

Lack of Transparency in Russian Energy Trade

The Risks to Europe

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LACK OF TRANSPARENCY IN RUSSIAN ENERGY TRADE THE RISKS TO EUROPE

Keith C. Smith

Summary

A major challenge to the new democracies of Central Europe is the corruption and lack of transparency in the importing of oil and natural gas from Russia and other energy producing states once part of the Soviet Union. This situation also undermines good governance and ethical business practices in the large and wealthier countries of Europe.

EU membership provides only limited energy security to the new democracies. The European Union has no enforceable policy regarding transparency and competition in the energy trade, nor does it have a common energy strategy concerning accountability by Russian state companies such as Gazprom and Transneft.

In Western Europe, there is a disturbing lack of understanding of, and support for, greater energy security in the Central European states. Nor is there significant support in Western Europe for a common EU energy market.

Wealth accumulation from the energy trade is often used by powerful groups in the East to buy support in Western countries for Russian economic and security policies. This situation is exacerbated by the lack of legal reporting requirements in the West concerning the outside funding of political and business groups.

It is already difficult for Western energy firms to make business decisions in the former Soviet area, due to the deeply rooted lack of transparency in Russian, Ukrainian, and Central Asian commercial dealings and to an absence of impartial court systems to enforce internationally recognized contracts between business firms.

The most serious threats result from the danger of intervention at any point in the commercial process on the part of elite cartels who dominate the energy trade, particularly in Russia, Ukraine, and Central Asia. These cartels are composed of governmental leaders, intelligence officials, and

favored business oligarchs. The composition of these elite groupings can and often does change suddenly, with a shift in the local political balance, only adding to business uncertainty.¹

There are several concrete measures that Western governments and the European Union could adopt that would result in greater business transparency, less corruption, and increased energy security, particularly in the more fragile democracies of East and South Central Europe.

Investment Atmosphere in the Energy Trade: Corruption and Non-transparency

Europe's dependency on non-transparent financial transfers in the energy trade is as serious a challenge as its increasing dependency on Russia as the primary source for oil and natural gas. Non-transparent and corrupt business practices can have a corrosive effect on European governments, especially on the new EU member states of East Central Europe. Western energy companies trying to conduct business in Russia, Ukraine, or Central Asia too often confront demands from governmental officials and Eastern energy companies to engage in shady business practices when considering investment decisions, long-term sales contracts, and accounting procedures. Lack of a common EU energy policy and of strong antimonopoly enforcement regarding energy importers, have increased opportunities for non-transparent state companies to secure influence among Western governments and with political and economic elites in neighboring states.

Dubious or outright corrupt business practices are distorting the energy decisionmaking processes in both consumer and supplier countries. According to Russian economists, the business climate within the Russian energy sector has become less transparent and more corrupt in recent years.² Increasing corruption, along with the renationalization in Russia of the large energy companies has led to a decline in new investment in exploration and development, by both private Western and Russian firms. This has contributed to a decline in oil and gas production in Russia and a decline in investment in new production fields. This also leads to greater uncertainty among potential importers and investors concerning the ability of Russia to fulfill its long-term energy contracts. Russia itself would be the greatest beneficiary of more transparent and less corrupt business and governmental sectors.

The U.S. government and some West European countries have levied substantial fines on some of their own largest firms as a result of charges stemming from companies having engaged in

¹ Margarita M. Balmaceda, "Filling a Gap, Filling a Pocket: Absent Institutions, Intermediary Companies, and Energy Dependency in the Post-Soviet World" (paper presented at the conference on the Cultural Politics of EU Energy Security, University of Michigan, Ann Arbor, May 2008), <http://www.lsa.umich.edu/UMICH/ceseuc/Home/ACADEMICS/Research%20Projects/Energy%20Security%20in%20Europe%20and%20Eurasia/Balmaceda.pdf>.

² Michael Stott, "Russia corruption 'may force Western firms to quit,'" Reuters, March 15, 2010, <http://www.reuters.com/article/idUSTRE62E1SU20100315>.

corrupt business practices abroad. This report contends that the further east one goes in Europe, the less likely one is to see criminal cases or even serious investigations of corruption charges, particularly in the highly profitable energy sector.

Defining what is meant by corruption can be a challenge. It is impossible to come up with a comprehensive list of what is and is not corruption. Does a transaction or activity have to be illegal in the jurisdiction where it occurs in order to be labeled corruption? How should one define a business deal involving state-owned or state-influenced companies that is conducted in a non-transparent manner in order to enrich certain individuals or groups? Businesses, private or public, normally conduct much of their activity non-transparently in order to maintain a competitive edge or to protect intellectual property. In some cases, nations make legal and illegal payments to individuals and organizations to increase influence or to collect information not obtainable on the open market. Another definitional problem is that some activities are considered legal in certain national jurisdictions but illegal in others.

