conduct proper business."
- "[Scholey] did succeed in changing the mentality of many managers. [He] changed the psychology of investment. Scholey changed a great deal in our society."

Combating Corruption

Investments and employee accolades notwithstanding, Scholey's efforts generate financial returns from AES-Telasi were repeatedly stymied by a web of opponents stretching from local corruption networks benefiting from free electricity supplies for their industrial firms or from the export of stolen electricity to Turkey to Moscow where the Russian government increasingly used its state-owned enterprises selling gas or electricity to exploit Georgian corruption networks in the interests of Russian foreign policy.

- Scholey's spent his first days in protracted and contentious negotiations with a state-owned company that had a legal monopoly on the import of electricity from Russia. The company refused to supply AES-Telasi, first claiming that it needed a bank guarantee and then continually inventing new explanations for why the electricity that AES-Telasi needed—and had counted on—was not being provided.[34] The real reason for the Russian company's machinations may have involved a complex effort by Russian interests to use the state-owned company and a shell company named Anglo Oil to sell Russian electricity in Turkey at a 100 percent profit.[35] Finally, after securing the permission of President Shevardnadze to violate the contractual provision preventing AES-Telasi from directly importing electricity from other sources for the first three months of its contract, Scholey negotiated a deal with the Armenians to supply electricity. Scholey hoped that his resourcefulness in securing supplies at any cost would demonstrate AES's commitment to keep the lights on in Tbilisi, even in the face of opposition by state-owned enterprises. Without reliable supplies, Scholey knew he would never be able to get consumers to pay.
- Scholey quickly learned that the problem of nonpayment extended far beyond the household sector to government offices and large industrial users. On March 12, 1999, he announced a high-profile campaign to identify and cut illegal power lines.[36] On April 15, 1999, the threat was even extended to the delinquent Georgian Parliament, which paid its bill on the same day.[37] Other government agencies failed to pay their electricity bills, leading AES-Telasi to subtract the delinquent bills from its payments to Sakenegro, the state-owned electricity

[34] Black Sea Press, 3/19/99.
[35] Text of article in Georgian newspaper 7 Dghe on 3/31/99 translated into English by BBC Monitoring on 5/16/99
[36] Black Sea Press 3/12/99.
[37] Prime News, 4/15/99.

generation company.[38] The dispute escalated and on June 28 of the same year, AES-Telasi switched off power to the national television broadcasting tower for nonpayment, and also threatened similar actions against the Ministry of State Security, Russian troop bases, foreign embassies, and President Shevardnadze's bodyguards.[39] Television broadcasts resumed when AES-Telasi received free advertising in exchange for electricity.[40]

- Scholey also struggled with the intractable problem of corruption in AES-Telasi, in the government, and in or enterprises closely connected to government officials.
    - Meter readers supplemented their income by reporting smaller payments than what they received or by tampering with meters. As a result, some of the most educated and capable staff on the payroll were out in the field reading meters.[41] One interviewee recounted how meter installers offered to install shorts that would make their meters read only half the electricity consumed, and other meter readers would then demand bribes not to report the transgression. When confronted with evidence of impropriety, Scholey responded aggressively. When his landlady showed him that she had paid the $60 (120 lari) monthly bill but her meter reader had booked only $10 (20 lari), he called an emergency press conference at his home to dismiss the meter reader.[42]
    - An employee at another regional distribution company in Georgia recounted how a AES-Telasi warehouse employees once offered to sell him meters at a bargain basement price. The same AES-Telasi employee reported to management back that the meters had been stolen. Similar rackets involved computers procured by AES as well as cell phones, digital cameras and video cameras.
    - The Azota chemical complex and other industrial consumers of electricity continued to receive electricity despite outstanding debts of over $10m. Many of these companies had secured direct linkages to the national dispatch center, so that AES-Telasi could not directly terminate their supply. The consumption of electricity by these delinquent customers, however, interfered with Scholey's ability to bring electricity to his own consumers. When supplies were short, any electricity received by Azota and the others was electricity not received in Tbilisi.

