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ganisations to undertake complex investigations involving huge and varied datasets, providing visualisation and analysis tools which are used by 1500 organisations in 90 countries. i2 Limited has very generously supplied this software to Global Witness, along with intensive support and consultancy.



Recommendations

The governments of the Russian Federation and Ukraine should:

- Require any companies employed in the transportation of Turkmen gas to be transparent, independently audited entities that make public the identities of all their shareholders and beneficiaries;
- Avoid the use of barter transactions in gas deals;
- Adopt best international practice in the publication, auditing and citizen oversight of natural resource revenues, drawing on such models as the Extractive Industries Transparency Initiative (EITI) and the International Monetary Fund (IMF) Guide to Resource Revenue Transparency.

The government of Ukraine should:

- Renew efforts to investigate alleged impropriety by government officials and intermediary companies, publish the results of investigations and, if wrongdoing is established, prosecute those responsible;
- Publish full, independent audits of the state oil and gas company Naftohaz Ukrainy for the years where information has not previously been available (that is, for most of the company's existence).

The government of the Russian Federation should:

- Show leadership on its G8 Presidency theme of energy security by investigating all credible allegations of wrongdoing in its natural gas sector and by endorsing and adopting best practice in revenue transparency;
- Ratify the Energy Charter Treaty and its Protocols which would provide for more transparent transit arrangements for gas and oil and provide for a rulesbased approach to dispute resolution;
- Extradite former Naftohaz Ukrainy chairman Ihor Bakai to Ukraine where he is wanted on charges of the misuse of state funds.

The government of Turkmenistan should:

· Provide for a full, independent and published audit of

all off-budget funds and adopt best practice in disclosure and management of natural resource revenues according to the EITI and the IMF Guide to Resource Revenue Transparency.

The government of Germany (and the governments of other EU member states) should:

• Tighten banking laws to prevent the use of domestic banks by foreign public officials who, like President Niyazov of Turkmenistan, are not subject to even a basic degree of public accountability for their use of state funds.

The European Union should:

- Not enter into any agreements with Turkmenistan, concerning trade or otherwise, until its government makes a commitment to, and shows measurable progress towards, implementing basic norms of fiscal transparency as defined, for example, in the IMF Manual on Fiscal Transparency and Guide to Resource Revenue Transparency;
- Recognise that good governance in neighbouring countries in the former Soviet Union, the Middle East and North Africa which provide energy to Europe, whether as producers or transit countries, is inextricably linked to the security of Europe's energy supplies;
- Make the promotion of transparency and improved governance in the energy industries of neighbouring countries a top policy priority. This theme should be embedded in all the EU's neighbourhood agreements signed with resource revenue-dependent countries and in the diplomatic, aid and trade activities of the EU and its member states. This work should include capacity-building assistance to help civil society groups in these countries act as independent monitors of their energy industries;
- Encourage all resource revenue-dependent countries in Eastern Europe, the Middle East and North Africa to join the EITI and implement the provisions of the IMF Guide to Resource Revenue Transparency and provide technical assistance to help them do so.

Summary



This is the story of a trade that brings natural gas from the Central Asian country of **Turkmenistan** through **Russia** and **Ukraine** to the **European Union** (EU). Far from being open to scrutiny by the citizens of these countries, this trade has long been controlled by a handful of people and a series of mysterious intermediary companies. Although the business is worth billions of dollars a year, it is still unclear where much of this money goes.

The EU is increasingly reliant on gas supplies from the former Soviet Union. The gas price dispute between Russia and Ukraine in the winter of 2005/6 sent shivers of anxiety across Europe that, in the depths of winter, the continent might not get enough fuel to keep warm and power its industries. Yet the dependence of EU countries on gas from Russia and Central Asia is only likely to grow. This report poses a difficult question for the EU and its neighbours: can they meet their energy needs without funding corruption and undermining good governance in the countries that supply or transport this energy? The time has come for transparency in the natural gas trade, to the benefit of citizens across the region.

The dictator and Deutsche Bank

The story starts in the Central Asian country of Turkmenistan, a former Soviet republic that is crumbling under the tyranny of its president, **Saparmurat Niyazov**. Turkmenistan is thought to earn more than US\$2 billion per year from natural gas but its citizens have no information as to where that money is going because the revenues are managed in a completely opaque way. It is clear that the money is not being spent on them: standards of health, education and living quality have plummeted since independence in 1991. Political freedom is non-existent, censorship is total and over half the population is unemployed. Despite its gas wealth, Turkmenistan's citizens are worse off than in Soviet times.

Global Witness has discovered that President Niyazov keeps most of the gas revenues under his effective control in overseas and off-budget funds. Indeed, a horrifying 75% of the state's spending also appears to take place off-budget. Global Witness has received several credible estimates that the total money under Niyazov's control and held overseas is likely to exceed US\$3 billion, some US\$2 billion of which appears to reside in the **Foreign Exchange Reserve Fund** (**FERF**) at **Deutsche Bank** in Germany.

Global Witness has discovered that, according to a 2001 contract, gas revenues from 2002 to 2006 were intended to be paid into Central Bank of Turkmenistan account no. 949924500 at Deutsche Bank, Frankfurt, but little else can be determined about exactly how Niyazov is managing Turkmenistan's money. Most worrying of all, it seems that no money from the sale of Turkmen gas even makes it into the national budget.

Niyazov appears to use these revenues to fund an increasingly bizarre personality cult replete with golden statues and lavish palaces. His picture is everywhere in Turkmenistan: on public buildings, on packets of salt and tea,

bottles of vodka and even floats eerily in the corner of television broadcasts. 'Turkmenbashi the Great' (Niyazov's appointed name, meaning 'the great leader of the Turkmen') has gone as far as to rename days and months of the calendar in an attempt to assert his hold over the Turkmen psyche. Schoolchildren are compelled to study his spiritual book, the Rukhnama, which is described on its official website as being 'on par with the Bible and the Koran'.

Shenanigans in Ukraine's gas industry

Most exported Turkmen gas is sold to Ukraine, and growing volumes are resold from there to European countries such as Poland and Germany. Ukraine is the transit point for more than a quarter of Western European gas imports from Russia and Turkmenistan and a major gas user in its own right. Ukraine has historically paid for much of its Turkmen gas supplies not in cash, but through the barter of chemicals, food, raw materials and machinery. This made sense in the past, given Ukraine's high inflation and shortage of hard currency, but as this report explains, barter as a form of trade is inherently vulnerable to mispricing, tax evasion and corruption.

Ukraine's gas industry has itself been mired in suspicious practices and mismanagement since the early 1990s. Under the presidency of Leonid Kuchma, Ukraine's energy sector became a highly politicised battleground for patronage; in many ways, it still is. The recent US trial of ex-Ukrainian premier Pavlo Lazarenko, who was in charge of allocating gas quotas to private companies, highlighted his extensive range of business enterprises that ran concurrently with his time in government. In 2005, Lazarenko was found guilty of money laundering and wire fraud. Though he was not found guilty on charges relating to his dealings with private gas companies, testimony from the trial highlighted payments from such a company to Lazarenko that have yet to be explained.

Following Lazarenko's dismissal as prime minister, the creation of Ukraine's state oil and gas firm NAK Naftohaz Ukrainy in 1998 allowed Kuchma to retake control of this lucrative sector. The man picked as its first chairman, **Ihor** Bakai, maintained a very close relationship with Kuchma until Bakai resigned amid allegations of corruption. Bakai is now wanted in Ukraine on criminal charges relating to his work in government positions following his time at Naftohaz. His successors seemed to have done little to approve the mismanagement of the state oil and gas company. Global Witness has obtained an unpublished audit which reveals the hair-raising practices of Naftohaz under Yuri Boiko, its chairman from 2002 to 2005, which are detailed in this report.

'Fishing in murky waters': the story of the intermediary companies

Perhaps the murkiest and most complex aspect of the Turkmen-Ukraine gas trade is the role of the intermediary companies that have inserted themselves for more than a decade between Turkmenistan, Russia, Ukraine and Europe. These companies have often come out of nowhere. parlaying tiny amounts of start-up capital into billion-dollar deals. Their ultimate beneficial ownership has been hidden behind complex networks of trusts, holding companies and nominee directors and there is almost no public information about where their profits go.

Turkmen gas can only reach Ukraine via pipelines controlled by Russia's Gazprom, the world's largest gas company, which is 51% owned by the Russian government. But instead of shipping the gas itself. Gazprom has let this lucrative role be taken over by the intermediary companies, some of whom were paid in Turkmen gas which they resold in Europe for up to four times the price. Why would Gazprom, in effect, give up these lucrative markets and their profits to potential competitors? There is an argument that the intermediary companies were better able than Gazprom to extract payment from cash-strapped Ukraine without upsetting Russian-Ukrainian relations. But recent explanations from Russia and Ukraine for the use of intermediaries have been inconsistent. Furthermore, the opacity of these companies raises questions as to whose interests they truly serve.

Despite persistent questions about the intermediary companies, against a backdrop of public concerns about official corruption and organised crime in the countries of the former Soviet Union, there has never been sustained, thorough and high-level oversight of these companies, and the structures and people involved in them. It is nigh on impossible to discover who sits at the centre of these corporate webs and thus to whom the profits from the transportation and sale of natural gas are going. An investigation into these matters must now happen in the public interest.

RosUkrEnergo and Ukraine's winter of discontent

This report looks at four intermediary companies which have straddled the Turkmen-Ukraine gas trade, one after the other, since the early 1990s: each raises troubling questions about transparency and governance. The most recent, RosUkrEnergo, is jointly owned by Gazprom and a unit of Austria's Raiffeisen Zentralbank. The latter is managing its shareholding on behalf of a consortium of Ukrainian

businessmen who have refused, despite fierce controversy in Ukraine, to disclose their identities to the public.

Ukraine's Orange Revolution, which put reformist president Victor Yushchenko into power in January 2005, has failed to clear up the mystery of who is behind this company. High-level Ukrainian sources have alleged to Global Witness that Ukraine's security service launched a criminal investigation into RosUkrEnergo and other intermediary companies shortly after President Yushchenko took power. Those sources also claim that enquiries came to an abrupt halt following Yushchenko's dismissal of the Ukrainian government and the resignation of its security chief in September 2005. Current Ukrainian security officials now deny that any such investigation took place. Against the background of this confusion, critics might question Yushchenko's political will to confront Kuchma's legacy of opaque and unaccountable business practices.

No wrongdoing has been established on the part of RosUkrEnergo, but the questions remain. Even though the chairman of Russia's Gazprom himself described the Ukrainian investigation into RosUkrEnergo as 'fishing in murky waters', Gazprom had previously agreed to this intermediary company's creation. Despite these questions, the major gas dispute between Russia and Ukraine in the bitter winter of 2005/6 ended in a deal between the two countries which led to RosUkrEnergo becoming the exclusive supplier of Turkmen gas to Ukraine in January 2006 and taking a share of the country's domestic market as well.

The gas price deal deviates sharply from industry best practice. It consists of a mere two sheets of paper signed by current Naftohaz chairman Oleksei Ivchenko (whose authority to sign such a deal on his own was widely questioned in Ukraine). The contract appears to assign all of Ukraine's future gas imports to RosUkrEnergo. It also appears to allow for negotiations on the price of Ukraine's gas imports to be reopened after six months, even though Naftohaz says the price is set for five years. Such confusion, and the possibility of further unexpected price hikes, is obviously not good for the energy security of Ukraine or gas customers downstream in Europe.

Documents seen by Global Witness highlight a curious relationship between RosUkrEnergo and the state-controlled Naftohaz Ukrainy after the former's creation in 2004. Although Naftohaz has no apparent investment in RosUkrEnergo, both the then-chairman (Yuri Boiko) and his deputy (Ihor Voronin) of Naftohaz held strategic positions on the coordination committee of this private intermediary company in the first year of its existence. It is unclear why a private company, 50%-owned by persons unknown, chose two top Ukrainian public officials to represent it. Also still to be fully explained are the roles of three British businessmen, Robert Shetler-Jones, who was also on RosUkrEnergo's coordination committee, and his associates David Brown and Howard Wilson, who have been associated both with RosUkrEnergo and the company that came before it, Eural Trans Gas.

Eural Trans Gas and the mysterious Mr Firtash

Eural Trans Gas (ETG) was founded in Hungary in late 2002 with a start-up capital of just US\$12,000. Although the current management of RosUkrEnergo has made state-

> ments that distance it from ETG, Global Witness investigations have discovered that the links between the two are more extensive than they first appear.

> ETG's early shareholders were an Israeli lawyer and three hard-up Romanians with no connection to the gas industry, one of whom was an out-of-work actress who says she took part in order to pay her phone bill. The day after ETG was founded, it received a contract to transport Turkmen gas to Ukraine, in return for



President Yushchenko has some explaining to do about Ukraine's gas deal. AFP/Getty/Pool

gas worth up to US\$1 billion on European markets. It then appointed as its chairman the former chairman of British Gas, Cedric Brown, who had become a controversial figure in Britain in 1994 after being awarded a massive pay increase. Far from objecting to this unknown company apparently taking a lucrative slice of its business, Gazprom provided ETG with financial guarantees worth US\$227 million.

It seems that Naftohaz and Gazprom first intended to set up a joint venture for the transportation of Turkmen gas but this is not what ETG became. Global Witness has discovered that three companies which bought shares in ETG. each based in a different country, are all ultimately linked to, and in two cases controlled by, the same companies in Cyprus whose beneficial owners are unknown. The role of the man who appears to have had ETG registered in the first place, Ukrainian businessman Dmytro Firtash, has never been properly explained.

Before ETG came Itera, which received hundreds of millions of dollars in loans from Gazprom, and whose top managers included a former deputy prime minister of Turkmenistan. Once again, it is not clear why Gazprom appears to have given up both the transit business and markets in former Soviet Union countries to Itera, which depended on Gazprom's own pipeline network. Documents seen by Global Witness show that in 2000, Gazprom bought Turkmen gas from Itera that it could have bought more cheaply from Turkmenistan itself.