Of course, some businessmen in former Communist states engage in what people in the West refer to as corrupt practices as a result of having grown up in a culture that considers bribery and coercion to be normal methods of conducting business. Then-President Vladimir Putin of Russia offered the job of chairman of Rosneft to Donald Evans, former U.S. commerce secretary, and reportedly said that he was doing it “as a favor to President Bush.”³ Putin may have considered this offer to be a standard way of influencing business decisions. Similar examples can be found in the West, including the often close ties between regulators and the regulated in the United States. Business contributions to key political figures are common occurrences in Western countries and particularly in the United States.⁴ A bribery-kickback scheme cost German industrial conglomerate Siemens nearly \$2.6 billion, including settlements with U.S. and German authorities.⁵

It is difficult to make a sharp distinction between activities that are illegal, those that are unethical, and others that are simply aggressive business practices. And yet, polling from Russia demonstrates that the man in the street, as well as domestic and foreign businessmen, define corruption pretty much as do people in more developed societies. “If it looks like a duck, walks like a duck, and quacks like a duck...” One should note that Transparency International’s Corruption Index has Russia and Ukraine tied as the 146th most corrupt countries in the world, along with Zimbabwe.⁶

³ Carl Mortished, “Putin has more plans in the pipeline for Schröder,” *The Times* (London), December 21, 2005, http://www.timesonline.co.uk/tol/sport/football/european_football/article774990.ece.

⁴ Mark Green, *Selling Out: How Big Corporate Money Buys Elections, Rams through Legislation, and Betrays Our Democracy* (New York: HarperCollins, 2002).

⁵ Siri Schubert and T. Christian Miller, “At Siemens, Bribery Was Just a Line Item,” *New York Times*, December 20, 2008, <http://www.nytimes.com/2008/12/21/business/worldbusiness/21siemens.html>.

⁶ Transparency International, “Corruption Perceptions Index 2009,” December 12, 2009, http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table.

Elite Beneficiaries

Corruption and tight Kremlin control of Russia's energy companies have weakened the bargaining position of Western firms that normally use "best practices" when engaging in East-West energy trading. The domestic monopoly power and designated export privileges of Russia's state-controlled energy companies have led to a marked reduction of alternative investment possibilities for Western companies. This further intensifies the pressure on Western firms to agree to demands by Eastern energy suppliers that they engage in behavior not acceptable when dealing with other Western firms. This also raises the temptation for Western governments to ignore questionable business practices by their own domestic energy firms engaged in trade with Russian suppliers.

Western firms are already at a disadvantage when making business decisions in the former Soviet area. The absence of a win-win business concept in the East, combined with a deeply rooted lack of transparency in Russian, Ukrainian, and Central Asian commercial dealings is a major challenge. Also, due to an absence of impartial court systems to enforce internationally recognized contracts between business firms, long-standing agreements are sometimes cancelled by the Kremlin through the use of false claims of environmental damage.

The most serious threats result from the danger of intervention at any point in the commercial process on the part of elite cartels who dominate the energy trade, particularly in Russia, Ukraine, and Central Asia. These cartels are composed of governmental leaders, intelligence officials, and favored business oligarchs. The composition of these elite groupings can and often does change suddenly, with a shift in the local political balance, only adding to business uncertainty.⁷

Western businesses are usually compelled to work with partners favored by elite cartels. Russia's Gazprom and Rosneft are possible examples. The same problem often holds true in Ukraine, Kazakhstan, and Turkmenistan. It appears to some observers that the purpose of these elite cartels is to build national and transnational networks and alliances. By doing so, they solidify their own power and wealth, while at the same time fending off challenges from more transparent and democratic business groups. This informal system of power also allows the elites to weaken, or even close down, nongovernmental organizations and political parties that demand greater transparency. The existing systems appear to be designed to enrich networks of higher level elites and/or their political parties, making it even more difficult for reform elements to bring about political and economic change.

In Russia, the Kremlin has been able to use funding from its energy monopolies to finance youth groups who often act as political "shock troops" by harassing and intimidating nongovernmental organizations (NGOs), opposition media, and even foreign diplomatic officials. Energy company officials may or may not have colluded with the government in the way their funds are disbursed,

⁷ Balmaceda, "Filling a Gap, Filling a Pocket."

but being state-controlled firms provides them with little alternative but to go along with direction from the Kremlin.⁸

Even in EU countries, elite groups may benefit from non-transparent transactions. The government of Prime Minister Ferenc Gyurcsány in Hungary was suspected by the political opposition of having too cozy a relationship with Eastern energy interests. It was one of the first governments to support Russia's controversial South Stream pipeline, in spite of opposition from Hungary's largest energy company.⁹ Budapest has been the headquarters of a succession of Ukrainian-owned intermediary companies that have been criticized for their lack of ownership transparency. Following considerable international comment regarding its activities, the controversial gas trading firm Eural Trans Gas, was closed down and replaced the same day (May 17, 2007), but with the same address and leadership, by Global Energy Mining and Minerals, which is also tied to gas trading firm EMFESZ.¹⁰ The latter company is now involved in a major court challenge with the little-known RosGas A.G., which took over the property of EMFESZ after RosUkrEnergo lost its assets in Ukraine.¹¹ There are rumors that all of these companies, with the exception of RosGas, are really majority owned by the same individual. In any case, none of these firms would qualify for listing on major international stock exchanges due to a lack of clarity regarding their ownership and financial situation.

In former Soviet-dominated states, such as Lithuania, business deals between pre-1990 Communist officials and Russian company representatives need closer examination. Thanks in part to indirect financial contributions from a Lukoil-related company, Lithuania's Social Democratic Party, was able to win the 2000 parliamentary elections and stay in power for the next eight years.¹² One can find similar cases in almost every Central and East European country.