Each time Scholey was provoked or challenged, he rose to the occasion. He found new supplies of electricity or gas when he needed to, he confronted government officials who were lining their pockets, and he switched off power to prominent non-payers including the Department of Defense and the Tbilisi airport. An observer described Scholey's strategy as one that "reacted to hostility with hostility, tit-for-tat." It was an approach that earned Scholey begrudging respect but did not necessarily turn the tide of policy toward his interests, either in the Republic of Georgia or in Moscow.

[38] Text of article in Georgian newspaper 7 Dghe on 5/17/99 translated into English by BBC Monitoring on 5/24/99.

[39] Transcription of Georgian Radio broadcast Mayak on 6/29/99 translated into English by BBC Monitoring on 6/29/99.

[40] Jack, Andrew *Financial Times*, 12/1/99 p. 3

[41] Jack, Andrew *Financial Times*, 12/1/99 p. 3.

[42] Transcription of Georgian Radio broadcast Mayak on 6/29/99 translated into English by BBC Monitoring on 6/29/99.

Public Relations

In June 1999, Scholey hired a full-time public relations staff member and began to develop a media strategy to impress upon the Georgian people the necessary link between payment and supply. Scholey was on television virtually every night explaining that electricity was like bread, a commodity that Georgians were used to paying for. "If you didn't pay you didn't eat," was his mantra. He took part in live debates with government officials in which, as an ex-employee recounted, Scholey "logically destroyed each of their positions in two sentences without insulting them or being rude." Television advertisements focused on AES's efforts to make a change for the better in the hope that consumers (at least those who had electricity when the spots were aired) would not fall behind.

Scholey and his staff also took this message directly to disaffected consumers. If there was a demonstration or if an argument flared in the billing office, Scholey and another senior manager would often appear together and engage with the public, talking to the people and confronting any challenger. Scholey even spent a day reading meters, seizing the opportunity to deliver his message directly to consumers. As a result of his concerted media campaign, Scholey became the most recognized faces in Tbilisi, to the point of even being satirized in a nightly cartoon [see Exhibit 4]. Ex-employees recounted that "Scholey was very charismatic, had a very good public image, a strong personality. He helped to keep [AES-Telasi's] image positive."

V THE ROAD AHEAD

As Scholey pulled himself out of the broken carrot car and began another cold wait of uncertain length for yet another passing car with whom he would need to negotiate a ride back to Tbilisi, he wondered if his efforts to win the hearts and minds of his Georgian employees and customers would ever allow him to realize his strategic goals. He had convinced many that AES was an ally and that the government—the Ministry of Energy in particular—was behind the long cold dark nights. However, shifting some consumers' mindsets wasn't enough to maintain a constant electricity supply. Could AES's model of empowerment and devolution of responsibility really be made to work in Georgia? Could post-modern management change post-socialist mentality *and* provide electricity to Georgia and a fair return to AES shareholders?

VI DISCUSSION QUESTIONS

As Scholey waited for another car to appear and the next stage of his odyssey to begin, he pondered several questions.

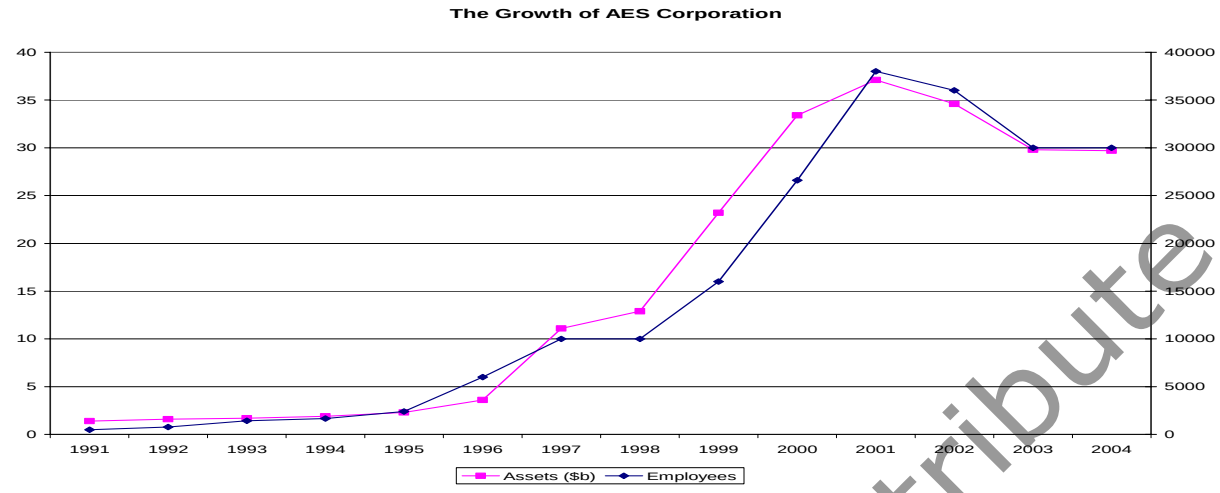
- Could AES'a management style and organizational structure work in a post-communist state such as Georgia? Why or why not?
- Who were his allies and the opponents in the struggle to make AES-Telasi a viable company? Why did they support or oppose AES's interests?