Itera was preceded by a company called **Respublika** which swapped Ukrainian goods for Turkmen gas in a series of bizarre barter deals, such as 12 million pairs of galoshes for Turkmenistan, a desert country which then had a population of about four million people. Respublika's head, Ihor Bakai, later became head of Naftohaz Ukrainy, the Ukrainian state oil and gas company and, as noted earlier, is now wanted by the Ukrainian authorities.

Time for transparency in the gas trade

The lack of transparency in the Turkmen-Ukraine gas trade exemplifies a wider problem in the global oil and gas industries. Oil, gas and mining companies rarely provide even basic information about their financial interactions with governments in countries where they operate: governments are similarly reticent about the revenues they earn from these industries. This opacity has allowed crooked officials and businessmen in many countries to misappropriate vast sums in revenue, as documented in recent scandals in Kazakhstan, Angola, Equatorial Guinea, and many other resource-rich countries. The result is unaccountable

government, corruption, social decay, increased poverty and the reinforcement of authoritarianism, which can ultimately lead to state failure and the spread of instability across regions.

There is an emerging international consensus that full public disclosure of revenue flows, combined with active monitoring by civil society groups in resource-rich countries. could make criminal activity much harder to hide and give citizens a better chance to hold their governments to account for the use of these revenues.

The main international vehicle for revenue transparency at the moment is the Extractive Industries Transparency **Initiative (EITI).** which was launched in 2003. The EITI promotes the full disclosure of payments by oil, gas and mining companies to governments, the disclosure of government receipts, the use of independent audits, and active monitoring by civil society groups to track money into the state's coffers. Most of the world's major international oil and gas companies and some 20 governments have now endorsed the EITI. Although it will be a long struggle to turn these rhetorical commitments into practice, the EITI is gaining international momentum and provides a template for possible reforms across the former Soviet Union.

Another model is the International Monetary Fund's Guide on Resource Revenue Transparency, which offers a template for measuring the openness of governments in resource-rich countries and suggests a path for reform that such governments can follow.

Azerbaijan and Kyrgyzstan are both actively implementing EITI standards in their oil and mining industries respectively, while Kazakhstan has promised to follow suit. Although it is hard to imagine Turkmenistan joining EITI under the secretive reign of President Nivazov, there is no reason for Russia and Ukraine not to draw on the EITI and on the IMF principles in managing the money garnered from natural resources.

Russia holds the G8 presidency through 2006 and its chosen theme is energy security, so now is the time for a cleanup of the energy industry, including an end to the use of opaque intermediary companies. Russia should also ratify the international Energy Charter Treaty, which it has already signed, because the Treaty provides for more transparent transit arrangements and a rules-based approach to dispute resolution (Ukraine, most EU states, and some countries in Central Asia are already members). Without transparency there cannot be predictability, and without predictability, there cannot be security of energy supply.

Time for the European Union to get its act together

The European Union needs to take a much greater interest in the problem of energy and transparency than it has to date. Europe is ringed by an arc of countries, from Algeria in the south to Ukraine in the northeast, which either produce energy for export to Europe or take part in its transit from third countries. The EU has been slow to act on the recognition that good governance in these countries is essential to the long-term security of Europe's energy supplies, and that transparency, by enabling public oversight, is a crucial factor in good governance. Current debates within Europe about a common EU energy strategy, as proposed by the European Commission Green Paper, A European Strategy for Sustainable, Competitive and Secure Energy of March 2006, offer a chance to factor such concerns into European thinking.

The EU and its member states could do much more to promote the transparency of oil and gas revenues in neighbouring countries and persuade them, via its diplomatic, aid and trade interactions, to make their public finances more open. Europe could also do much more to build the capacity of local civil society groups to monitor the flow of revenues and hold government officials to account, and to ensure that its own banks and companies do not collude in corruption or the looting of public money from resource-rich countries.

It is hard to see how Germany's vital interest in the security of energy supply can be reconciled with a preparedness by Germany's biggest and most prestigious bank to act as banker to an unhinged tyrant whose arbitrary handling of Turkmenistan's gas resources is driving its economy into the ground, with potentially injurious consequences for the future peace of Central Asia.

It is deeply concerning that the banking laws of Germany (and other industrialised countries for that matter) do not prevent the country's financial system from being used as a piggy bank by megalomaniac dictators who have no accountability to their own people for their uses of state funds. A figure such as Niyazov, who is not subject in practice to any basic checks and balances, can dispose of state funds through the banking systems of Germany and other European countries without anybody knowing what exactly it is that he does with the money.

Time for Ukraine to open the books

Ukraine's Orange Revolution promised reform and a clampdown on the corruption that had plagued the presidency of Leonid Kuchma. The new government must not go back on

these promises and should continue investigations into the companies and personalities named in this report. At the time of writing, parliamentary elections had just taken place: whatever administration emerges, Ukraine needs clear reforms to promote open and accountable management of its gas industry, including the declaration of the beneficial owners of key companies such as RosUkrEnergo. Without these reforms, the transit of gas to Ukraine will continue to be a highly politicised, opaque and unstable business.

The new government should also investigate the accounts of the state oil and gas company, Naftohaz Ukrainy, from 1998 to 2001, when no proper audits were published, or, it seems, even carried out. It should publish credible and independent retrospective audits of Naftohaz Ukrainy's accounts relating to the company's activities in 2004 and 2005; audits concerning these years are yet to materialise on the company's website.

In the longer term, Ukraine should work with donor governments and multilateral institutions like the European Bank for Reconstruction and Development and the IMF to improve transparency of revenue flows from resource extraction and from transit fees, and build effective mechanisms for independent public oversight.

Turkmenistan on the brink

Turkmenistan and its intransigent president pose a particular challenge for the international community, which must use what leverage it has to press the government for more accountability. This could be done by promoting transparency in the gas trade downstream of Turkmenistan, to make clear how much money the country should be earning. Europe should not reward this despotic government for its refusal to reform, and there should be no expansion of existing EU relations with Turkmenistan, whether in the form of trade agreements or otherwise, until the latter shows a genuine and measurable commitment to apply the basic norms of accountable public financial management.

Despite Niyazov's claims that Turkmenistan is in a 'golden age', the country is in danger of becoming a fully-fledged failed state with massive unemployment, widespread heroin addiction, and woeful education and health-care systems. The collapse of Turkmenistan, in a region that is already highly unstable, could have disastrous consequences for peace and for the supply of energy. Niyazov's claim in the Rukhnama that 'within the borders of Turkmenistan ... the natural resources are the people's national wealth and property' sounds ever more hollow as time passes. It is time for Europe, Ukraine and Russia to act.

1. Turkmenistan gains its independence – and a dictator



Global Witness

The people of the Central Asian republic of Turkmenistan had reason to be optimistic in 1991, when their country gained its independence following the fall of the Soviet Union. With only a moderate population (five million compared to neighbouring Uzbekistan's 25 million), and large reserves of natural gas (these have yet to be fully explored, but are believed to rank about sixth in the world²), it looked as if the new Turkmen nation would prosper. 'In a few years we'll be wading in money up to here,' said a minister in 1994.3

The man in charge of the economic transition following the Soviet Union's collapse was Saparmurat Ataevich Niyazov, who had been First Secretary of Turkmenistan's Communist Party since 1985. In late 1991, the Communists renamed themselves the 'Democratic Party' and Niyazov was elected president for a five-year term, standing unopposed and win-

ning 99.5% of the vote.4 His rule was extended in 1994 through a referendum that cancelled the 1997 election. Official figures from Turkmenistan state that 99.99% of the voters endorsed the motion with a 99.9% turnout.⁵

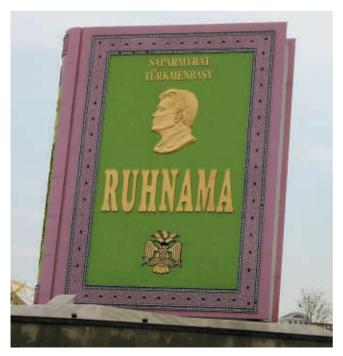
In 1999, the Turkmen People's Council (Turkmenistan's supreme legislative body) changed the constitution to remove all limits on Nivazov's term of office⁶ and in 2002, he was confirmed 'president-for-life'. Although there is no official title, the fact that Niyazov is also the chairman of the People's Council makes him the country's de facto prime minister,8 thus all lines of executive control pass to him. Regular sackings by Niyazov of members of his government make sure that he has no potential rivals (see box: Chaos at the Central Bank). In April 2005, Niyazov told the chairman of the Organization for Security and Cooperation in Europe

I have thanked God a hundred thousand times since I was five years old that I inherited honour, nobility, patience, highness of spirit and objectives from my parents in my body and soul. ... This becomes a fountain that will never dry up for my Turkmen people Saparmurat Niyazov, President of Turkmenistan¹

(OSCE), a regional security organisation, that he will retire in 2009.9

Since his ascension to the presidency, Niyazov has constructed a personality cult around himself to rival that of North Korea's Kim Jong Il. He is now referred to as 'Beyik Turkmenbashi', a title bestowed on him by the People's Council, meaning 'the Great Leader of all the Turkmen'. Niyazov's name is not the only one to have been changed: there is now a Turkmenbashi town (formerly Krasnovodsk), which lies in Turkmenbashi bay, a Turkmenbashi airport, a Turkmenbashi oil refinery, even a Turkmenbashi meteor that landed in Turkmenistan in 1998. In November 1999, a state newspaper seriously suggested that Turkmenistan should be renamed 'Turkmenistan of Saparmurat Turkmenbashi'. 10 And in 2002, he renamed the months of the year - January is now, of course, Turkmenbashi. The People's Council declared 2003 to be the year of Gurbansolte. Nivazov's late mother (who also graces the Turkmen calendar as the month of April), and 2004, the year of Atamurat, his father.

December 1998 saw the unveiling of the Arch of Neutrality – a tower 75 metres high, topped by a 12-metre golden statue of Nivazov that rotates to face the sun. His image adorns billboards and buildings across Turkmenistan, cartons of salt, packets of tea and bottles of vodka and brandy. His golden profile also appears in the corner of Turkmen television channels. Stories about him feature to such an extent on Turkmen television that people sometimes jokingly say 'change the Niyazov' instead of 'change the channel'.11



Twenty-foot motorised statue of Niyazov's holy book, Ashgabat.

Global Witness

Niyazov claims that there is no personality cult, that his idolisation is a spontaneous act of affection by a grateful people: 'If I was a worker and my president gave me all the things they have here in Turkmenistan, I would not only paint his picture, I would have his picture on my shoulder, or on my clothing ... I'm personally against seeing my pictures and statues in the streets, but it's what the people want,' he said to CBS News in 2004.12

The ceremony that confirmed Niyazov as president-for-life saw him presented with a white robe and a palm staff, traditional symbols of the Prophet Mohammed. 13 His self-transformation from communist to something akin to a Turkmen prophet is confirmed by a book he has written, entitled the 'holy' Rukhnama, which has been designated the official Turkmen spiritual code, and is described on its official website as being 'on par with the Bible and the Koran.'14

Foreign companies working in Turkmenistan pay for the book to be translated into various languages; at the moment over 25 different versions exist, in languages ranging from German to Zulu to Braille. The book, full of guasiphilosophical meanderings and questionable poetry, has become the central text in Turkmen education. All state workers must pass a test in order to gain employment, as must learner drivers, who have to undertake a 16-hour Rukhnama studies course before they obtain their licence.

Not only is the Rukhnama itself studied in Turkmen schools, along with lessons on Niyazov's politics and teachings, but it also forms the basis of foreign language and mathematics lessons. The International Crisis Group's report on Turkmenistan in 2004 gave this example:

Gulnara was reading the book *Rukhnama*. She read six pages on the first day. On the second day she read four more pages than on the first day. On the third day she read five pages less than on the second day. How many pages of Rukhnama did Gulnara read on the third day?¹⁵

The mandatory period of schooling in Turkmenistan has been reduced from eleven to nine years, making students ineligible for higher education anywhere in the world, other than in their home country, where higher education has been virtually abolished anyway. Places have been cut by thousands, and those that are available are prohibitively expensive for the average family, with admission being dependent on knowledge of the Rukhnama. To complete the circle, degrees obtained in other countries are no longer recognised in Turkmenistan – all public sector workers (and there is virtually no private sector) must have qualifications from Turkmenistan.



The State holds very highly its citizens' lives, health, security, prosperity, education and excellence in physical and spiritual development Saparmurat Niyazov¹⁸

Niyazov's focus on Turkmen nationhood and 'the Turkmen people' in practice results in the active suppression of a large populace of other ethnicities (estimates range from 300,000 to 1 million citizens), some of whom, including ethnic Uzbeks and Armenians, have lived in Turkmenistan's territory since before the foundation of the Soviet Union. All Kazakh, Uzbek and Armenian language schools have closed and only one Russian language school exists in Turkmenistan's capital, Ashgabat. Ethnic Turkmen are often preferred to candidates of other ethnicities when seeking employment, 16 and non-Turkmens often find their applications to higher learning or other institutions blocked.

This ethnic discrimination is encouraged by Nivazov himself, as can be heard in some of his more sinister pronouncements: 'In order to weaken the Turkmen, the blood of the Turkmen was diluted in the past. When the righteous blood of our ancestors was diluted by other blood our national spirit was low. Every person has to have a clean origin. Because of that it is necessary to check the origin up to the third generation.'17

'The Worst of the Worst' (Freedom House)

The international media often concentrates on the black comedy aspect of Niyazov's personality cult, highlighting its absurdity and increasing madness. Yet this often masks the very real human rights abuses that take place on a regular basis in Turkmenistan, where the personality cult is a serious issue; Turkmenistan is rapidly slipping away from the world under the one-man show of its president.