In his excellent monograph regarding Gazprom's involvement in corrupt practices, the late Roman Kupchinsky wrote:

throughout the eight years of Vladimir Putin's presidency, Russia's state-owned natural gas monopoly Gazprom and its subsidiaries Gazpromexport and Gazprombank systematically created an elaborate web of opaque companies throughout Europe and Russia acting in league with various European partners. This network is linked to nameplate companies in Cyprus,

⁸ Anselm Waldermann, "The Nashi Movement: Russian Youth and the Putin Cult," *Spiegel Online International*, November 2, 2007, <http://www.spiegel.de/international/world/0,1518,514891-2,00.html>.

⁹ Judy Dempsey, "Hungary chooses Gazprom over EU," *New York Times*, March 12, 2007, <http://www.nytimes.com/2007/03/12/world/europe/12iht-hungary.4885468.html>.

¹⁰ Hungarian Ministry of Justice, [feketelista.hu](http://www.feketelista.hu), April 28, 2010, <http://www.feketelista.hu/kereses-egy-konkret-cegre/cegazonositas/248558-global+energy+mining+and+minerals+kereskedelmi+szolg%C3%A1llat%C3%B3+%C3%A9s+befektet%C3%A9si+kft/1/>.

¹¹ Stefan Wagstyl, Thomas Escritt, and Roman Olearchyk, "Gas billionaire claims fraud over lost unit," *Financial Times*, May 8, 2009, accessed at <http://www.unian.net/eng/news/news-314733.html>.

¹² Inga Pavlovaitė, "News from Lithuania: Toward the end of the campaign," *Central Europe Review* 2, no. 34 (October 2000), <http://www.ce-review.org/00/34/lithuanianews34.html>.

private foundations in Austria, and finance companies in Lichtenstein, which in turn are owned or controlled by shadowy Russian companies. The purpose for the creation of this web of companies is not only a mystery, but also a matter of growing concern for European businessmen, politicians, and law enforcement officials. Such elaborate layers, experts point out, are an indication of money laundering and possible kickbacks to officials involved in their creation. The companies are also believed to be linked to Russian and other organized crime groups.¹³

Greed and Political and Economic Consequences

In Ukraine's 2004 presidential election campaign, there was suspicion that funding by Ukrainian oligarchs, including some energy traders, may have been used by the Yanukovich forces to intimidate the "Orange" opposition and to provide financial "incentives" to those willing to vote for the official list of candidates.¹⁴ Unfortunately, the oligarchs and their supporters in Ukraine have no reason to change a system that empowers and enriches them, irrespective of the damage it inflicts on economic growth and the general standard of living.

Some observers are convinced that the destruction in Russia of the highly modernized and profitable Yukos oil company was a result of the company publishing its financial data, including the net worth of the firm's top executives. Once the size of their personal assets became publicly known (in order to meet transparency requirements for listing on Western stock exchanges), the elites in the Kremlin may have been motivated to take the company over and jail its top leadership. The political meddling of Khodorkovsky was a possible factor in the company's destruction, but greed by potential elite beneficiaries may have been at least as important an incentive for powerful individuals to hijack the company and silence Yukos's leadership.¹⁵ If Khodorkovsky had not been as well known in the West, he might well have suffered a fate worse than jailing, as have some of the Kremlin's other critics.

Russia's greater economic vulnerability, following the 2008 Western banking crisis and the subsequent lower demand for energy imports, was in part due to the failure of the elite beneficiaries of the energy wealth to invest the oil and gas income of the pre-2008 crisis period in innovative technologies and other export generating sectors. Too many members of the elites benefiting from the energy export revenues preferred to stash their wealth abroad or in property investments in Russia and Europe. This nontransparent wealth accumulation added to the real estate boom (and then bust) in the Baltic States, the United Kingdom, France, and Spain—and even in the United States.

¹³ Roman Kupchinsky, *Gazprom's European Web* (Washington, D.C.: Jamestown Foundation, February 2009), p. 4.

¹⁴ Edward Chow and Taras Kuzio, "The Real Yanukovich," *The Moscow Times*, May 19, 2010, <http://www.themoscowtimes.com/opinion/article/the-real-yanukovich/406258.html>.

¹⁵ Paul Quinn-Judge, "The End of the Affair," *Time*, July 11, 2004, <http://www.time.com/time/magazine/article/0,9171,662739,00.html>.

Non-transparent Wealth Accumulation Is Part of Larger Corruption Pattern

Polling among Russian business leaders indicates that corruption has increased significantly in the past six to eight years. The same polls claim that the widely applauded anticorruption program of President Dmitry Medvedev has had little to no effect on the number and size of illegal payments demanded of domestic and foreign companies in Russia.¹⁶ A few highly publicized cases, such as the Swedish company Ikea's unwillingness to pay off local officials in Russia, have resulted in pockets of progress.¹⁷ Unfortunately, the vast majority of corruption cases never make the news.