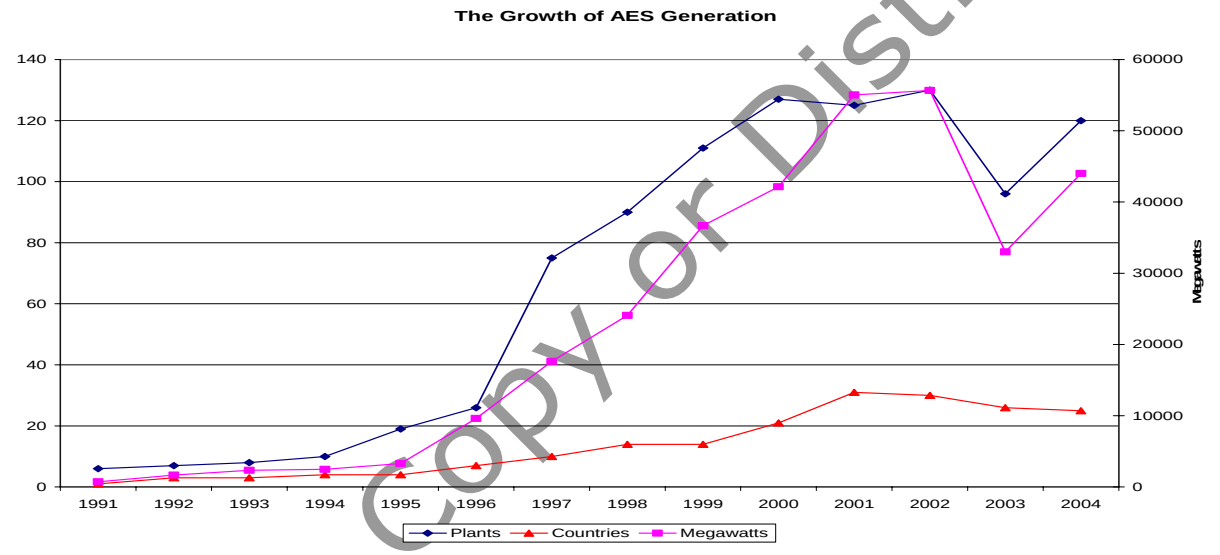
Scholey also reflected upon his strategy for overcoming the challenges in Georgia and considered his interactions with various constituencies. How could he improve his relationships with the following constituencies in order to realize his mission in Tbilisi?