In one of its more lucid moments the Rukhnama maintains, 'Turkmenistan accepts international human rights standards accepted by other members of the international community,'19 a statement reiterated in the Turkmen constitution. But, as an OSCE report stated in 2003, 'the contrast between the law as it is presented and the reality marked by terror and fright is mind-boggling.²⁰

Freedom House, a respected American non-governmental organisation, has given Turkmenistan the lowest possible scores for both political rights and civil liberties for 11 years running. Such scores are reserved for countries with 'the broadest violations of civil liberties, including freedom of speech, rule of law, and personal autonomy', the 'worst of the worst', which puts Turkmenistan on a par with seven

other countries with appalling human rights records and a lack of personal freedoms: Burma, Cuba, Libya, North Korea, Saudi Arabia, Sudan and Syria.²¹

The human rights situation in Turkmenistan has deteriorated since an alleged assassination attempt on Niyazov in November 2002. Though the Turkmen authorities released little information concerning this incident, when Nivazov's motorcade was allegedly strafed with gunfire, 22 over a hundred people were subsequently arrested, with some 67 people charged and 46 convicted23 after sentencing in what the OSCE dubbed 'show trials'.²⁴ According to the US Department of State: 'There were credible reports that authorities detained and threatened to torture relatives of those implicated in the attack to coerce confessions, that relatives of those implicated in the attack were beaten with water bottles to avoid bruising, injected with psychotropic drugs, and subjected to electric shock torture, and that their female relatives were sexually assaulted and threatened with rape.'25

In October 2003, the European Parliament published its resolution on Turkmenistan, which stated that: 'Turkmenistan is consistently violating all its obligations under ... international Conventions' and 'the already appalling human rights situation in Turkmenistan has deteriorated dramatically recently, and there is evidence that this Central Asian state has acquired one of the worst totalitarian systems in the world.'26

Those who escape Niyazov's regime often have terrible stories to tell. A civil law attorney, jailed for three years after defending a woman who allegedly lost her job because of her religious faith, stated to the UN regional news network: 'There are no constraints on the police, interrogators or national security officials in using torture. They are given full authority to do as they wish ... I knew two people, both physically fit, who were tortured to death. What they did to these men behind the prison's walls cannot be described.'27

Niyazov stated in 2005 that 'there is not a single person held in Turkmen prisons for political motives or ideas'28 and maintained, 'there can be no greater democracy than this'.29 Yet currently only one political party is allowed in Turkmenistan - Niyazov's 'Democratic Party'. In 1999, a Turkmen citizen who announced he was forming a political party in Turkmenistan was arrested several months later



Backs turned on human rights. Global Witness

and then jailed, having been found guilty of embezzlement of state property.³⁰ And in 2004, Amnesty International reported that a man who had written to Niyazov asking if he could hold a peaceful demonstration against the government's policies was arrested and placed in a remote mental asylum.31

Travel within Turkmenistan is strictly monitored; during a cross-country journey by car, one would expect to pass through a checkpoint about every half an hour. Prior police permission is needed to visit two of the country's five provinces. 'You need a permit here to go to the toilet,' joked one man grimly to Global Witness.

Reporters sans frontières, an NGO that examines press freedom, ranked Turkmenistan's media as the third least free out of 167 countries, with only North Korea and Eritrea being worse.³² A 2002 OSCE report on Turkmenistan noted the 'absolute monopoly of the state over all media'33 and went on to say 'censorship in Turkmenistan is total'.³⁴ An OSCE representative wrote to Turkmenistan's foreign minister, concerned over 'the absolute lack of any freedom of expression' within Turkmenistan.35

Any independent journalists willing to stay in Turkmenistan face serious consequences for speaking out. In September 2003, a Turkmen Radio Free Europe/Radio Liberty (RFE/RL) correspondent, who covered sensitive subjects such as the government's human rights record, was arrested and detained for three days. He claims he was injected with an unknown substance and was told he faced 20 years imprisonment for 'creating problems' through his journalistic activities.³⁶ Two months later, after continuing his work, he was reportedly bundled into a car, beaten and left at the side of the road after being threatened with being buried alive.³⁷ He has since found political asylum in the United States.

And as Global Witness went to press, another two RFE/RL journalists had allegedly been detained by authorities without due process. They were released after ten days in custody. One later said to RFE/RL: 'They told us not to speak out against government policies, saving if we did not follow what they said they would 'smash us' and they wouldn't stop with this and continue dealing with our family members and children in the same way.'38

Economic growth... or collapse?

Since 1999. Turkmenistan's official statistics have boasted very high rates of economic growth, averaging 18% annually, 40 including a 21% increase in gross national product from 2004 to 2005.41 This would make the country one of the fastest growing economies in the world.

However, official data from Turkmenistan are highly unreliable and other reports point to a less healthy situation. As the World Bank states, the lucrative profits from the sale of gas and oil 'mask serious structural problems with the Turkmen economy ... among all CIS countries, Turkmenistan has progressed the least in terms of economic reforms since independence.'42 Yet according to Turkmen authorities, reporting to the International Monetary Fund (IMF), this actually benefits the people: 'The authorities believe that their cautious approach toward economic liberalization has served Turkmenistan's people well and delivered more desired results in terms of the people's well-being.'43

Whatever the true figures for economic growth, the money is not benefiting the people of Turkmenistan. The United Nation's Human Development Indicators (HDI), which assess countries on standards of health, education and quality of living, are sliding in Turkmenistan. In 1991, Turkmenistan's HDI score was ranked 31st in the world. In 1995, Turkmenistan was ranked 86th out of 174 countries, slipping to 100th in 1998 (when gas exports reached an all-time low).44 In 2005, the country was ranked 97th out of 177 countries. 45 The World Bank's estimate of the percentage of the population living in poverty is 58%. 46 According to the US Department of State, unemployment is estimated at 50% in urban areas and as high as 70% in rural areas, where the majority of the population lives.⁴⁷

Sources in Turkmenistan also expressed concern to Global Witness about the problem of heroin addiction which, according to the Institute of War and Peace Reporting, citing the United Nations, has increased 17-fold from 1991 to When wealth is acquired in improper ways, the moral structure of society is harmed, and society is damaged gradually ... I do get upset when I see that some people are spending money on improper deeds. Learn more about how to spend when one is wealthy. When you earn, spend so that your expenditure benefits your nation, relatives and family! Saparmurat Niyazov 64



2002.48 This, combined with the growing numbers of women forced into prostitution, makes the threat of HIV infection loom large. Turkmenistan's healthcare is already woefully underfunded; an undercover BBC reporter caught a first-hand glimpse of the shockingly low standard of care. The journalist reported seeing: 'A man [with] blood pouring out of his nose, [who] looks like he has been in a car accident. I watch as a nurse uses a dirty rag from the sink to clean his wounds. He is roughly handled even though he may have fractured his spine.'49 In the autumn, doctors, like most people in Turkmenistan, are sent into the fields to pick cotton. In 2004, Niyazov ordered thousands of nurses to be replaced by conscript soldiers, and even advised that all medical facilities outside of Ashgabat (where only 10% of the population live) should be closed, saying 'Why do we need such hospitals? If people are ill, they can come to Ashgabat.'50 Though there are reports that provincial hospitals are still operating, these cost-cutting measures suggest that cracks are beginning to show in the Turkmen budget.

As this report went to press, further drastic cuts appear to have been imposed: state sick leave and maternity benefits have been reduced, and senior citizens have had their pension entitlement either removed or cut by a third.⁵¹ The pension cuts will affect 400,000 people, leaving approximately 100,000 without any entitlement.⁵² The Turkmen Ministry of Foreign Affairs stated that the information was 'deliberately perverted' by Russian media outlets,53 but reports from inside the country by non-Russian sources seem to confirm that these cuts have been carried out, causing widespread fear and chaos.⁵⁴

The Turkmen government has so far managed to placate the people with heavy subsidies, making water, gas and salt free, and housing, petrol and flour cheap. Yet in April 2004, Niyazov admitted on television that many public sector workers had not been paid for at least six months, and that the arrears totalled up to US\$286 million.55 The IMF concluded in an unpublished report:

The build-up of payment arrears raises substantial doubt over the government's claims to be successfully managing the budget. Moreover, given the high level of export revenue – and the healthy trade surplus – reported in recent years, the government should in theory have sufficient resources to meet public sector salaries in full...⁵⁶

The true extent of the structural problems is difficult to ascertain due to the fact that Turkmenistan's economic governance is almost completely opaque. An ordinary Turkmen citizen is unable to obtain any information on what the government is up to. Surveillance by international financial institutions such as the IMF and the European Bank of Reconstruction and Development (EBRD) has broken down in recent years. As the Economist Intelligence Unit wrote in 2004: 'Almost no budget data have been released since 2002, suggesting that the government is finding it increasingly difficult to present the budget accounts in such a way as to hide a growing structural deficit.'57 Although Turkmenistan allowed the IMF to conduct a consultation in 2004, it is understood that the bare minimum information was released.⁵⁸ The report itself also remarked on the 'political interference in the processing and dissemination of data [of macroeconomic statistics].'59

A financial expert who worked for several months in Turkmenistan told Global Witness that he 'had no faith' in the government's official data 'at all ... what was worse is that when you got something you always wondered what it meant, they were not drawn up to any set of standards ... There is no independent audit function here so there is no basis for believing what limited financial information is provided ... Nothing can be completely relied upon.'60

One major problem is that since 1998, the exchange rate of Turkmenistan's national currency has been fixed at 5,200 Turkmen manat per US\$1.61 However, virtually all trade takes place at the unofficial rate – currently around 25,000 Turkmen manat per US\$1. The dual exchange rate allows the Turkmen authorities to present certain economic statistics in the best light. For example, the average state income is US\$2,400 per annum at the official exchange rate; in reality, in local currency the wage is worth around US\$500 per annum.

Internal sources and other observers report Turkmenistan's method of budget management to be chaotic and incomprehensible. The financial expert who had worked in Turk-

A future built on gas: Turkmenistan's 'Golden Age'?



The fantasy is glittering... Global Witness

Turkmenistan relies on its gas for its survival: 70% of Turkmenistan's income comes from its natural resource exports.65 Niyazov himself has stated that 'Turkmenistan's future completely depends on oil and gas.'66

Despite the fact that, in the Rukhnama, Niyazov writes 'within the borders of Turkmenistan the natural resources ... are the people's national wealth and property',67 most of the money from the sale of Turkmenistan's gas and oil does not appear to be reaching its citizens; it is being used to create the façade of the President's self-proclaimed 'Golden Age'.

To create an appearance of splendour, Niyazov has embarked on a massive spree of expensive construction projects, mostly in Ashgabat, the capital city. Global Witness has calculated on the basis of press reports that, in the 15 years since independence, the amount of announced spending on building projects by just two of the many construction firms has surpassed US\$3.5 billion. The total amount spent on building projects by the Turkmen government is likely to be many times this amount.

The new buildings include a presidential palace, a national museum (with a whole wing devoted to Niyazov's achievements), a golden-fronted Central Bank and a series of high-rise apartment blocks built from imported Italian marble. His recent proposals have grown more outlandish: an ice-palace (in a country where temperatures can reach 45°C) and the 'Disneyland World of Turkmen fairy tales' pleasure park.68

A financial expert spoke to Global Witness about the senselessness of some of the projects. In 2000, a new complex consisting of a hotel, a restaurant, a hospital, a business centre, and a day-care centre was proposed. It was clear that the expensive project had not been evaluated for economic feasibility and, worse still, a similar complex had already been built - about half a mile away. 69 The spending for such prestige projects takes place off-budget. As the European Bank for Reconstruction and Development states, 'if such [investment] projects are funded outside the budget, a proper and publicly accountable evaluation process would seem to be impossible.'70

A senior official from an international financial institution told Global Witness that government ministers often hold money on behalf of Niyazov and are allowed to use a small percentage. This is usually put into construction; in Ashgabat, there is a series of 25 hotels standing next to each other, each named in relation to a particular ministry, with fewer than 20 rooms in each that are hardly, if ever, used.71

... but the people are still waiting for prosperity. Global Witness



menistan told Global Witness that budgets he had seen from the health ministry did not record specific expenditures, but only recorded net amounts, hiding capital projects and other costs. To make matters worse, the budget has two components, cash and non-cash payments – the treasury has only enough money to give a portion (possibly about a third) of a ministry's appropriation in cash (used for salaries).62

Following a series of high-profile sackings in 2005 (see box: Chaos at the Central Bank), an anonymous source in the Turkmen Ministry of Economics and Finance told the Institute of War and Peace Reporting: 'Neither the president nor the newly-appointed senior officials are aware of the true situation either in the country as a whole or in specific sectors. None of the new people will dare present the true picture to Niyazov. That implies that we're going to keep on moving towards a total [economic] collapse.'63

Turkmen public finances: many questions of transparency and good governance

The Turkmen public finance system has, confusingly, two levels or 'tiers'. The first tier is the normal state budget. The second tier covers extra-budgetary operations and revenues, and the spending of industrial complexes and industrial state funds. These extra-budgetary operations dwarf the money in the first tier, as confirmed by the IMF: 'The state budget ... excludes the operations of the state funds and the self-financing ministries, which constitute some 75-80% of central government operations.'72

This massive amount of opaque spending outside of the budget makes the budgetary data that is released highly unreliable; the citizens of Turkmenistan cannot see how much money is being spent on them, and where and to what purpose money is being transferred. At the end of 2005, the Turkmen parliament approved total spending for 2006 of 81.3 trillion manats, US\$15.6 billion at the official exchange rate, or US\$3.3 billion at the unofficial rate. One Turkmen news agency reported that 76% of this total 'belonging to the hydrocarbon sector and some other branches' would belong to the 'second tier' - thus not recorded in the main budget.⁷³

The Turkmen Central Bank account in Germany

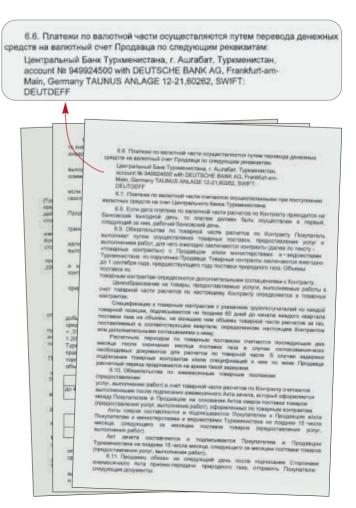
In an interview with Global Witness, former Turkmen Central Bank chairman Khudaiberdy Orazov stated that the Turkmen Central Bank has one main government account with various correspondent accounts held in banks around the world. 74 According to Orazov, this main account is held

at Deutsche Bank in Frankfurt. Global Witness has seen a document which confirms that such an account does exist at Deutsche Bank.