Why should we in the West assume that the increase in business corruption in Russia has not already spilled over into the activities of these same state-directed firms when they operate in the European Union, or even in the United States? Swedish economist Anders Åslund, who has worked for many years in Russia and Ukraine, estimates that 50 percent of Gazprom's investments are "lost" through corrupt practices.¹⁸ William Browder, who is now barred from entering Russia but for years was active in Hermitage Capital Management, a firm that was heavily invested in Gazprom, questioned publicly why Gazprom voluntarily forgoes significant profit each year by consigning large amounts of its business and revenue to murky intermediary firms. Many commentators assume that Browder is now being "punished" for having the temerity to question the practices of a firm indirectly managed from the Kremlin.¹⁹

Browder raises a good point, one that any Western firm or government dealing with Gazprom or any other state-controlled Russian company should consider before increasing its financial exposure in the energy sector. Some Western energy companies attempting to negotiate joint ventures with Russian firms have called off talks with potential Eastern partners rather than agree to funnel profits through off-shore accounts or to intermediary firms that bring no added value to the venture. Cyprus, Lichtenstein, and certain Caribbean islands are filled with "store front" companies or in some cases just bank boxes that are reportedly used by intermediaries in the energy business between Russia, Central Asia, and Europe. It would be unfair to assume that all firms located in these areas are laundering operations, but many of them, on closer examination, do appear to have been established for that reason.

¹⁶ Cynthia English and Neli Esipova, "Perceptions of Corruption High in Russia," Gallup, February 5, 2009, <http://www.gallup.com/poll/114145/Perceptions-Government-Corruption-High-Russia.aspx>.

¹⁷ "Growing IKEA Russia Corruption Scandal: Two Execs Fire," *Russia Monitor*, February 15, 2010, <http://www.therussiamonitor.com/2010/02/growing-ikea-russia-corruption-scandal.html>.

¹⁸ Anders Åslund, "Gazprom in crisis: a chance for reform," *European Energy Review*, April 26, 2010, http://www.europeanenergyreview.eu/index.php?id_mailing=67&toegang=735b90b4568125ed6c3f678819b6e058&id=1898.

¹⁹ "Russia 'is now a criminal state', says Bill Browder," BBC News, November 23, 2009, <http://news.bbc.co.uk/2/hi/8372894.stm>.

Norwegian journalists investigated the Shtokman Company that Statoil and Total were partnered with in a large multibillion-dollar gas development project in the Barents Sea. They discovered that the company headquarters was not much more than a post box located in Zug, Switzerland.²⁰ This leads to the question of why a highly respected company, Statoil, would accept this type of business arrangement. The same post box also served as headquarters for several other Russian-promoted companies. Of course, there may be tax advantages that come from its Swiss location, but maintaining a “virtual office” such as the Shtokman Company in Zug is one way of avoiding greater financial transparency. Operating at a more transparent level would provide a greater degree of assurance to investors and potential importing countries.

Zug is also the site for the head office of the Russo-German Nord Stream Company, which is building a controversial natural gas pipeline under the Baltic Sea from Primorsk, Russia, to Germany. The CEO of this company is former German chancellor Gerhard Schröder. While in his final days in office, he pushed successfully for German government loan guarantees for this pipeline project.²¹ He then joined the company almost immediately after stepping down as chancellor. His deputy at Nord Stream is Mattias Warnig, a former East German intelligence officer who helped put the pipeline deal together. Warnig was also associated with then-KGB officer Vladimir Putin, when the latter was operating out of Dresden during the Cold War.²² While this is not evidence of corruption, the manner in which the deal was put together leads to questions of whether it should have been allowed to proceed. One has to ask why the European Union endorsed the project after almost no debate and no investigation of the environmental and financial consequences of a project designed to avoid passing through a member state.

Gazprom Germania, the German company that supplies Russian gas, is majority owned by Gazprom. Several of its top officials are former East German intelligence officers.²³ Having been a Stasi officer may be excellent training for wheeling and dealing in the relatively non-transparent world of energy trading. Securing influence is the name of the game, and these intelligent and savvy gentlemen are masters of the trade. Former Soviet bloc intelligence officials have been particularly successful in Germany and Austria, although they retain considerable influence in most of the former Warsaw Pact countries.

²⁰ Goran Skaalmo and Trond Sundnes, “Dr. Shtokman,” *Dagens Naeringsliv*, September 21–22, 2008.

²¹ “Schroeder attacked over gas post,” BBC News, December 10, 2005, <http://news.bbc.co.uk/2/hi/europe/4515914.stm>.

²² Tom Parfitt, “Putin’s enemies call for investigation into links with Stasi agent,” *Telegraph.co.uk*, February 27, 2005, <http://www.telegraph.co.uk/news/worldnews/europe/russia/1484535/Putins-enemies-call-for-investigation-into-links-with-Stasi-agent.html>.

²³ Roman Kupchinsky, “Gazprom’s Loyalists in Berlin and Brussels,” *Eurasia Daily Monitor* 6, issue 100 (May 26, 2009), http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=35034&cHash=9d3187ad25.

Gazprom's murky relations with Italian businessmen and alleged Sicilian mafia figures are described in detail in Roman Kupchinsky's well-documented *Gazprom's European Web*.²⁴

In 2002, Curt Weldon, the former U.S. representative from Pennsylvania who was prominent in attempts to improve relations with Moscow, helped arrange a grant from the U.S. Trade and Development Agency to Russia's Itera, a gas trading company, for the sum of \$868,000. His daughter Karen was hired by Itera at a salary of \$500,000.²⁵ Although Itera registered itself in Florida, the company was almost wholly owned by well-connected Kremlin friends, and it received its natural gas from Gazprom. Much of Itera's business in Europe was replaced by Eural Trans Gas, which was later taken over by RosUkrEnergo. The latter two companies relied on Gazprom gas, but they were often questioned by the press for their lack of transparency and even the need for their existence.