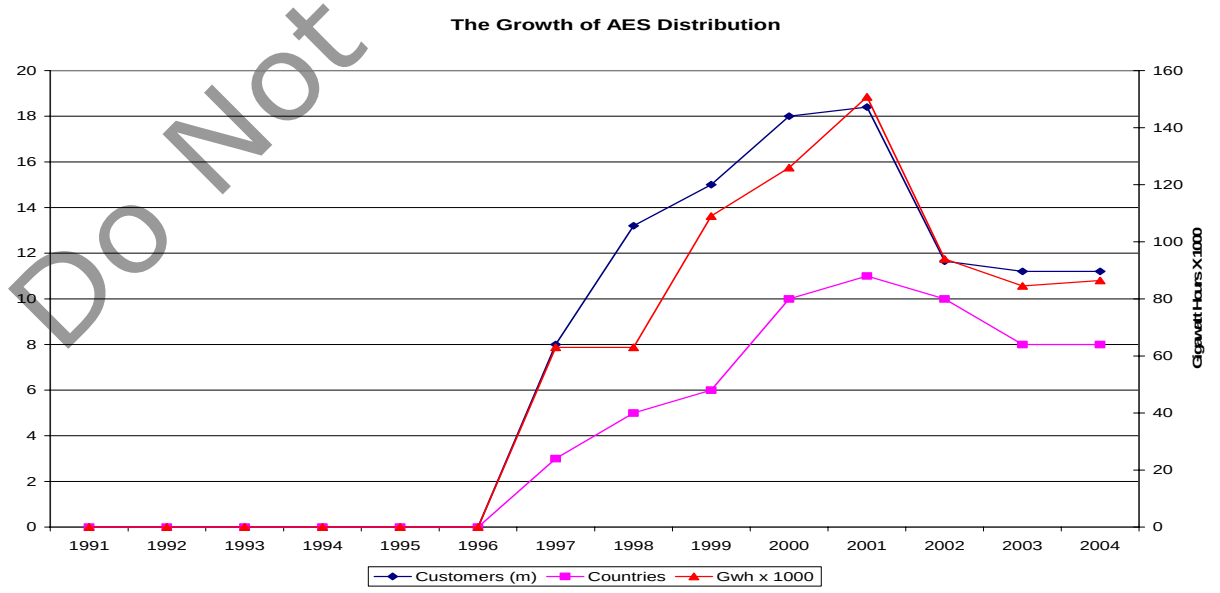
1) AES-Telasi employees
2) AES-Telasi customers
3) AES-Telasi suppliers
4) Representatives of the US government and/or intergovernmental organizations (e.g., the EBRD, the World Bank etc.)
5) Georgian political and regulatory actors

Exhibit 1: Map of Georgia

Exhibit 2: The Growth and Globalization of AES Corporation







Source: AES Annual Reports, 1991-2004.

Exhibit 3: Excerpts from AES 2001 10K Regarding Corporate Values and Organization

A core part of AES's corporate culture is a commitment to "shared principles or values." These principles describe how AES people endeavor to commit themselves to the Company's mission of serving the world by providing safe, clean, reliable and low-cost electricity. The principles are:

• Integrity – AES strives to act with integrity, or "wholeness." AES people seek to keep the same moral code at work as at home.
• Fairness – AES wants to treat fairly its people, its customers, its suppliers, its stockholders, governments and the communities in which it operates.
• Fun – AES desires that people employed by the Company and those people with whom the Company interacts have fun in their work. The Company believes that making decisions and being accountable is fun and has structured its organization to maximize the opportunity for fun for as many people as possible.
• Social Responsibility – Primarily, the Company believes that doing a good job at fulfilling its mission is socially responsible. But the Company also believes that it has a responsibility to be involved in projects that provide other social benefits, and consequently has instituted programs such as corporate matching of individual charitable gifts in addition to various local programs conducted by AES businesses.

AES recognizes that most companies have standards and ethics by which they operate and that business decisions are based, at least in part, on such principles. The Company believes that an explicit commitment to a particular set of standards is a useful way to encourage ownership of those values among its people. While the people at AES acknowledge that they won't always live up to these standards, they believe that being held accountable to these shared values will help them behave more consistently with such principles. AES makes an effort to support these principles in ways that acknowledge a strong corporate commitment and encourage people to act accordingly. For example, AES conducts annual surveys, both company-wide and at each business location, designed to measure how well its people are doing in supporting these principles through interactions within the Company and with people outside the Company. These surveys are perhaps most useful in revealing failures, and helping to deal with those failures. AES's principles are relevant because they help explain how AES people approach the Company's business. The Company seeks to adhere to these principles, not as a means to achieve economic success but because adherence is a worthwhile goal in and of itself…