The document is a contract signed in 2002 between the Turkmen and Ukrainian state oil and gas companies concerning Ukraine's gas purchases from Turkmenistan. It reveals that the Turkmen state account is held at Deutsche Bank in Frankfurt. This type of account is named a 'Nostro' account, one held at a bank for a foreign government. The contract, signed by former Turkmen deputy prime minister Yolly Gurbanmuradov (now jailed, see box: Chaos at the Central Bank), states that payment for Turkmenistan's gas will go to:

Central Bank of Turkmenistan, Ashgabat. Acc # 949924500, Deutsche Bank AG. Frankfurt-am-Main, Germany.

The contract stipulates that 50% of the contract, from the years 2002 to 2006, is to be paid in cash to the value of US\$840 million, with 50% to be supplied in barter goods worth the same amount.⁷⁵



The off-budget funds

Numerous sources also point to a number of related foreign-currency funds that were established by presidential decree, and are under the President's personal control. These funds also appear to be held at Deutsche Bank, though it is not clear whether this money is deposited in the main Turkmen Central Bank account or elsewhere. The largest of these are the Foreign Exchange Reserve Fund (FERF) and the Oil & Gas Development Fund (OGDF).⁷⁷

These funds are closely linked to the country's natural resource exports: well-informed sources explained to Global Witness that the FERF receives 50% of all hard currency gas revenues and 30% of all oil and cotton revenues as a tax.⁷⁸ The OGDF receives 25% of the gas money, with the remaining 25% put directly back into the industry's infrastructure.⁷⁹ This reveals a startling fact: it would appear that almost none of the revenues from Turkmenistan's gas sales are accounted for in the country's budget.

By examining the details given above in the 2002 gas contract between Ukraine and Turkmenistan, it is possible to approximate the totals flowing into these funds. The contract, worth US\$1.6 billion, is split 50:50 into barter and cash payments, worth US\$840 million each. If the sources who spoke to Global Witness are correct, this would mean that 50% of this - US\$420 million - would be allocated yearly to the FERF and 25% - US\$210 million - to the OGDF.

The gas supply contract with Turkmenistan has since been renegotiated, with the most recent deal featuring Swiss-registered company RosUkrEnergo (see section: The gas transit and trading companies) buying the majority of Turkmen gas from Gazprom's export arm Gazexport which pays Turkmenistan in cash, with no barter component. This means that this year Turkmenistan will receive over US\$2 billion for its gas, with US\$1 billion allocated to the FERF.

It is unclear how much remains in the Turkmen Central Bank account at Deutsche Bank and in funds such as the FERF, and how much is spent, since revenues accrued in the FERF are not accounted for in the state budget.⁸⁰

Buried money is of no use to you or society. That will only add to your fears, hesitations and doubts. It will ultimately cause problems for you. Saparmurat Niyazov⁷⁶

Orazov told Global Witness that, in 2003, he thought that some US\$1.8 billion was held in Deutsche Bank. This approximate figure was confirmed by a source in an international financial institution in 2005, who stated that this money was in the FERF.81 Orazov also stated that another US\$1 billion was held in a correspondent account in a bank in Switzerland, bringing the total to US\$2.8 billion, by his calculation. The EBRD's last estimate of Turkmenistan's foreign reserves, 'most of which is known to be accumulated in the FERF' was US\$2.6 billion in 2004, citing the Turkmen Central Bank. 82

The Foreign Exchange Reserve Fund: Niyazov's 'Presidential' Fund

Nivazov told the IMF in 2004 that 'Turkmenistan has no secrets',83 vet little is known about the FERF. Multiple sources have however confirmed to Global Witness that this billion-dollar fund is located at Deutsche Bank in Frankfurt.

According to Khudaiberdy Orazov, who was crucial in setting up the account holding Turkmenistan's foreign currency reserves, the origins of the FERF date back to the final two years of the Soviet Union, when the Turkmen authorities were prompted by an epidemic in Turkmenistan's Dashoguz region to obtain a general licence from the Soviet Central Bank that allowed them to manage foreign currency at their own Turkmen commercial bank.

In 1992, the money was moved to Turkmenistan's Vnesheconombank, and then to the Central Bank of Turkmenistan in July 1993, with the government retaining control of the account, as confirmed by the IMF.84 Around 1995, according to Orazov, the money then moved to Deutsche Bank, the first European bank to agree to hold Turkmenistan's money, at its main headquarters in Frankfurt. Following this final move, Orazov maintains, Nivazov established control over these funds. 85

It is not clear how many signatures are required to transfer money from the FERF and other funds, but many sources from the international financial community and others in a position to know have told Global Witness that they are directly controlled by the president alone. Though the Central Bank chairperson is a key figure in the disbursing of such funds, he or she is under Niyazov's orders and can be fired at any time (and frequently has been, see box: Chaos at the Central Bank).

The chairman of the Oil and Gas Development Fund is also Niyazov; it is he who gives the orders to the politically ap-



Deutsche Bank, Frankfurt, holds Turkmenistan's gas money under Niyazov's effective control.

Getty images/ Ralph Orlwoski

pointed acting director of the fund. Until recently the director was the then-minister for oil and gas, Guychnazar Tachnazarov.86 It is currently Geldimurat Abylov – the former first deputy head of the Turkmen Central Bank, highlighting the close link between Turkmen politics, its oil and gas and the country's foreign reserves. 87 Nivazov, by contrast, is accountable to nobody. One man's sole control over state funds is unusual practice indeed.

Countries with plentiful natural resources often establish such extra-budgetary funds, but these should be fully audited, transparent entities. As the IMF recommends in its Guide to Resource Revenue Transparency: 'All resource revenue-related transactions, including through extra-budgetary funds, [should be] clearly identified, described, and reported in the budget process and final accounts documents ... A basic principle in each case is that the tax payments are under the supervision of the relevant tax authorities, and all transactions are included in the budget (or related) analytical presentations.'88

Yet formal accounting structures are absent from the FERF. It is controlled and can be accessed only by President Niyazov⁸⁹ and is even referred to as 'the presidential fund' by insiders who spoke to Global Witness.⁹⁰ Because of this, former Turkmen Central Bank Chairman Khudaiberdy Orazov, now the head of an opposition party in exile, told Global Witness that, for all intents and purposes, money accumulated in Deutsche Bank, ostensibly held in a state account, is Niyazov's own, referring to this account as Niyazov's

'personal pocket money'.91 Though Orazov is now in opposition to Niyazov, his information is backed up by other independent sources from the international financial community that have confirmed that the lavish construction developments and 'prestige projects', including Niyazov's golden statues and palaces, are funded by the FERF,92 and thus, by extension, the sale of Turkmenistan's natural resources.

A source from the international financial community told Global Witness that as well as financing prestige projects, the FERF is sup-

posed to fulfil the function of a savings fund for future generations. However, the source added, no investment plan is prepared and the FERF has no explicit sector priorities. 93

All major international financial institutions pinpoint the FERF as being of particular concern. The World Bank will not provide new loans until the Turkmen government puts in place 'a transparent system of public resource management that can direct public resources to priority uses'.94 As outlined in its policy strategy for Turkmenistan, the EBRD has refused to fund private investments in the production and export of oil and gas which are linked to the FERF. 95

There is nothing inherently wrong with a government keeping public funds in overseas bank accounts, and Global Witness does not suggest that Deutsche Bank has broken any laws by taking the deposit of Turkmen public funds. However, there is a clear ethical concern, as, in practice, the person with ultimate control over these funds is President Niyazov, a repressive dictator who is entirely unaccountable to his own people for what he does with their money.

It is hard to reconcile Deutsche Bank's role in managing Turkmenistan's money, which is under Niyazov's effective control, with the long-term interest of Germany in promoting stability in Central Asia. Global Witness wrote to Deutsche Bank seeking reassurance that Turkmen government accounts at the bank have only been used for legitimate public purposes; we are disappointed that Deutsche Bank chose not to reply.

Germany needs to address the question of its banks' business relations with Turkmenistan: data from the Bank of International Settlements shows banks in Germany to be the largest reporting lender to Turkmenistan, with US\$723 million in outstanding repayments in December 2004.96 What is the ethical justification for German banks to provide such enthusiastic support to a regime which treats its own citizens with cruelty? Is it wise, given the growing risks of instability and state failure in Turkmenistan, for the German government to turn a blind eye to the role of the German financial system in managing Turkmenistan's finances?

Global Witness believes it is vital to determine that Turkmen official funds on deposit in Germany and other European banks have not been misused by Niyazov. There is currently no way for a Turkmen citizen or any other concerned observer to find this out. And the Turkmen rules and regulations are clearly not a meaningful check on Nivazov because he has absolute control. Banking secrecy is not an excuse for ignoring the implications of helping a repressive megalomaniac to keep control of his country's finances.

US\$41 million missing from the Turkmen **Central Bank**

Concerns over the management of such large amounts of money grew, when, in September 2002, more than US\$41 million went missing from the Turkmen Central Bank. Nivazov called for an investigation and criminal proceedings to be brought against those responsible for the alleged theft. Nivazov stated on television that no-one, apart from presumably himself, would then be allowed to control state funds. 97 Deutsche Bank was absolved of all blame by the Turkmen authorities.

Investigations by Russia's public prosecutor suggested that a group of people from Turkmen and Russian banks illegally used an electronic system of payments and transferred the millions from the Central Bank of Turkmenistan to banks in Russia and Latvia. 98 One of the alleged Turkmen thieves was found stabbed to death in a St Petersburg apartment.99 Two other men (a Russian banker and a Turkmen Central Bank employee) were accused of aiding the thieves and stood trial in Moscow in 2004.

Court documents seen by Global Witness reveal new information concerning the crime and the Turkmen Central Bank account at Deutsche Bank. The prosecution claimed that money had been stolen over a number of months from various funds; US\$3.75 million had allegedly been diverted via a contract with the Oil & Gas Development Fund at Deutsche Bank. In total, it appeared that just over US\$41 million had disappeared: however, it could not be confirmed that US\$20 million of this money even belonged to the Turkmen state because the Turkmen authorities failed to provide any information to the court which would corroborate its origin. The court's final sentence document, seen by Global Witness, states: 'The conclusion of the investigation that the funds belonged to the budget of the Republic [of Turkmenistan] is based only on suppositions, and cannot be considered an established fact just on the basis of witness' testimony and confirmations by investigative organs of another government ... the victim was not established, and during the trial nobody testified to being the victim.'100

Furthermore, the Turkmen authorities did not provide the prosecution with such vital information as copies of the allegedly fraudulent 'Swift' transfers, the system used to transfer money between accounts. Without these it was impossible to show that money had indeed been embezzled. The sentencing document continues: 'The prosecution did not present written evidence to the court that the fact that the transferring of funds from the account at the Central Bank of Turkmenistan had taken place.'101 The Russian banker was found guilty and received a jail sentence for money laundering – knowing that the money he transferred had been unlawfully gained. However, without a victim or direct evidence of embezzlement, both the banker and the Turkmen Central Bank employee were found not guilty on



Turkmenistan's central bank is little more than a facade. Global Witness

Chaos at the Central Bank, chaos in the gas sector

Khudaiberdy Orazov was the chairman of the Central Bank from 1993 to 1999; in 2000, Niyazov dismissed him from all government positions for 'serious shortcomings in his work'103 (a common reason for many of the government firings over the years). In 2002, he fled Turkmenistan and became an opposition party leader. Since then, Niyazov's increasingly erratic hiring and firing of Central Bank chairmen (three people held the position in 2002 alone) in-

dicate not only that its management is completely at odds with a stable economy, but also that he has complete control over state financial flows.

Seitbay Gandymov was Orazov's successor at the Central Bank, but was dismissed in May 2002, for 'making serious mistakes' and allegedly transferring funds to his relatives, according to Niyazov. 104 His successor, 34-year old Imamdurdy Gandymov (no relation to Seitbay), lasted less than six months. He was sacked for alleged involvement in the case of the missing US\$41 million from the Deutsche Bank account.

His public dismissal on television was a prime example of Turkmenbashi man-management; as Imamdurdy wept and wiped his nose with a handkerchief, Niyazov berated him: 'Come here ... We appointed you, young lad, to the chairmanship ... From the first day I warned you, "Look Imamdurdy, be careful, take some measures to clean it out." However, instead of this you have made it an even dirtier place ... You will get at least 20 years. Just you yourself imagine - your children, you have relatives too -... Why have you been carrying out money transactions in Frankfurt?'105 Both Gandymovs have been jailed: neither has been heard from since their incarceration.

For three years, there was no proper Chairperson of the Central Bank; until 2005, Sekersoltan Mukhammedova was the 'acting' head. 106 But she too was dismissed in May 2005, for allegedly 'conspiring criminally' with former deputy prime minister in charge of the oil and gas sector, Yolly Gurbanmuradov, the man who signed gas contracts on behalf of Turkmenistan. 107 As this report goes to press, it is unclear what has happened to Gurbanmuradov, Niyazov's former 'number two', who was sentenced to 25 years in jail in June 2005¹⁰⁸ but was not present in court hearings.