In recent years, President Vaclav Klaus of the Czech Republic has developed a close relationship with Russia's Lukoil, the company that paid for the translation into Russian of Klaus's book *Blue, not Green Planet*,²⁶ which pans the idea of global warming.²⁷ Klaus was also one of the few European leaders who did not criticize Russia over its 2008 war with Georgia. It was reported in the Czech media that twice within 18 months, Klaus met secretly with Vagit Alekperov, the CEO of Lukoil. Czech intelligence sources reportedly stated that Russia is using its energy companies to influence the Czech Republic's energy security.²⁸ While there is no reason to believe that this is a case of corruption, it does indicate the substantial degree of influence exercised by Russia's energy companies in the new democracies. More attention should be given to this influence by Europe's media and other government watchdogs.

In 2008 in the United Kingdom, it was reported that Pauline Neville-Jones, then shadow security minister and former chair of the Joint Intelligence Committee, now UK minister for security, accepted a considerable amount of money from the DF Group, a company linked to Ukrainian businessman Dimitri Firtash, who is a major shareholder in RosUkrEnergo, along with Gazprom.²⁹ Press and other reports have alleged that Firtash has been connected to a major

²⁴ Kupchinsky, *Gazprom's European Web*.

²⁵ Carol D. Leonnig and R. Jeffrey Smith, "Homes Raided in Rep. Weldon Influence Probe," *Washington Post*, October 17, 2006, <http://www.washingtonpost.com/wp-dyn/content/article/2006/10/16/AR2006101600545.html>.

²⁶ Вацлав Клаус, *Синя, а не зелена планета* (Prague: International Relations Publishing House, 2008). The book was also published in the United States: Vaclav Klaus, *Blue Planet in Green Shackles: What Is Endangered: Climate or Freedom?* (Washington, D.C.: Competitive Enterprise Institute, 2008).

²⁷ Jiri Kominek, "Russian Energy Companies Expand their Operations in Central Europe," *Eurasia Daily Monitor* 6, issue 55 (March 23, 2009), http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=34746.

²⁸ Tom Lawrence Jones, "Russian energy interests linked to Czech political financing," *Czech Business Weekly*, March 11, 2010, <http://www.cbw.cz/article/russian-energy-interests-linked-to-czech-political-financing.aspx>.

²⁹ David Leigh and Solomon Hughes, "Oligarch's adviser funds Tory," *Guardian.co.uk*, October 25, 2008, <http://www.guardian.co.uk/politics/2008/oct/25/partyfunding-conservatives>.

organized crime figure in Russia.³⁰ Although the British Electoral Commission ruled that the donations were not illegal, it did state that it was keeping the situation under review. The same company reportedly founded the British-Ukrainian Society and contributed money for courses at Cambridge University.³¹

While the above three cases cannot be labeled as evidence of corruption, there is certainly suspicion that the energy firms involved were dispersing funds to politically influential people with the expectation that they were buying “good will.” Gazprom, according to the U.S. Justice Department, spends about \$250,000 a month in Washington, D.C., on public relations and other services, and spends substantial sums in Brussels and other European capitals for the same purposes.³² Unfortunately, most East Central European countries do not have an aggressive investigative press that can throw similar light on the activities of Russian/Ukrainian energy companies in the West. Nor do most European governments require the detailed reporting that is necessary in the United States.

Investment Risks

The well-known asset losses and contractual problems of Shell, BP, Exxon, Matsui, and Mitsubishi in Russia are only the most highly publicized cases of contracts being arbitrarily changed. It seems that when doing business in Russia, too often a contract is not a contract—even if there are solid international arbitration clauses written into the original agreement. The continuing legal and political troubles confronting BP’s joint venture with TNK, the ostensibly private but politically connected Russian company, should be closely studied by Western companies contemplating new energy ventures in Russia.³³

Western firms are rarely in a position to bid on projects in Russia in which there are transparent and well-supervised tenders. Even when they do, the results seldom meet Western transparency standards. Too often, in Russia, Ukraine, and Central Asia, taking a “local partner,” who is a member of some elite oligarchic group, is the admission ticket. Paying the admission fee, however, often leads to a watering down of the Western partner’s assets or ultimately to a complete takeover by the local “investor.” A good example to study in this regard is the long, drawn-out investment project in Ukraine by U.S.-owned Vanco Energy. Its original UK partner,

³⁰ Roman Kupchinsky, “The Role of Russian Organized Crime in the Gas War of January 2009,” *Eurasia Daily Monitor* 6, issue 17 (January 27, 2009), http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=34416.

³¹ Cahal Milmo, “Tories took donations from Briton linked to Ukrainian billionaire,” *Independent.co.uk*, October 25, 2008, <http://www.independent.co.uk/news/uk/politics/tories-took-donations-from-briton-linked-to-ukrainian-billionaire-973381.html>.

³² “Fact sheet on Russian government’s lobbying efforts in the United States and Europe,” U.S. Department of Justice, November 12, 2008.

³³ Robin Pagnamenta, “Trouble on the Russian front as BP offshoot faces loss of big gasfield,” *The Times* (London), February 17, 2010, http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article7031428.ece.

