DEN NORSKE ATLANTERHAVS KOMITE
THE NORWEGIAN ATLANTIC COMMITTEE

Security Brief **4-2008**

INVESTMENT ATMOSPHERE IN THE ENERGY TRADE: CORRUPTION AND NON-TRANSPARENCY

By Keith C. Smith (Center for Strategic and International Studies)

The growing dependency in Europe on non-transparent financial transfers in the energy trade is as great a danger to Europe as is the increasing dependency on Russia as the primary energy source. Non-transparent and corrupt business practices can have a corrosive effect on European governments, and especially on the new EU member states of East Central Europe. Western energy companies trying to conduct business in Russia, Ukraine or in Central Asia confront constant pressure from local officials and energy companies to engage in shady business practices when considering investment decisions. Record high energy prices have increased opportunities for non-transparent Russian 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 decision-making processes in both consumer and supplier countries. According to Russian economists, the business climate within the Russian energy sector has become even less transparent and more corrupt in recent years. Increasing corruption, along with the re-nationalization in Russia of the large energy companies has led to a decline in new investment in exploration and development. This has resulted in tighter energy markets, higher prices and greater uncertainty among potential importers and investors in the ability of Russia to fulfill its long-term energy contracts.

Corruption and re-nationalization has also weakened the bargaining position of Western firms using best practices when engaging in East-West energy trading. The increasing dominance of Russian state-controlled energy companies has also led to a marked reduction of alternative investment possibilities for Western companies. This further increases the temptation by Western firms to agree to demands by Eastern energy suppliers to engage in practices not acceptable when dealing with another Western firm. It also raises the likelihood that some Western governments will ignore questionable practices by their countries' energy suppliers.

Predictability in making business decisions is already difficult for Western energy firms. This is more the result of the increased danger of intervention at any point by elite cartels who dominate the energy trade, particularly in Russia and Central Asia. These cartels are composed of governmental leaders, intelligence officials and favored business oligarchs. The composition of these elite groupings can suddenly change, with a shift in the local political balance, only adding to business uncertainty. Western businesses are often compelled to work with partners favored by elite cartels, with Gazprom and Rosneft as prime examples. The same often holds true in Ukraine, Kazakhstan and Turkmenistan. The purpose of these elite cartels is to build national and transnational networks and alliances that solidify their own power while they stave off opposition by more transparent and democratic business groups. The result is to enrich networks of higher level elites, making it even more difficult for reform elements to bring about political and economic change.

Polling among Russian business leaders indicates that corruption has significantly increased in the past six to eight years. 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 EU, or even in the U.S.? The Swedish economist Anders Aslund, who has worked for many years in Russia and Ukraine, estimates that 50 percent of Gazprom's investments are lost through corrupt practices. William Browder who is now barred from entering Russia, but for years has been active in Hermitage Capital Management, a firm that is heavily invested in Gazprom, has questioned publicly why Gazprom voluntarily foregoes significant profit each year by consigning a large amount of its business to murky intermediaries? Many commentators assume that Browder is being "punished" for having the temerity to question the practices of a firm indirectly managed from the Kremlin.

However, Browder asks a good question, one that any Western firm 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 state 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 and other off-shore havens are filled with companies that are reportedly intermediaries in the energy business between Russia, Central Asia and Europe, but bring no added value to the transactions. It would be an exaggeration to think that all Cyprus-based firms are laundering operations, but many of them appear to have been established for that reason.

The highly-publicized asset losses and contractual problems of Shell, BP, Exxon, Matsui and Mitsubishi in Russia are only the most highly publicized cases of contracts being arbitrary changed. It seems that when doing business in Russia, a contract is not a contract – even if there are solid international arbitration clauses written in to the original agreement. The recent legal troubles of TNK/BP should be closely studied by Western companies contemplating new energy ventures in Russia.

Western firms are rarely in a position to bid on projects where there is a transparent well-supervised tender. Too often, in Russia, Ukraine and in Central Asia, taking in a "local partner" who is a member of one or another 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." One European observer said, "Russia pretends to adhere to international business standards, and Europe pretends to believe that this poses no risk to Europe or international security."