Following Gurbanmuradov's arrest, Niyazov purged many top officials, including many from Turkmenistan's oil and gas sector. Sackings were announced by Niyazov via state media, with jail sentences confirmed on television by Turkmenistan's prosecutor general. Facts concerning the conduct of these trials cannot be ascertained. Yet in 2004, the US Department of State described Turkmenistan's judicial system as controlled by the President

> himself and expressed its concern over 'unfair trials.'109

Ilyas Chariev, the head of Turkmenistan's oil and gas trading body, was sacked in June 2005¹¹⁰ and sentenced three months later to 25 years imprisonment for various crimes.111 In July, the former head of Niyazov's presidential administration, Rejep Saparov, was found guilty of a range of crimes and sentenced to 20 years imprisonment. 112 In August, Saparmamed Valiev, the head of Turkmenistan's state oil company, was sacked due to 'serious deficiencies in his work and abuse of office'113 and jailed for 24 years. 114



Turkmen Gas HQ. Global Witness

At the end of October, Guychnazar Tachnazarov, the former director of the Oil and Gas Development Fund, and Gurbanmuradov's replacement as minister in charge of gas and oil, was also sacked for 'grave shortcomings'. 115 At the same time the Turkmen ambassador to Ukraine, Amengeldi Bairamov, was recalled. 116 A few days later, Niyazov sacked Allamurat Ovezov, the head of the Turkmen gas concern, who was appointed only in June, accusing him of bribe-taking and other abuses of office. The timing of these many sackings led some commentators to link them to a Ukrainian criminal investigation into intermediary companies trading in Turkmen gas (see section: The criminal investigation that never was?). The fact that Turkmenistan's national security minister stated in June that Gurbanmuradov had been charged in connection with having ties to foreign intelligence services on 'ways of selling cheap and oil and gas abroad' may confirm this. 117

Who now remains with the expertise to run Turkmenistan and its gas industry? In August, it was announced that Niyazov had appointed a former bodyguard as one of Turkmenistan's new deputy prime ministers. 118

The Republic of Turkmenistan has surpassed in a month the distance which would normally be crossed in a year. It has been observed that Turkmenistan is progressing towards being a rich and developed country. All have seen this, friends, foreigners, even the blind!

Saparmurat Niuazov¹¹⁹

the greater charge of embezzlement by means of fraud and commercial bribery. 102

Due to the lack of forthcoming information from the Turkmen authorities, approximately US\$20 million was never recovered. This is an alarming indictment of Turkmen opacity: it appears that the authorities would rather impede a successful prosecution than afford scrutiny of their accounting practices by disclosing relevant evidence, a shining example of incompetence and possible corruption in Turkmenistan, which does nothing to ease fears concerning Saparmurat Niyazov's personal control over such funds and the competence of his management.

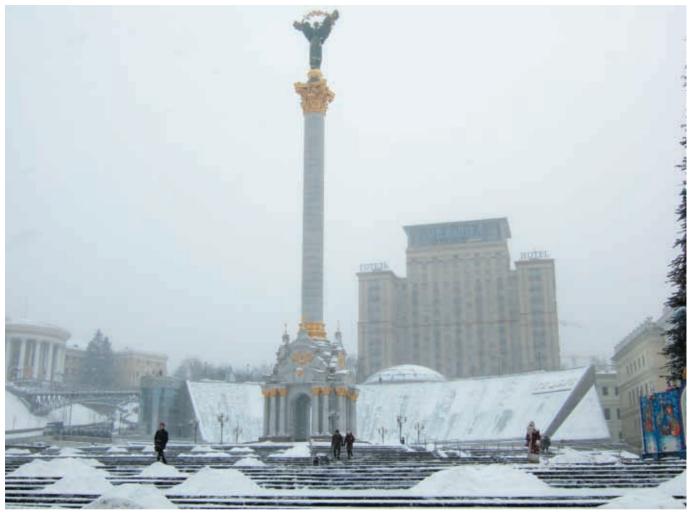
In conclusion, President Saparmurat Nivazov's complete control of virtually every aspect of Turkmen life and its governance has produced one of the most totalitarian states in the world. No free expression is tolerated, the nation's youth is being raised on study of the president's *Rukhnama*, and citizens not of 'pure' Turkmen extraction are being increasingly ostracised. To fund his increasingly bizarre personality cult, he appears to be using proceeds from the sale of his country's gas and oil. This money that rightly belongs to the people of Turkmenistan is being held out of sight and offshore in various funds such as the Foreign Exchange Reserve Fund at Deutsche Bank, Frankfurt. This money is not included in the Turkmen budget and is controlled directly by Niyazov. Worse, this apparent personal control of state funds seems to be leaving an ever larger hole in state finances, as shown by the recent cutbacks on state pensions and in Turkmenistan's healthcare system. The true situation of the Turkmen economy is impossible to judge, due to the authorities' secrecy, widespread use of off-budget funds, and confusion over the dual exchange rate. In short, Turkmenistan is in grave danger of becoming a fully-fledged failed state. In such a volatile area as Central Asia, the consequences of this are worrying to say the least.

As the EBRD recommends, 'for the long-term sustainability of Turkmenistan's economic development, the FERF needs to be transformed into a proper stabilisation fund, with some proportion of it saved for future generations. Critical for the operation of such a fund ... would be proper accounting of all financial flows, as well as the requirement to disclose all operations to the public.'120 The current Turkmen government is unlikely to put the EBRD's recommendations into practice for the good of its people. The international community must therefore hold the Turkmen government to account on the issue of proper accountability of the management of its state funds.



Turkmenistan's gas trade to Ukraine is a tangled business. AFP/ Sergei Supinsky

2. Ukraine



Maidan Square, one year on: the euphoria of the Orange Revolution has cooled. Global Witness

Ukraine has been Turkmenistan's main gas export partner for the last 12 years. ¹²¹ Although Ukraine produces some of its own gas, it imports some 50% (around 40 billion m³) of its demand from Turkmenistan. ¹²²

Turkmenistan also exports some gas to Russia, the world's largest gas exporter. Over 80% of Russian gas exports to Western Europe has to go through Ukraine, ¹²³ a fact that poses difficult questions for the continent's energy security, as many countries discovered at the beginning of 2006 when Russia shut off its gas supply to Ukraine. In 2004, some 100 billion m³ of Turkmen and Russian gas was ex-

ported to Western Europe, representing over a quarter of natural gas imports into the continent.¹²⁴ Turkmenistan is vital for Ukraine's gas supply, which is in turn fundamental to Europe's supply. If gas supply from Turkmenistan to Ukraine was disturbed for a long period, Europe would experience a harmful knock-on effect.

Back in the early 1990s, analysts considered Ukraine well positioned to make a successful transition to a free market economy because of its geographic location between Eastern Europe and Russia. Yet, the Ukrainian economy did not record a single year of growth until 2000, 125 at which point

I cannot help paying attention to the fuel and energy complex, because the situation there has crucial importance for the economic and political stability of the state, for the economic development and life of the people. Unfortunately, this key sector is the most criminalised, according to the opinion of all experts. It is also too politicised.

Former President of Ukraine Leonid Kuchma, speaking in 2000

economic output had shrunk to 40% of its 1991 level. 126 Corruption was rife in most areas of Ukrainian life. In a review, completed in May 2000 by the Economist Intelligence Unit, which ranked the quality of the business environment of sixty countries, Ukraine was placed fourth bottom with only Iraq, Iran and Nigeria ranked worse. 127 Without legislative norms and their enforcement to protect property, and with one of the weakest anti-money laundering and anticorruption systems in the world, foreign investors stayed away. World Bank president James Wolfensohn even sent a letter to the then-Ukrainian president Leonid Kuchma in early 1997, criticising corruption within the government. 128 Much corruption seemed centred around the energy sector, a fact confirmed by former President Kuchma, who stated on television in 2000 that the 'key sector' of fuel and energy was 'the most criminalised, according to the opinion of all experts. It is also too politicised.'129

This is the legacy of endemic corruption inherited by Viktor Yushchenko following his election as Ukrainian president after the Orange Revolution in 2005. This section of the report highlights how, under Yushchenko's predecessor Leonid Kuchma, political power in Ukraine in the mid-1990s became centred around its energy sector, leading to opaque and incestuous relations between government officials and gas companies. This created a predatory and unaccountable operating environment in which Turkmen gas deals were struck. There is an examination later in this section on how the gas industry's reliance on barter schemes allowed individuals to profit while the state's debt multiplied. These effects are still being felt today.

The first part of this section examines the rise and fall of Pavlo Lazarenko, a former minister in charge of the oil and gas sector, who became Kuchma's prime minister in 1996. A year later, he was fired and formed his own rival political party. With many business interests Lazarenko had become a rich and powerful man, vet his eventual arrest in America ended his hopes of challenging Kuchma for the presidency. A long court case in the US found Lazarenko guilty on 14 counts of money laundering, wire fraud and interstate transportation of stolen property in 2005, though he is yet to be sentenced.

Following Lazarenko's defection in 1997, President Kuchma seemed to consolidate his own power-base with the formation of the state oil and gas company NAK Naftohaz Ukrainy. Hair-raising details of Naftohaz's accounting practices detailed below suggest that the company, run by Ihor Bakai and his successors, including Yuri Boiko (who will reappear later in this report), was a financial black hole run more for the interests of the elite than the state and its customers.

The case of Pavlo Lazarenko



In a country whose power was very much focused on clans. regional Pavlo Lazarenko, a former governor of Dnipropetrovsk where Leonid Kuchma had headed a nuclear missile de-

sign factory – was well placed to further his political career in the newly-independent Ukraine. His story is a prime example of a Ukrainian politician using his position to gain huge sums of money from questionable business practices which he then held in offshore accounts.

In September 1995, Lazarenko was appointed by President Kuchma as the Ukrainian first deputy prime minister in charge of the energy sector, and was responsible for allocating quotas to private companies. A previous attempt to use a third party to supply Turkmen gas to Ukraine had not helped his country's spiralling gas debt (see section: Respublika).

These private companies were entitled by the state to import foreign gas (of mainly Turkmen and Russian origin) and sell it to state-owned factories in particular regions. A company's profit therefore depended in part on the volume of gas it was allowed to supply. In early 1996, before he became prime minister in May, Lazarenko restructured the scheme to allow a company named Itera to supply around 18 billion m³ of gas from Turkmenistan. Itera had supplied Turkmen gas to Ukraine in 1994/5, though it is not clear what volume of gas was involved. 130 The other major quota allocation was given to United Energy Systems, headed by Yulia Tymoshenko (Ukraine's prime minister from January 2004 to September 2005), which was allowed to continue supplying around 25 billion m³ to various factories. Lazarenko has stated in an interview with a journalist that his allocations were fair, based on the amounts of gas that each company was able to buy.¹³¹

Lazarenko was sacked by Kuchma in the summer of 1997; some put his dismissal down to Kuchma's fear of a political rival, others considered it a result of mounting dissatisfaction with the restructured gas scheme. Later that year Lazarenko formed a political party with the intention of challenging Kuchma for the presidency. The subsequent formation of Naftohaz Ukrainy allowed President Kuchma to reclaim power over the energy sector, along with Naftohaz's newly-appointed head, Ihor Bakai, a businessman whose company, Interhaz, had seen its quota reduced by Lazarenko in 1996.

In 1998, Ukrainian officials accused Lazarenko of siphoning state money into Swiss bank accounts and called on Switzerland to begin an investigation. Lazarenko was arrested, crossing by car with a Panamanian passport from France to Switzerland, in December 1998. 132 He posted bail, returned to Ukraine, but later fled, fearing for his safety. He was arrested again in America in February 1999 and charged with laundering US\$114 million¹³³ that, according to the US Justice Department, had been diverted to institutions in California's Bay Area, including Commercial Bank, Pacific Bank, and the Bank of America¹³⁴ from accounts in Switzerland and Antigua.¹³⁵ A US grand jury alleged that while Lazarenko was a public official, he unlawfully received over US\$200 million from various Ukrainian businesses and had thus defrauded the people of Ukraine of 'money and property and his honest services'.136

The indictment alleged that Lazarenko had announced in 1997 that his income for 1996 was 9,397 hryvnia (approx US\$5,040) and that he had no income from business activities, and no money in financial institutions 'when in fact he had ownership interests in companies doing business in Ukraine and in 1996 received more than US\$165,000,000 into bank accounts he controlled.'137

The Justice Department revealed that he had previously bought a mansion in California for over US\$6 million. 138 Press reports describe the property as having 41 rooms including a ballroom, five swimming pools, five dog kennels, nine bathrooms and two helicopter landing pads. 139 Lazarenko maintained that he earned the money legitimately and that he moved large tranches to foreign banks to prevent Kuchma from confiscating funds of a political opponent.140

In 2000, a Swiss court sentenced him to an 18-month suspended sentence in absentia for laundering US\$6.6 million.¹⁴¹ The American trial was severely delayed but finally took place in 2004 in San Francisco. Lazarenko originally faced a total of 53 charges in the United States, but the judge dismissed 24 of them, mostly charges involving Lazarenko making huge profits improperly through the gas industry. The charges were thrown out by the judge due to the prosecution's failure to prove that Lazarenko's actions had violated both Ukrainian and American law at the time the acts were committed. He was thus found not guilty of any charges connected with Itera and other gas companies.

However, the court proceedings revealed interesting information about Lazarenko's relationship with Itera, the company to which he had awarded a major franchise in early 1996.

Theodoros Kavalieros, currently vice-president of Itera International Energy Corporation, was guestioned by Martha Boersch, a US government lawyer working on the Lazarenko case. He testified that he transferred millions of dollars through Itera's Cypriot affiliate Omrania to a company named Bainfield Ltd, an offshore company controlled by Lazarenko (see box: *Kavalieros' testimony*). 142

The following day Itera issued a press release stating that it had nothing to do with the crimes Lazarenko was charged with, that it had no idea Lazarenko was behind Bainfield Ltd and that the payment given to this company was one of dozens of barter deals.¹⁴⁴

However, a Moscow Interfax report stated: 'Lazarenko's lawyers say that their client was an Itera shareholder and the money he received [via Bainfield Ltd] was part of the company's profits'. This was denied by Ted Kavalieros in his testimony, who said that Lazarenko was not a shareholder in the main Itera holding company, though it is unclear which particular branch of Itera Lazarenko's lawyers were referring to, and Kavalieros said in his testimony that he did not know who was a shareholder in other companies, such as Itera-Ukraine.