JNR Eastern Investment, the Rothschild's Eastern European investment company, pulled out of the venture even after securing exploration rights in Ukraine's territorial seas. The reasons for JNR's decision to abandon the project are not clear, but it quickly became evident that Vanco had somehow acquired new partners, including one who is Ukraine's leading oligarch, in addition to two other firms with unclear ownership.³⁴

Cardinal Resources, an American-Canadian company producing oil and gas in Ukraine was forced out of business there in 2007 as a result of the sudden introduction by the Yanukovich government of a decree that set a price cap for foreign companies involved in joint activity agreements.³⁵ This move was clearly aimed at Cardinal by setting a price that it could charge for its products at a level that was far below the cost of production. It was an obvious maneuver by local business interests to take over Cardinal's profitable venture. It is easy to conclude at times that energy decisionmakers in Ukraine and Russia pretend to adhere to international business standards, and Europe pretends to believe that this poses no risk to Europe or international security. This is especially the case in energy deals with European companies that are negotiated by the Kremlin.

Weak Western Reaction

The feeble reaction of Western governments and the European Union to non-transparent business practices by Moscow only encourages the Kremlin to believe in the effectiveness of its aggressive energy policies. As evidence of the West's weak reaction, one could point to the willingness of Western governments to ignore politically motivated energy disruptions in East Central Europe caused by Transneft and Gazprom. The European Union's lack of effective action also extends to the apparent acceptance of monopoly and antitrust practices on the part of Russian companies. These antitrust and anticompetition practices are a clear violation of Article 82 of the EC Treaty, Article 45 of the Energy Charter Treaty, and now of the Lisbon Treaty.³⁶

Western governments continue to be reluctant to investigate and enforce the antibribery laws and regulations of the European Union and the Organization for Economic Co-operation and Development (OECD). The lack of a common EU approach to Russian and Central European

³⁴ Myroslav Demydenko, "Ukraine, Vanco Energy, and the Russian Mob," *Eurasia Daily Monitor* 5, issue 177 (September 16, 2008), http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=33941&tx_ttnews%5BbackPid%5D=166&no_cache=1.

³⁵ Morgan Williams, "Ukraine decree 31 is destructive to the development of energy resources—Rob Bensch, President of Cardinal Resources," Unian.net, August 13, 2007, <http://unian.net/eng/news/news-207517.html>.

³⁶ European Union, "Consolidated Versions of the Treaty on European Union and of the Treaty Establishing the European Community," *Official Journal of the European Union*, December 29, 2006, <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:321E:0001:0331:EN:pdf>; and Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents* (Brussels: Energy Charter Secretariat, 2004), http://www.encharter.org/fileadmin/user_upload/document/EN.pdf.

energy policies allows Moscow to carry out a “divide-and-conquer” strategy that plays to the particular vulnerabilities of each European state.

Most EU member states do not require that their national firms accepting payments from foreign governments or companies report this information to official government agencies or that facts concerning such payments be made available to the public. This makes it virtually impossible for the local government, the press, or private researchers to know who is behind foreign-directed public relations campaigns or political influence peddling.

The problem is particularly pronounced in countries where the media is either not able or unwilling to engage in aggressive investigative reporting. Many newspapers and television stations in the new democracies are in precarious financial positions and are vulnerable to offers of help from well-financed foreign companies or their intelligence services. In 1999, it was widely reported in the local press that a former KGB officer was assigned as Russian ambassador to Lithuania.³⁷ Almost immediately, the editorial position of at least one newspaper changed dramatically, with a clear bias in favor of Russian over American investment in the country’s key energy facility. The assumption made by some was that this paper was taking financial support from the Russian embassy.

The EU organizations in Brussels are particular targets of Eastern intelligence services, who in many cases are promoting the interests of their country’s energy companies. Although the European Union attempts to track their activities, the scale of the challenge is beyond the European Commission’s resources. The European Union does try to determine the origins of companies doing business directly with the European Commission, European Parliament, and other EU-financed organs, and some firms have been barred informally from doing business with the Commission. Although the European Commission has established a voluntary registry of foreign firms that lobby that organization, the European Council has yet to establish any requirement. Firms that do not register with the Commission, however, may be treated with extra caution.³⁸ The European Parliament does not investigate firms that lobby its members, but it does limit passes to official buildings to one year at a time. This may not act as a deterrent to questionable activities, since the Parliament does not have a formal list of firms that are barred from doing business in EU buildings.

Nevertheless, lobbying and public relations firms in Brussels are frequently hired directly and indirectly to further the interests of Gazprom and other Russian companies.³⁹ Russian nationals are regularly employed by the European Union, and while there is no public evidence that they

³⁷ “Former KGB Agent to Represent Russia in Lithuania,” *Bridges* 23, issue 8 (October 1999), <http://www.lithuanian-american.org/bridges/iss899/current.html>.

³⁸ Leigh Phillips, “Majority of Brussels lobby firms avoid registry,” *EUobserver.com*, March 11, 2010, <http://euobserver.com/9/29658>.

³⁹ Marlena Mistrzak, “Moscovites in Brussels,” *Wprost weekly*, January 17, 2010, accessed at http://www.robertamsterdam.com/2010/01/the_russian_lobbyist_invasion_of_brussels.htm.

add to corruption, it is logical to wonder whether some of these people serve the interests of Moscow before those of the EU members.