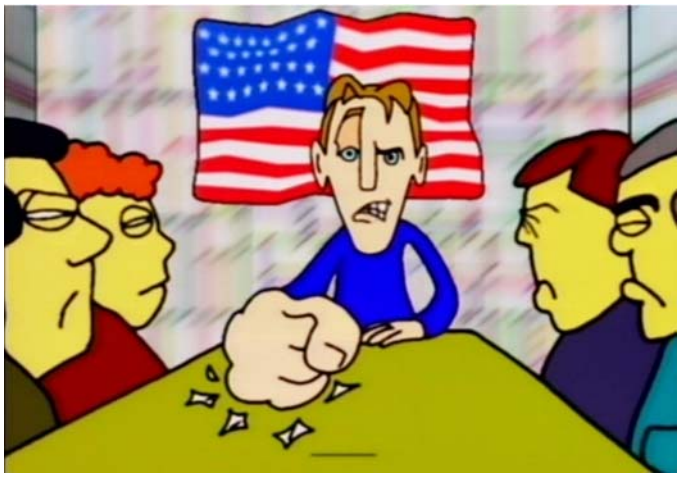
Where do profits fit? Profits...are not any corporation's main goal. Profits are to a corporation much like breathing is to life. Breathing is not the goal, but without breath, life ends. Similarly, without turning a profit, a corporation too, will cease to exist...At AES we strive not to make profits the ultimate driver of the corporation. My desire is that the principles to which we strive would take preeminence.

The Company seeks to adhere to these principles, not as a means to achieve economic success, but because adherence is a worthwhile goal in and of itself. However, if the Company perceives a conflict between these principles and profits, the Company will try to adhere to its principles – even though doing so might result in dominated or forgone opportunities or financial benefits…

In order to create a fun working environment for its people and implement its strategy of operational excellence, AES has adopted decentralized organizational principles and practices. For example, AES works to minimize the number of supervisory layers in its organization. Most of the Company's plants operate without shift supervisors. The project subsidiaries are responsible for all major facility-specific business functions, including financing and capital expenditures. Criteria for hiring new AES people include a person's willingness to accept responsibility and AES's principles as well as a person's experience and expertise. Every AES person has been encouraged to participate in strategic planning and new plant design for the Company. The Company has generally organized itself into multi-skilled teams to develop projects, rather than forming "staff" groups (such as a human resources department or an engineering staff) to carry out specialized functions. Many people have asked us about our team structure and how it works. To begin with, there is no one person in charge of teams and there is no Human Resources department. Teams are the basis of our structure, and they encompass the four values of our company. They are fluid; many people are members of more than one team at one time. A team is somewhat autonomous; all decisions about a project are made within that team, with final say granted to that team. Decisions are made not from the top-down, but from the bottom-up. Furthermore, responsibility is pushed to the lowest level possible, encouraging everyone to be part of a decision. As a result, each team member views the project in terms of a whole. Colleagues and team members must trust each other to follow through to the best of their ability. Because people are what make up AES, we have decided not to resort to an organizational model. Instead, we give you the following comments from AES people regarding teamwork. In general, AES teams work extremely well in both achieving a common goal and having fun while doing so. The following ideas provide insight on what makes teams work well and what can stimulate true and productive teamwork. 'Teams imply friendship; not only the ability but the desire to work together. Starting with the wonderful example set by the original AES team, Roger and Dennis, working together in small groups has been a natural way to get big things done while preserving the dignity of each person.' 'There are two reasons why teams are successful at AES: the type of people we have here and the environment in which they work. People at AES tend to be independent and thrive in a loose environment where roles and responsibilities are not always clearly defined. The environment at AES is one where responsibility is pushed down to the lowest level possible, encouraging everyone to take ownership for not only their piece of the project, but for the project in its entirety.'"

Source: AES 2001 10K and Grant, Robert AES Corporation: Rewriting the Rules of Management http://www.blackwellpublishing.com/grant/docs/17AES.pdf).

Exhibit 4: Screen Capture of Michael Scholey Cartoon from Georgian Television



Source: Source: Studio Vasha, Power Trip