Global Witness wrote to Lazarenko's lawyer, Doron Weinberg, and to Itera's Igor Makarov for clarification on the reasons behind Itera's payment to Bainfield Ltd. Both parties have vet to reply.

Lazarenko's actions as prime minister may well have not violated Ukrainian law, such as it was at the time. Yet receiving money from Itera for whatever reason, whether Itera knew of Lazarenko's involvement in Bainfield Ltd or not, was a clear conflict of interest for Pavlo Lazarenko, the man in charge of allocating gas quotas in 1996/7 to private companies.

The jury found Lazarenko guilty of 29 charges in April 2004. The judge then threw out 15 of the convictions due to lack of evidence, but upheld the remaining 14 and dismissed the motion for a new trial. 145 The government is seeking forfeiture of the defendant's ill-gotten gains, including US\$21,696,000, which may be imposed at sentencing. 146 Lazarenko was due to be sentenced in early 2005, but this was postponed to July, and then to December, and once more to March 2006 - seven years after Lazarenko's arrest in America. At the time this report went to press in April 2006, Lazarenko had still to be sentenced.

Kavalieros' testimony

The following excerpts¹⁴³ are from Kavalieros' testimony. In it he claims that he as the vice-president of Itera International Energy did not know why money was being transferred to Lazarenko's company. This was known, Kavalieros said, by Itera's president Igor Makarov.

Martha Boersch, a US government lawyer: And what does this particular instruction [on an Omrania document signed by Kavalieros] refer to? What does it request?

Ted Kavalieros: It is a request to transfer to the company named Bainfield Company, Limited, the amount of US\$400,000.

MB: And on what date?

TK: The date is January 31st 1996.

MB: Now, were you familiar with a company called Bainfield?

TK: No.

MB: Do you have any idea where that company is located?

TK: No.

MB: Do you - when the instructions came in to you to transfer money, would you - did you know anything about the purpose for the transfer of the money?

TK: No, because this activity was done in Russia, and the contracts were signed there [...]

MB: Did you ever see any contracts between Bainfield and Itera?

TK: No.

MB: Do you have any idea whether or not there ever were any contracts between Bainfield and Itera, based on your personal knowledge?

TK: I cannot answer the question. I have to guess again that there be [sic] the contracts.

MB: But you don't know?

TK: No.

MB: That was not part of your job to know what was happening on the other end?

TK: No.

MB: Do you recall how much money total was transferred from Itera to Bainfield?

TK: Approximately 25 million [US dollars].

MB: And when these other requests came in for - to transfer the money again, did you have any personal knowledge of what the basis was for the transfer?

TK: No.

This seemed to be common practice within the company, as confirmed by the following testimony excerpt, when Kavalieros was cross-examined by Lazarenko's lawyer, Doron Weinberg:

Doron Weinberg: And with respect to those transactions [to buy products], were you informed about why you were transferring money?

Ted Kavalieros: No.

DW: That's not true only of these Bainfield transactions, is it? It was generally the case that you were asked to send money to places without being told why, correct?

TK: Yes.

DW: And roughly how much money went through the Itera International Energy Corporation account in a given year; say, for example, 1996?

TK: I cannot answer. I have to check into that. I don't have the - that off my head.

DW: Do you have any estimate?

TK: It could have been more than US\$200 million.

DW: And that money – it was no longer coming from the sale of foodstuffs by 1996, was it?

TK: No. That was money from the sale of gas.

DW: In Russia?

TK: In the ex-Soviet Union.

DW: All around the ex-Soviet Union?

TK: Yes.

Bakai is a talented manager, but he, how can I say, sometimes does not know when to apply the brakes.

Leonid Kuchma, September 2005



Bakai (left) with Kuchma (extreme right). Kommersant

Naftohaz Ukrainy under Ihor Bakai

Following the dismissal of Lazarenko, in 1998, President Kuchma created the Ukrainian state oil and gas company, NAK Naftohaz Ukrainy. In part, this was to regain control over his country's lucrative energy sector, previously controlled by Lazarenko. Ihor Bakai, a wealthy gas trader, was chosen by the cabinet ministers of Ukraine as its first chairman.

Although a Kuchma-led commission had investigated Bakai in 1994 (see section: *Respublika*), they appear to have become very close associates; Bakai was also an unofficial advisor to Kuchma during his time as Naftohaz chairman. Some reports state that he could enter the presidential office at any time, although this was denied by Kuchma in an interview in 2005. ¹⁴⁸ Even after Bakai left Naftohaz amid rumours of corruption and mismanagement, Kuchma employed him again in his administration in late 2003 before the presidential election in 2004. Bakai is now living in Russia, wanted in Ukraine on charges relating to various crimes allegedly committed while working in this capacity.

Under Bakai, no audits of Naftohaz were carried out, nor was the accounting chamber of Ukraine allowed to investigate or audit it. In 1997, Kuchma twice vetoed a law that would have given the chamber the right to look at the state's energy accounts. 149 In fact, no audits by international companies were carried out on the state oil and gas company until 2001. In an interview in 2005 with *In*vestGazeta, a Ukrainian financial newspaper, the head of Ukraine's main auditing directorate, Mykola Syvulsky (a close associate of then-prime minister Tymoshenko), stated that: 'The work of Naftohaz was completely ineffective, but we were unable to check all the company's areas of activity ... Naftohaz, back from the times of Ihor Bakai, built up a structure that made it impossible to carry out a high quality check. The company's internal security service does not allow auditors to talk directly with executives and get information from them.'150

During the 1990s, certain common practices allowed certain individuals in Ukraine to amass large fortunes. Firstly, gas

was illegally siphoned from Russian pipelines, a practice which was finally stopped in May 2000. Secondly, companies avoided cash payments and taxes through the arrangement of complex barter deals. Finally, gas was imported from Russia and other countries and sold to consumers, while passing on the costs to the Ukrainian state. Bakai was the chairman of Naftohaz when all three of these practices were rife.

Although Naftohaz under Bakai monopolised the country's internal gas trade, supplying an estimated 85% of the market, with 300 of the top state companies buying more than half their gas from Naftohaz, it also ran up huge debts. In early 2000, Bakai himself estimated this debt at US\$760 million. At a press conference in March 2000 he stated: 'My greatest mistake and problem is that I let our debt to Gazprom grow by US\$500 million over the three months of 2000.'154

These debts seem to have been accrued through the use of various opaque barter schemes and 'gas trading houses'. Former deputy minister in charge of the fuel and energy sector Yulia Tymoshenko spoke about the latter in 2000:

[Gas trading houses] paid anything but cash to those extracting or importing gas. For example, they paid by devalued promissory notes, trade liabilities et cetera. The real value of all these securities was much less than it had been declared: they bought them for 10-15% of their face value and sold them at 100% to energy producers who simply had no choice. Before the appointment of the Yushchenko government [who became Ukrainian prime minister under Kuchma in 2000] Naftohaz Ukrainy headed by Ihor Bakai simply gave away billions of hryvnas worth of gas to commercial companies. And nobody received anything at all. It was a free gift. 155

In August 2000, then-Ukrainian prime minister (and current president) Viktor Yushchenko admitted that Ukraine had illegally siphoned off Russian gas from pipelines, but stated that it was stolen without the government's knowledge. ¹⁵⁶ An international tribunal of arbitration found that Russian gas had gone missing in Ukraine in 1999. ¹⁵⁷ This took place when Bakai was chairman of Naftohaz and therefore in theoretical control of Ukraine's gas transport infrastructure.

Barter madness: 12 million galoshes for 4 million people in a 40°C heat

After the fall of the Soviet Union, high inflation rates and scarce hard currency made cash transactions unattractive in countries such as Ukraine. Instead, resources such as oil and gas were often swapped for other items which the country was in short supply of – food products, fertiliser, metal, equipment. Before the Russian financial crash of August 1998 this trade in barter dominated Ukraine's energy sector; it has been estimated by one commentator in the *Financial Times* that 90% of all energy commodities in Ukraine in the mid to late 1990s was paid for in barter. 158

The system is open to a wide range of misuse; many aspects of barter can be exploited, which, when combined, produced an opaque and chaotic system of payments for gas and other natural resources. For example, instead of tangible products, construction contracts and services such as technical assistance are often rendered as part of barter deals. The value of such work is hard to quantify, and construction contracts are open to inflated pricing.

For tangible goods, the complex system of barter arrangements revolves around manufacturers pricing their products at 'coefficients' - a multiple of the production price, usually between one-and-a-half and three times the factory price of the goods. 159 For example, for a product costing US\$1 per item, a coefficient of one would mean that the buyer receives 10 items for US\$10, a coefficient of two would mean the buyer receives five items for US\$10, and so forth. By manipulating the coefficients, large profits can be generated and either the buyer or seller can benefit. As the IMF states, 'the use of barter to pay for gas imports has meant that transactions are largely nontransparent and as such have contributed to price discrimination and created opportunities for corruption and tax evasion.'160

Up until 2005, virtually all of the gas contracts signed by the government of Turkmenistan stipulated that part was to be paid in hard currency and the rest in barter (sometimes 50%, at other times 60%). For example, from 2003 to 2005, Turkmenistan's gas contract with Russia was worth US\$44 per 1000 m³, with 50% to be paid in barter. An expert familiar with the deal told Global Witness that the contract was worth only US\$33 per 1000 m³ - the value of the barter portion halved due to the true value of the goods being less. 161 With so much gas being sold, the barter portions are worth a great deal: a contract signed



in 2002 between the Turkmen and Ukrainian state oil and gas companies seen by Global Witness states that US\$840 million worth of barter goods would be supplied yearly to Ukraine. 162

The goods themselves can be resold, often abroad, and the profits retained offshore. These revenues are not registered as being earned by the company selling the gas and as a result are not liable for tax. Though arguably not illegal at the time, this practice stripped the Ukrainian economy of enormous amounts of money, resulting in higher energy prices for the ordinary citizen. One commentator in the Financial Times went so far as to characterise the Ukrainian energy sector in the 1990s as 'a scheme of monopolies, transfer pricing and barter which [was] designed to suck all the profits from the Ukrainian economy into foreign bank accounts.'163



Furthermore, the goods that are often given in exchange for gas are sometimes of questionable quality, or even plainly absurd. Ihor Sharov, who worked with Ihor Bakai at Respublika (see section: Respublika), joked openly in an interview with a newspaper about some of these deals: 'Respublika brought a huge income to the [Ukrainian] state by exporting domestic TV sets at a price of US\$1,000 per item and we were able to trade with Turkmenistan, with its 4 million population, who bought 12 million pairs of galoshes from us!'164 Concerning the Ukrainian bomber aircraft that Bakai gave to Russia to settle part of Ukraine's gas debt, according to a Russian newspaper, over half were 'incapable of performing combat missions' with the others needing a major overhaul. 165 Russia may have been, in effect, paying over US\$300 million for scrap metal. Recently Ukraine gave Turkmenistan 3,000 spruce trees¹⁶⁶ as partial repayment for its gas debts.

A journalist back in 1994, reporting on the then-French president François Mitterrand's official visit to Turkmenistan, witnessed a fleet of black Mercedes 600 limousines and brand-new Volvos driven by the Turkmen authorities. When asked why Turkmenistan had so many luxury cars, an aide to the Turkmen president told him: 'Moscow is paying for our gas with them. They got them in barter deals from Sweden. We also have 600 Russian warplanes, including the modern MiG-29s in exchange for gas. We only have seven pilots, although the French have offered to train more for us.'167

On 1st January 2005, Turkmenistan stopped scheduled gas supplies to Ukraine, after Niyazov expressed concern about the high price of barter goods coming from Ukraine. The price of the gas was raised (from US\$44 to US\$58 per 1000 m³) but the barter portion retained. A few months later, the Turkmen foreign office asserted that Ukraine had failed to supply items worth about US\$600 million for the barter portion of the gas contract, with most of the debt accumulated during the first five months of 2005. Niyazov called Ukrainian barter schemes 'a mechanism for swindling'. 168 Commentators believed that this was due to Ukrainian price rises for commodities such as steel, or a rise in the coefficient. Therefore, Turkmenistan would have been receiving a lesser quantity of goods. With such large quantities of gas sold – 36 billion m³ – Turkmenistan experienced huge losses.

In July 2005, the new head of Naftohaz Ukrainy following the Orange Revolution, Oleksei lychenko, stated that the new contract with Turkmenistan (active from 1st July 2005 but renegotiated in early 2006) would bring an end to barter transactions: 'It's been my opinion from the first ... that we should get out of barterisation, especially in respect of the Turkmen contract. Neither Naftohaz Ukrainy nor the Ukrainian budget benefit in any way from this scheme. Benefits were accrued only to some unclear commercial structures that worked in this area, '169

Russia's gas dispute with Ukraine at the beginning of 2006 saw an end, for now, to deals involving barter trading, with Gazexport buying gas from Turkmenistan and selling it on to Swiss intermediary RosUkrEnergo in cash. However, as Global Witness goes to press, the Ukrainian parliament had asked for more information concerning this intermediary which could ultimately see the contract being renegotiated again, with the possible reintroduction of barter deals.

Bugged: Kuchma and 'Tapegate'

Allegations abound that under President Kuchma, the state oil and gas company Naftohaz Ukrainy was being used for private political patronage, but these allegations have not been fully and publicly investigated.

These allegations stem in part from secretly recorded conversations purporting to be from the presidential office made by one of his bodyguards, Major Mykola Melnychenko. Ukraine was rocked by the revelation of these tapes in November 2000, which led to the so-called 'Tapegate' scandal and to major demonstrations against President Kuchma the following year.