The United Nations, Russia, Food for Peace, and Spies

In order to relieve what was believed to be a serious health problem among children as a result of economic sanctions imposed on the Saddam Hussein regime, the United Nations carried out what was billed as an “oil-for-food” program from 1996 to 2002. According to a report subsequently commissioned by the United Nations to examine the results of the program, over \$1.8 billion in kickbacks and illegal surcharges were made by Iraq in collusion with over 2,000 companies worldwide. The report claims that the Russian state and a multitude of Russian companies, organizations, and individuals were the largest beneficiaries of the illegal payments. These Russian groups clearly benefited by illegal trading that diverted money from a humanitarian program designed to relieve starvation among Iraq’s children. Companies from many other countries took part in the scheme, including an American firm, but the bulk of the illegal payments reportedly ended up in Russia.⁴⁰

The little-known Russian energy company named Zarabeneft (sometimes referred to as Zarubeneft), which is tied directly to the Kremlin, was reportedly given the largest amount of oil from Iraq, 174.5 million barrels. Lukoil, Gazprom, Russneft, Moscow Oil Company, Slavneft, Surgetneftegaz, and Soyuzneftgaz were also implicated in the scheme.⁴¹ Even the Russian Orthodox Church and the Moscow Academy of Sciences reportedly benefited. According to a former KGB officer, the UN official who played a key role in the diversion of almost half a billion dollars from the humanitarian side of the program was also an undercover agent for Russia’s foreign intelligence service.⁴² Not surprisingly, the Russian government refused to cooperate with the UN investigation, and Russia’s foreign minister denigrated the veracity of the report when it was released.⁴³

The constant world demand for oil and natural gas, combined with a lack of transparency in much of the energy trade, opens the window for corruption, coercion, and collusion on a scale not seen in other economic sectors. With new energy discoveries in Africa, the World Bank has come

⁴⁰ Sharon Otterman, “Iraq: Oil for Food Scandal,” *Backgrounder*, Council on Foreign Relations, October 28, 2005, <http://www.cfr.org/publication/7631/iraq.html>.

⁴¹ Nimrod Raphaeli, “The Saddam Oil Vouchers Affair,” Inquiry & Analysis Series Report No. 164, Middle East Media Research Institute (MEMRI), February 20, 2004, <http://www.memri.org/report/en/0/0/0/0/0/1067.htm>.

⁴² James Bone and Tony Halpin, “Comrade Sid: spy who siphoned off \$½ bn from Iraq Oil-for-Food deal,” *The Times* (London), March 28, 2008, http://www.timesonline.co.uk/tol/news/world/us_and_americas/article3636018.ece.

⁴³ Jaclyn Schiff, “Oil-For-Food Probe Charges Denied,” CBS News, October 29, 2005, <http://www.cbsnews.com/stories/2005/10/28/world/main994343.shtml?CMP=ILC-SearchStories>.

to recognize that it is next to impossible to institute sustainable anticorruption laws and regulations in new energy producing states. Of course, the case cited above regarding the illegal diversion of funds from the UN Oil-for-Food Program did not involve new energy producers or unsophisticated government officials. The question for both old and new EU member states is to what degree they should trust the business ethics of those companies implicated in Saddam Hussein's scam.

Competition and Transparency

Market liberalization and privatization of energy assets in European states with weak judiciaries or antitrust enforcement has been an advantage for Russian state companies competing with Western firms for business in the region—especially when the latter adhere to the OECD convention on antibribery of foreign officials. There is a danger that this may lead, or may have already led, to the enrichment of some well-positioned individuals in EU member states by firms attempting to overcome Western restrictions.

The new democratic states of Central and Southeastern Europe have been relatively passive in dealing with transparency and anticorruption issues. One reason for this could be that there are large numbers of political and economic leaders in the region who are holdovers from the Communist period. In the chaos resulting from the collapse of the Soviet Union and the Warsaw Pact, many former officials were able to gain control of the Communist Parties' assets and/or purchase large industries cheaply. Not surprisingly, the business ethics of most former Communist officials did not significantly change with the fall of the old system. Of course, the leaders of the new democracies are already faced with many problems, not the least of which is implementing the multitude of laws and regulations required for EU membership. Reformers find it difficult to curb the activities of the old-new business elite, particularly when these people already possess much of the countries' wealth and influence and often control large parts of the media.

A lack of attention to this problem by the European Union may, to some extent, be the result of the European Commission's concentration having been diverted by the need to deal with "widening and deepening" issues and securing the passage of the Lisbon Treaty. Nevertheless, the European Union has not focused enough on transparency issues in new member states once membership has been achieved, with the possible exception of Bulgaria and Romania. Like the U.S. government, the large European states lost much of their previous interest in "nation building" in the post-Communist states once the formal democratic structures were in place.

Murky Alliances

The weak state of transparency in Central Europe aids the formation of new alliances between East European elites and the former Communist/intelligence class in Russia who dominate the major energy companies. This again puts Western firms at a clear disadvantage when negotiating for facilities acquisition or pipeline construction. With the renationalization of Russian energy

assets, more of the negotiations with the West are carried out by top Kremlin officials. Fewer agreements are carefully negotiated at the company level. It is fair to ask whether there are many Western political leaders who can negotiate effectively with the seasoned intelligence officers in the Kremlin who determine Russia's energy policies.