The feeble reaction of Western governments and the EU to non-transparent actions by Moscow only encourages the Kremlin to believe in the effectiveness of its aggressive energy policies. As evidence of the West's weak reaction we could point to their willingness to ignore politically motivated energy disruptions in East Central Europe by Transneft or Gazprom, and to the acceptance by Europe of monopoly and anti-trust practices on the part of Russian companies. These anti-trust and anti-competition practices are a clear violation of Article 82 of the EC Treaty and of Article 45 of the Energy Charter Treaty.

There continues to be reluctance on the part of Western governments to investigate and enforce EU and OECD anti-bribery laws and regulations. The lack of a common EU approach to Russia and Central European energy policies allows Moscow to carry out a "divide and conquer" strategy that plays to the particular vulnerabilities of each European state.

Market liberalization and the privatization of energy assets in European states with weak judiciaries or anti-trust enforcement has been an advantage for Russian state companies competing with Western firms – especially when the latter adhere to the OECD convention on anti-bribery 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 European member states.

The new democratic governments of Central Europe have been relatively passive in dealing with transparency and anti-corruption issues. This may be a result of the large number of political and economic leaders who are holdovers from the communist period. The attention to these matters by the EU has also been diverted by the need to deal with "widening and deepening" issues. Not enough focus has been given to transparency issues in new member states once EU membership has been achieved, with the exception of Bulgaria and Romania.

The weak state of transparency in Central Europe facilitates the formation of new alliances between East European elites and the former communist/intelligence elite in Russia who dominate the major energy companies. This puts Western firms at a clear disadvantage when negotiating for facilities acquisition or pipeline construction. With the re-nationalization of Russian energy assets, more of the negotiations with the West are carried out by top governmental officials. Fewer agreements are seriously negotiated at the company level. It is fair to ask whether there are many Western leaders who can negotiate effectively with the seasoned intelligence officers in the Kremlin who are in charge of Russia's energy policies? Western leaders rarely have the skills or the ability to fully mobilize state resources required to negotiate on an equal basis.

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 the Western firm to know if those doing the due diligence are really objective agents – even in cases where the firm is headquartered in the West and staffed with Western personnel. Too many Western energy firms have been taken by surprise by issues that should have been flagged during the due diligence phase.

RECOMMENDATIONS:

- The EU Commission and Council should push for full implementation of the Parliament's September 26, 2007 resolution that called for a "common European foreign policy on energy." 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 profit that stems from monopoly control of piped natural gas exports from the Caspian Sea countries and Russia to Europe.

- Western firms should petition the EU, DG COMP and national governments to enforce more vigorously existing anti-trust and competition policy, 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 also increase the supply of oil and gas coming from Russia and Caspian countries and bring more predictability in supply. The "unbundling" policies being pursued by DG COMP would be a positive step forward.

- The Council and 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. It would report to the Commission regarding the likely effect of the proposed agreement on the broader EU energy market. The agency could enforce a minimum level of 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, the offering of tenders for energy contracts and when conducting talks for the sale of existing facilities within their border. This might counteract the "divide and conquer" activities of

B
NORGE
DISTRIBUERT AV POSTEN NORGE
P.P.
Returadresse:
Den Norske Atlanterhavskomité
Fr. Nansens pl. 8
0160 Oslo

Russian state-owned energy firms, thereby leading to greater cooperation by EU states.

- Western energy companies would benefit from a uniform reporting requirement that applied to domestic and foreign firms doing business within the EU; one that mandates 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.

- Firms should be barred from including confidentiality clauses that hide revenue transparency in contracts with foreign energy companies.

- The EU 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. An unwillingness to defend EU members from this kind of disruption only disadvantages the energy firms and the state interests targeted by Moscow. It also further encourages those elements in Russia who oppose domestic reform and enforcement of the rule of law.

Keith C. Smith is a Senior Associate with the Energy and national Security Program at the Center for Strategic and International Studies in Washington

The views expressed above are solely those of the author and do not necessarily represent those of the Center for Strategic and International Studies.

www.heglandtrykk.no

DNAK Security Brief:

The DNAK Security Brief series aims to present current topics in foreign and security policy in a succinct way.
The series was firs published in June 2001.

Editor: Neving Rudskjær
ISSN: 1502-6361