Though acknowledging his office had been bugged, Kuchma maintained that certain portions of these tapes, recorded between October 1999 and September 2000, were carefully constructed fakes using sections of speech taken from different times and sources.¹⁷⁰

Controversy over the tapes was heightened not least because a voice broadly recognised to be that of Kuchma is heard to order that a journalist, Georgiy Gongadze, should be seized and dumped in Chechnya as punishment for publishing defamatory articles on the internet and for openly challenging him on television about his ineffectiveness in fighting corruption. Gongadze was abducted in September 2000 by persons unknown and his headless body found buried in a forest that November.

Experts disagree about the authenticity of the extracts, in part because the original recordings are digital, which means that they are easier to manipulate than analogue tapes. A test made on several samples by a former FBI agent working for US company BEK-TEK Corp at the behest of the Ukrainian parliamentary committee on Gongadze, a specialist who has analysed audio material in both the Watergate affair and the Kennedy assassination, showed that 'based on the flow of the speech in the five designated portions, no phraseology or sentence structure was pieced together by using individual phonemes, words or abort phrases ... though the existence of digital manipulation is highly improbable if it did occur, without now being obvious, then the most probable scenario would be a loss of data, and not additions or editing of content.'171 Ukraine's National Institute of Court Experts found the portions of the recordings that they tested might not be genuine. 172

Part of the problem of establishing the tapes' authenticity is that only copies and excerpts of the original recordings have been tested; Melnychenko has yet to release the full cata-



logue of his recordings (over 1,000 hours), which he says he will not do because they contain state secrets. Clearly, the only way to assess the authenticity of the tapes is for a full open and public inquiry using independent international experts.

Various sources have confirmed to Global Witness a transcript of one portion of the recordings which apparently features a voice alleged to be Kuchma's berating Ihor Bakai for not providing enough funds: 'I looked you in the eye, and you said that you would provide 250 million [US] dollars for the election campaign.'173 Another purported conversation with one of Kuchma's election fundraisers covers a similar theme. A voice similar to Kuchma asks: 'And where is Bakai? ... I need to discuss something with him. He has transferred 10 million. But what is 10 million if 20 million dollars is needed till the end of the month. Well, give the account number where to transfer, I will think who to give it to.'174

Allegedly on 10th February 2000, after the presidential election, a voice considered to be that of the head of the tax of-

fice, Mykola Azarov, discusses Bakai with someone whose voice sounds similar to that of President Kuchma: 'Well about this Naftohaz. I invited Bakai, as we agreed and showed him everything. My people worked on that and I trust them ... And I literally told him, "Well, Ihor, you have put at least a hundred million in your pocket, at least. I understand that, of course, I will not set them up. I give you two weeks, a month at the most. Destroy them, these, so to say, your papers, which prove directly or indirectly all of your – you did it foolishly and stupidly". And I showed him that he did everything foolishly and stupidly" [...] Well, he could have done it in a smart way. But, no, he did it so that any stupid inspector could see his false schemes. Even a stupid one.'175 Global Witness wrote to Azarov in April 2006 to confirm whether he had said these words and to get his opinion, as the former head of the tax administration, on Bakai's time as Naftohaz chairman. As this report went to press, Azarov's press secretary told Global Witness that Azarov had wanted to respond but had not had time because of the recent Ukrainian parliamentary elections. However, the press secretary stated that Azarov had launched a criminal investigation concerning Naftohaz's management when he was head of the tax office.

The Melnychenko recordings, if genuine, imply that Naftohaz was being manipulated and its funds raided for private political patronage. As mentioned, investigators do not agree on their authenticity and Kuchma has said certain portions of the tapes are cleverly constructed fakes; therefore, a full, open public inquiry into these allegations is necessary.

In an interview with a Ukrainian website, Bakai said he had sent smaller sums (between US\$2–5 million) at the request of regional governors who had received orders from Kuchma, saying that he had to comply because Naftohaz was a state structure. ¹⁷⁶

Global Witness has tried to contact Ihor Bakai concerning these allegations but has been unable to reach him since his relocation to Russia. His response in clarifying the matters outlined above would be gratefully received.

Wanted: Ihor Bakai

Bakai's position at Naftohaz was weakened following a state visit by President Kuchma to America in December 1999. Bakai, who was to accompany Kuchma on the trip, was refused a visa by the United States amid allegations of corruption. Bakai has since maintained his visa refusal was because of confusion concerning his family's American properties (see section: *Respublik*a) and the fact he had sold military aircraft to Russia. 178

In March 2000, Bakai resigned from his position at Naftohaz, saying that he did not want his name to be used in blackmailing Ukraine's highest-ranking officials, ¹⁷⁹ though it is unclear what he meant exactly. It is impossible to document Naftohaz's business practices under the chairmanship of Ihor Bakai because no reliable financial information was released by the company and no audits were published. However, in late 2002, Ukraine's Supreme Court pushed for an investigation into alleged misappropriation of US\$42 million by senior Naftohaz managers during payment transactions for gas supplies but like so many other investigations in Ukraine, it appears to be on hold.¹⁸⁰

Oleksiy Donskiy worked on this case until April 2004 as a senior investigator of Kyiv's prosecutor's office. In an interview with Global Witness, Donskiy spoke more about the details of the investigation. The investigation sought to trace payments allegedly made by Naftohaz to a Latvian account of a now defunct company named Fahr European Ltd, which had been registered in the American state of Oregon in late March 2000. 181 Oregon state law does not require a company to name its directors, shareholders or officials. In March 2000, Bakai was no longer head of Naftohaz: the acting head of the company was a man named Ihor Didenko. According to Donskiy, Didenko was a close associate of Bakai's, dating back to the latter's time at Respublika. 182

Donskiy told Global Witness that money had been moved out of Naftohaz's accounts through a series of contracts with fictitious companies through UkrGazBank, a Kyiv investment bank which dealt with Naftohaz's accounts. ¹⁸³ In a Ukrainian television interview, Vasyl Horbal, the chairman of UkrGazBank, stated that Bakai was a shareholder of this private bank until 2000 – when Bakai was still head of Naftohaz. ¹⁸⁴ This was confirmed by Donskiy, speaking to Global Witness.

A source familiar with Fahr European, who asked not to be named, told Global Witness that the FBI enquired about this company in June 2002, at the request of the Ukrainian government. Donskiy also stated that the case was being stalled by higher-ranking officials because of its political sensitivity and that he had been sacked because of his close involvement in the case. 186

Bakai returned to government work in 2003; in July he was appointed, by presidential decree, the chairman of the state committee for water resources.¹⁸⁷ Then in October Bakai became, again by presidential decree, the director of the president's state affairs.¹⁸⁸ New allegations concerning Bakai's conduct during this period surfaced in 2005.

ITAR-TASS, quoting the Ukrainian interior ministry's public relations department, stated that Kviv's Pechery district court issued a warrant for Bakai's arrest on seven charges relating to his time in the presidential administrative department concerning 'the abuse of occupational duties' (Article 365 of the Ukrainian criminal code) and 'perpetrating a crime or supervising its preparation and execution' (Article 27).¹⁸⁹ According to Ukraine's department for auditing, cited by ITAR-TASS, the charges were based on allegation that the presidential administrative department and its central staff misspent US\$156 million.¹⁹⁰

Sometime during 2004, Bakai moved to Russia. He was then granted Russian citizenship by a special presidential decree signed by Vladimir Putin. The decree states that citizenship was granted for Bakai's contributions 'on behalf of Russian culture and art.'191 The Ukrainians have asked for Bakai to be extradited, and have placed him on Interpol's wanted list, ¹⁹² to little response from the Russians. The current Ukrainian authorities certainly suspect Bakai of wrongdoing, having presented the Russian prosecutor general with information concerning Bakai and his activities totalling one hundred volumes. 193 In March 2006, Ukrainian interior minister Yury Lutsenko stated in a television interview: 'There are 15 criminal cases [concerning Bakai] which were opened by the prosecutors ... based on materials obtained by the department for fighting organised crime and the department for fighting economic crime'. 194 In recent television interviews, Bakai denied the allegations made by Lutsenko¹⁹⁵ and even stated that unnamed top Ukrainian officials had consulted with him in early 2006 in Moscow about Russian-Ukrainian gas issues. 196

It is unclear why the Russians are not cooperating with Ukrainian authorities, especially since Bakai was in charge of Naftohaz when Gazprom's gas was being siphoned illegally, as acknowledged by the then Ukrainian government. Global Witness has been unable to contact Ihor Bakai concerning these allegations since his relocation to Russia. We would welcome Ihor Bakai's response in clarifying his role in the matters outlined above.

Naftohaz Ukrainy's chairmanship: from Ihor Bakai to Yuri Boiko

Following Bakai's resignation in early 2000, Ihor Didenko became the acting head of Naftohaz. His tenure lasted only three months. He was later arrested in Germany in July 2001 and charged with embezzling US\$38 million that Germany had disbursed to Ukraine to compensate victims of Nazi slave labour camps. 197 He was sentenced to four years and three months in jail in June 2004. 198 Didenko's replacement was Vadim Kopylov, whose tenure lasted from July 2000 until February 2002 when he was fired by President Kuchma.

Kopylov's successor, Yuri Boiko, appointed by presidential decree, occupied the post until just after the Orange Revolution. He was even awarded the title of 'Hero of Ukraine', Ukraine's highest state decoration, by President Kuchma in August 2004.¹⁹⁹ Yet investigations carried out under the premiership of Yulia Tymoshenko suggest that Boiko did little to improve the lack of transparency and mismanagement that were associated with Bakai and Didenko.

In 2004, Yuri Boiko stated he wanted to obtain an international credit rating for the release of Eurobonds, for which retrospective audits of the company from 2001 to 2003 were needed.²⁰⁰ The audit from 2003 proved interesting reading. The accounting chamber of Ukraine, a statutory agency, now allowed to examine Naftohaz audits, stated that: 'the profit received by Naftohaz Ukrainy ... decreased almost threefold, whereas the Company's sales revenues increased nearly twofold.' Though Naftohaz disagreed with the accounting chamber's conclusion that this decrease in profit was down to inefficient management of state corporate rights, the data was not refuted by Naftohaz, according to the accounting chamber.²⁰¹



Yuri Boiko in the news again: it was Naftohaz, now it's politics and his relationship with RosUkrEnergo. Global Witness



According to auditing directorate boss Mykola Syvulsky, speaking to *InvestGazeta*, every seventh employee was provided with a car at a total cost of 31 million hryvnas (US\$6.2 million). Without naming individuals, Syvulsky concluded that managers 'had schemes installed allowing the enrichment of private persons and structures.'²⁰² No Naftohaz audit has been published on its website for 2004, Yuri Boiko's last full year as chairman. Global Witness spoke to Konstantin Borodin, who was Naftohaz's press secretary at the time of Boiko's chairmanship, concerning Syvulsky's claims and the downturn of the company's profits in 2003. Global Witness sent questions to Borodin at his request but has not received a reply.

However, Global Witness has seen a copy of an unpublished full management audit on Naftohaz in 2004, written in March 2005. The audit gives information which tends to confirm Syvulsky's claims and paints the picture of a creaking and inefficient state monolith with declining profitability. Though sales venues and gross profit again went up, the net profit went down, as the company took on more borrowings and incurred a large amount of fines. Apparently, at no time during the audit did the auditors receive any finalised documents from Naftohaz about the company's plans for natural gas deliveries and distribution in 2004.²⁰³

The main problems highlighted by the audit report run as a litany of bad management: (1) low-profit but high-cost operations, (2) use of intermediaries in its export operations, (3) high bonuses built into agreements between Naftohaz and its affiliated companies, (4) ineffective use of its tariff-regulating

powers, (5) ineffective management decisions, (6) the current dividend policy, (7) huge amounts of fines levied against the organisation (some 1.19 billion hryvnia (US\$240 million) in 2004 or 20.8% of all its operational costs), (8) major unpaid debts, which prompted the audit's authors to call for an audit of the indebted companies themselves, (9) ineffective supervision by the Naftohaz supervisory board, (10) confused and ineffective management structures including a multiplicity of departments that duplicated each others work.²⁰⁴

In conclusion, the report notes: 'Certain management decisions, from the point of view of profitability, do not contribute to the effective use of the Company's assets and, as a result, they decrease the Company's profit and payments to the State budget.'205 In January 2006, following the resolution of Ukraine's gas dispute with Russia, London-based credit ratings agency Fitch Ratings revised the outlook on Naftohaz's long-term local and foreign currency ratings from 'Stable' to 'Negative', meaning that it thought the company was now less able to pay off its debts.²⁰⁶

Much controversy around Naftohaz has centred in recent years on its failure to either dispense with or take control of the intermediary companies that have been contracted to transport Turkmen natural gas to Ukraine. Naftohaz's current management has stated in the past that it believes this area should not involve such companies, but should be organised solely by itself and Gazprom.²⁰⁷ Yet schemes signed under former Naftohaz chairman Yuri Boiko, which involve such intermediaries, continue to this day. These mysterious companies are the subject of the next part of this report.

3. The gas transit and trading companies



Introduction

Ukraine only produces about 25% of the gas that it needs, forcing it to import large amounts from Turkmenistan and Russia. Gas bought from Turkmenistan has to travel over 3,000 km to reach Ukraine. The pipeline that runs from Turkmenistan to Ukraine, the Central Asia-Centre pipeline, is controlled by Gazprom, the giant gas company which is 51% controlled by the Russian government.