Western leaders rarely have the skills or the ability to fully mobilize the state's resources to negotiate on an equal basis, and they often lack good intelligence regarding the tactics of the other side. Russia's top leadership is directly involved in energy sector deals with other countries. Prime Minister Putin devotes more time and attention to promoting his country's energy interests than does any leader from a Western country. Putin knows how to effectively use the Russian intelligence services to promote pipeline projects and downstream acquisitions. This does not necessarily indicate that the agreements are the result of corruption, but present or former intelligence officers involved in cross-border deals are not constrained by OECD anticorruption agreements or by laws such as the U.S. Foreign Corrupt Practices Act.⁴⁴

In addition, Western firms that attempt to carry out due diligence on prospective partners or on government ministries and regulatory agencies, are often frustrated by either a lack of information or the reliability of the data fed back to them. In some cases, it is impossible for a Western firm to know if those doing their due diligence are truly objective agents—even in cases where the firm is headquartered in the West and staffed with Western personnel. Too many European, American, Canadian, and Japanese energy firms have been taken by surprise by issues that should have been flagged during the due diligence phase. At some point, one has to ask whether they really wanted to know “too much” about their Eastern business partner. If the Eastern partner has succeeded in being listed on the New York or London exchanges, there is a fair chance that the partner has an incentive to “play by the rules.” If not listed, and most are not, a lot of “red flags” should have been raised.

One should keep in mind that some well-known Western banks have colluded with Russian or Ukrainian interests to hide the true ownership of companies engaged in the energy business. Some governments have also been visibly lax in enforcing laws against money laundering by their nationally registered banks. This works to the advantage of non-transparent, state-owned energy companies in Russia and murky private companies registered in EU states.

In sum, corruption in East-West energy trade will only end or diminish significantly when the large import countries decide that it is in their collective interests to abandon the practice of looking past non-transparent practices. They must be persuaded to stop attempting to give their own countries' energy firms a competitive edge at any cost. If they demand “best practices” by their own commercial interests and closely monitor the activities of government officials engaged in energy transactions, the more vulnerable “new democracies” will be more inclined to follow. When the large and more prosperous countries of Europe ignore corruption in the energy trade,

⁴⁴ *Foreign Corrupt Practices Act, U.S. Code*, Chapter 2B Securities Exchanges, July 22, 2004.

they indirectly facilitate coercion of the new and smaller states of the region by more non-transparent, state-directed energy importers and foreign investors.

Recommendations

- The European Commission and European Council should push for full implementation of the European Parliament's September 26, 2007, resolution that called for a "common European foreign policy on energy."⁴⁵ Carrying out the Parliament's recommendations would help "level the playing field" for Western investors, reduce opportunities to engage in non-transparent or corrupt business practices in the East-West energy business, and decrease the large profits that stem from monopoly control of piped natural gas exports from the Caspian Sea countries and Russia to Europe.
- Western governments and firms should petition the EC Directorate General for Competition (DG COMP) and national governments to enforce more vigorously the existing antitrust and competition policies, particularly in regards to Russian state companies. Greater import competition would lower prices for consumers and for Western power and refinery operators. Opening existing Russian pipelines to competitors would increase the supply of oil and gas coming from Russia and Caspian Sea countries and bring more predictability in supply. This might also increase competition and exploration and development in Russia by incentivizing smaller energy firms.
- Wider enforcement of the "unbundling" policies being pursued by DG COMP would be a positive step forward. This should be of particular interest to the smaller EU member states, since they are hurt by the national energy "champions" in the larger and more prosperous states that demand protection against competition.
- The European Council and European Parliament should consider establishing an independent regulatory agency with the authority to monitor (but not approve or disapprove) all major energy agreements between EU and non-EU companies. Such an entity would report to the European Commission regarding the likely effect of the proposed agreement on the broader EU energy market. The agency could enforce a minimum level of accounting and revenue transparency in international energy contracts, extending to all companies (domestic or foreign) that do business within EU member states.
- Require all member governments to notify the Commission at the start of negotiations with foreign entities regarding the construction of new energy pipelines, when offering tenders for energy contracts, and when conducting talks for the sale of existing facilities within their

⁴⁵ European Parliament, "Towards a common European foreign policy on energy," resolution, September 26, 2007, <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2007-0413&language=EN&ring=A6-2007-0312>.

borders. This might counteract the “divide-and-conquer” activities of Russian state-owned energy firms, thereby leading to greater cooperation by EU states.

- Western energy companies would benefit from tighter enforcement of uniform reporting requirements applied to domestic and foreign firms doing business within the European Union—mandating revenue transparency reporting for their operations at home and abroad. This would weaken the present advantage held by firms from countries with high levels of business corruption and an unwillingness or inability to enforce existing contracts. It would also help lead to more information regarding the real ownership of companies registered in countries that shelter firms from tax and other transparency requirements that should be enforced in OECD member states.
- Firms should be barred from including confidentiality clauses that hide revenue transparency in contracts with foreign energy companies. The OECD should encourage member firms to conduct more comprehensive due diligence on prospective partners in countries with less rigorous accounting and reporting requirements. Perhaps the OECD could draw up guidelines that would help new or less experienced firms that are becoming more actively involved in international energy trade and investment.
- The European Commission should be more active in defending member states against politically motivated disruptions in energy flows from Russia, such as occurred in Lithuania and Latvia. Leaving this issue unresolved also further encourages those elements in Russia that oppose domestic reform and enforcement of the rule of law.
- The European Union, the United States, and the World Bank should provide greater assistance to the new democratic states in strengthening their judicial systems, particularly commercial law courts.
- Judicial reform in some Western states could include discouraging the courts from supporting “libel tourism,” where large, well-financed energy companies, which may be engaged in corrupt or shady business practices, use the court system to silence their critics in the media or academia. This problem, most evident in the United Kingdom, discourages investigative journalism and contributes to continued corrupt business practices.

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