Since the break-up of the Soviet Union, however, Gazprom has not been the sole direct controller of the transit of gas from Turkmenistan to Ukraine. Instead, this has been the domain of third-party intermediary companies which arrange transport of the gas with Gazprom to the Ukrainian border and resell it to the Ukrainian state oil and gas company Naftohaz Ukrainy. Gazprom itself often had difficulty getting payment for gas supplies from cash-strapped Ukraine, and the economic rationale for using these intermediary companies was that they could use their superior knowledge of the Ukrainian market to get paid, typically through barter. Another explanation offered to Global Witness by Russian energy expert Professor Jonathan Stern

was that the intermediary companies 'could enforce certain commercial conditions that Gazprom could not itself enforce for political reasons' - in other words, the intermediary companies, unlike Gazprom, were private entities which could press Ukraine to fulfil contractual terms without triggering a diplomatic spat with Russia. Intermediaries have thus acted as buffers in disputes between Russia and Ukraine, allowing both sides to claim they have benefited from the resolution of the dispute. This happened most recently in the winter of 2005/6 when Gazprom wanted gas prices higher than Ukraine was able to meet. The intermediary company RosUkrEnergo served as a solution, agreeing to buy the more expensive Russian gas and to supply Ukraine with cheaper Turkmen gas via Gazexport, Gazprom's export branch.

Yet the use of intermediary companies has been highly controversial in Russia and Ukraine. As this report will show, Gazprom has not only been accused of giving up lucrative business to the intermediaries which it could have kept for itself, but the companies themselves are highly opaque, both in their business dealings and their ownership structures. They have often come out of nowhere, parlaying tiny

sums of start-up capital into billion-dollar deals, with their true owners and beneficiaries hidden behind trusts, holding companies and 'scarecrow' directors – people not actively involved in the running of the company. Persistent questions about the true nature of the relationship between these companies and state officials in Russia and Ukraine, against a background of public concerns about official corruption and organised crime, remain unanswered. Given Europe's increasing need for Russian and Central Asian energy, lack of transparency casts a disturbing shadow over a gas trade that is growing increasingly important to European energy security.

The next part of this report examines four intermediary companies involved in the transportation of gas from Turkmenistan to Ukraine, the individuals behind them, and the deals they have struck.

1. Respublika

One of the first companies to transport gas from Turkmenistan to Ukraine was Respublika, headed by a Ukrainian businessman called Ihor Bakai, later the chairman of Naftohaz Ukrainy (see section: *Naftohaz under Ihor Bakai*). In February 1994, gas shipments to Ukraine from Turkmenistan were suspended because of Ukraine's non-payment of its accumulated gas debt. Desperate for gas supply to be resumed, the Ukrainian government sold its debts to Turkmenistan – around US\$800 million – to Respublika, a private company. According to the agreement, Respublika was to pay Turkmenistan US\$275 million in hard currency and US\$580 million in goods, including 10,000 tonnes of animal fat and 2,000 tonnes of baby food. On the solution of the supplies of the

However, Respublika failed in its task of clearing Ukraine's gas debt and Turkmenistan cut off gas supplies again in November 1994, prompting newly-installed Ukrainian president Leonid Kuchma to target Bakai's company a few months later and create a state commission to inspect its activities:

At a news conference in Kiev, Wednesday [9 November 1994], [Kuchma] declined to make any preliminary conclusions, though he said he was amazed at the fact that 'a structure with a registered capital of 500 million karbovantsy [About US\$3,000] obtained a multi-billion dollar contract'. Kuchma drew the journalists' attention to the fact that the concern, granted all possible privileges by the state, sold Ukrainian goods on the Turkmen market at prices much higher than their actual values. For example, the price of a Ukrainian-made TV set was above US\$1,000. All this was told to Kuchma by Turkmen president, Saparmurat Niyazov, he said. 'Something has gone wrong in our state,' Kuchma said.²¹⁰

We bring warmth to people! *Itera motto*

Bakai himself is reported to have said in 1998 that 'all rich people in Ukraine made their money on Russian gas,'211 though Respublika dealt primarily with Turkmen gas. Documents seen by Global Witness show that Ihor Bakai and his then-wife Elena bought a house in April 1994 for US\$1.8 million in cash in Meadowbrook, Pennsylvania.²¹² Bakai has stated that his father-in-law was the real buyer, and that he only contributed 10% of the total price,²¹³ even though it is Bakai's name on the deed. His father-in-law became the official owner of the property in December 1997. Documents also show that Elena Bakai purchased land worth US\$475,000 in the same area of Pennsylvania in July 1995.²¹⁴ In an interview with a Ukrainian website, Bakai admitted that his mother-in-law had purchased land in Florida, but maintained that he had nothing to do with this purchase.²¹⁵

Respublika's activities were never fully investigated. Some reports speak of a fire destroying its offices in 1995, preventing authorities from examining its tax records and financial dealings. ²¹⁶ Out of Respublika's ashes Bakai formed Interhaz, which supplied Russian gas to Ukraine in 1996. In 1997, President Kuchma, the same man who had launched an inquiry into Bakai's Respublika three years earlier, agreed to the appointment of Bakai as the first deputy chairman of the state committee for the oil and gas industry. In 1998, this committee became part of the state company Naftohaz Ukrainy with Bakai officially appointed as chairman of the board.

2. Itera

Origins

Respublika had failed to clear Ukraine's gas debts to Russia and Turkmenistan, which were still having trouble getting

payment for their gas. Another company, Itera, was to move onto the scene and control the supply of gas from Turkmenistan to Ukraine from 1994 to 2002. The founder of Itera, Igor Makarov, had previously had some success trading Turkmenistan's natural resources. Born in Turkmenistan, Makarov was a championship cyclist before

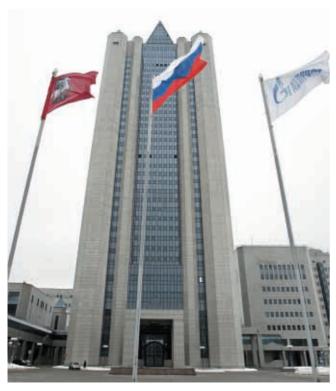


Igor Makarov. Kommersant

moving into business, selling jeans in the Russian city of Kazan in the late 1980s.²¹⁷ In October 1992, he registered a company called Omrania Trading in Cyprus.²¹⁸ In 1993, Makarov supplied Turkmenistan with food products in exchange for Turkmen crude oil.²¹⁹ This was his first experience in dealing with natural resources.²²⁰ Makarov himself told a Russian journal that he had entered the gas industry by accident when the Turkmen authorities offered to reimburse him in gas cargoes, worth US\$30 million, that he then resold in Ukraine.²²¹

In February 1994, Makarov registered a new company called Itera International Energy in Jacksonville, Florida.²²² By 2000, Itera, under its main holding company, Itera Group NV, had grown into the fourth largest gas company in the world based on its gas reserve base.²²³ Makarov said in August 1999 that the group contained sixty companies with over 3,000 employees.²²⁴ By 2001, Itera Holding, part of the Itera Group, had grown to 8,000 employees and 130 subsidiaries, with sales in 2000 of more than US\$3 billion.²²⁵

Makarov has stated that the key to his initial success was the fact that: 'boyhood friends were moving into key government positions in Turkmenistan and "it was like a snowball."226 It is unclear exactly who these 'boyhood friends' were, but the links between Itera and the Turkmen government are very apparent.



Why would Russia's all-powerful Gazprom give up lucrative business to upstart companies when it owns the pipelines? AFP/Yuri Kadobnov

Turkmen president Niyazov's right-hand man at the end of the 1980s was Valery Otchertsov, the vice-president of the Turkmen parliament from 1989 to 1991.227 After Turkmenistan gained its independence, Otchertsov became the minister of economics and was responsible in part for setting up TurkmenRosGas in August 1996, a company contracted to transport Turkmen gas to Ukraine. This company was a joint venture between the Turkmen government with a 51% stake, Gazprom with 45% and Itera with 4%.228 Fourteen days after it was set up, Otchertsov was relieved of his duties in the Turkmen cabinet and made an advisor to the Turkmen ambassador in Moscow.²²⁹ Otchertsov has stated to a Russian newspaper that his move to Moscow was due to 'family problems'. 230 According to Otchertsov, six months later he accepted an offer from Makarov to join him at Itera as vice-president.²³¹ Otchertsov has said that he absented himself from Itera's dealings with Turkmenistan as his previous position in the Turkmen government would have made it 'unethical'.232 Global Witness wrote to Otchertsov with questions concerning his work in Turkmenistan and at Itera. Otchertsov is yet to reply.

Itera's business was founded on trade with Turkmenistan and Makarov himself said, as noted above, that the company's position was due in part to his 'boyhood friends' within the Turkmen government. Even when Itera branched out into other sectors, Makarov stated in 2003 that the group's main business had been transporting Turkmen gas to Ukraine.233 Itera came to play an increasingly important role in this business after TurkmenRosGas was disbanded in June 1997. Niyazov blamed Itera for this business failure, asserting that the group owed Turkmenistan more than US\$200 million.234 Itera claimed, in turn, that it had been let down on barter deals with Ukrainian customers.235

Itera's 'know-how'

The joint venture between Turkmenistan, Gazprom and Itera appeared to end in acrimony, prompting President Niyazov to call for 'direct sales' from Turkmenistan to Ukraine. Yet if Niyazov was apparently ready to dispense with the services of Itera, Gazprom was not. The then-chairman of Gazprom, Rem Vyakhirev, stated that direct sales would be impossible as both Gazprom and Turkmenistan needed Itera. 236 He even described Itera as 'one of the best, if not the best company,' according to the Washington Post.²³⁷

Makarov told journalists in 2001 that Itera had 'set down mutually beneficial playing rules with Gazprom'.238 He explained that Gazprom was not getting paid for gas sales to Ukraine, due to the shortages of hard currency common in post-Soviet countries in the 1990s, but could not cut Ukraine out of the supply chain because its gas had to cross Ukrainian territory to reach more lucrative markets in Western Europe. Makarov said that Itera, on the other hand, had the 'know-how' to get payment out of Ukraine using a 'sophisticated and highly developed barter structure'.²³⁹ Therefore, Gazprom, unwilling and unable to deal profitably with Ukraine, allowed Itera to try its luck in the hope that the latter would boost business in the wider region.

By 2002, however, Itera had gone beyond just arranging the sale of Turkmen gas in Ukraine. The group had moved into lucrative markets in other parts of the former Soviet Union which had previously been controlled by Gazprom. Even though Itera appeared to be taking business away from Gazprom, the Russian company seems to have given Itera a financial helping hand. In 1999/2000, Gazprom granted around US\$880 million to Itera in loans, guarantees and other services, at a time when Gazprom was in a difficult financial position.²⁴⁰

One expert view is that Gazprom supported Itera at this time because it was vital for Gazprom to maintain supplies to Western Europe, which meant relying on Itera in Ukraine.²⁴¹ But some were deeply troubled. Hermitage Capital, a Moscow-based investment fund and a minority shareholder in Gazprom, produced a report in 2000 which alleged that, far from being 'mutually beneficial' (in the words of Itera's Makarov), the relationship between Gazprom and Itera was highly favourable to the latter and went beyond allowing Itera to sell gas through barter deals in Ukraine.²⁴²

Gazprom and Itera: too generous by half?

In December 1999, Gazprom's head Rem Vyakhirev was involved in negotiating a new gas contract with the Turkmen government. Global Witness has seen documents from Gazprom and the Russian accounts chamber which show that Itera bought gas from Turkmenistan, used Gazprom's own pipeline to transport it, then sold the gas back to Gazprom at a substantial mark-up.

In 2000, Itera bought a large volume of Turkmen gas at a price of US\$35.37 per 1000 m³, according to a report from the accounts chamber of the Russian Federation. The same document states that Gazprom bought about a third of this volume of gas from Itera at a price of US\$45 per 1000 m³. Gazprom's own consolidated financial statements, recorded an even higher price in roubles, equivalent to about US\$50 per 1000 m³. ²⁴³ In other words, Gazprom paid Itera much more than if it had bought the gas at source in Turkmenistan.

According to a press report, Gazprom's management explained that the difference in price was due to 'Itera's transportation costs'. ²⁴⁴ The inconsistency apparent in this explanation is that the document from Russia's accounts chamber states that transportation costs were reimbursed by Gazprom in a separate agreement. ²⁴⁵ Although the exact cash value of such deals is hard to calculate because of the barter element, the figures in the contract suggest that Itera may have made more than US\$100 million by selling gas to Gazprom that the Russian company could have bought directly from Turkmenistan.

One analyst who spoke to Global Witness about this deal suggested that Gazprom might not have been able to buy directly from Turkmenistan; Itera's strong links with that country meant that the group 'knew how to deal with the Turkmenbashi [President Niyazov].' But the analyst noted that this does not explain why Gazprom allowed Itera to sell its own gas in Gazprom's traditional markets around the former Soviet Union: 'How did Itera get Gazprom to agree to third party access for its gas from the place it wanted, to the place it wanted, when nobody else could? That's the mystery.' The scale of Itera's expansion into these markets was huge: Hermitage Capital estimated that from 1996 to 2002, Gazprom surrendered over 50% of its gas markets in the former Soviet states to Itera.²⁴⁶

Concerning his company's relationship to Gazprom, Itera's Igor Makarov stated in an interview with a Russian newspaper: 'I want to clarify once again that Gazprom does not give us any special deals or offer us any preferential conditions.'247 Yet Gazprom minority shareholders wanted further clarifications and called in 2000 for the relationship between Itera and Gazprom to be investigated in the form of an independent audit. A proposal for an audit by Deloitte and Touche was rejected by Gazprom chairman Rem Vyakhirev, who instead appointed Gazprom's own accountancy firm PricewaterhouseCoopers (PwC) in January 2001.²⁴⁸

The audit was completed in June 2001 and found no improper links between the two companies. The report was heavily criticised by William Browder of Hermitage Capital Management, who sued PwC for what he regarded as a misrepresentation of the facts. The case was dismissed by Russian courts, on the basis that his fund had no direct business relationship with Gazprom's auditors and therefore could not sue PwC. Another minority shareholder, Boris Federov, a former Russian finance minister, spoke out against what he saw as PwC ignoring information in order to retain its relationship with Gazprom. ²⁵⁰

A Russian accounts chamber report completed in July 2001 also did not conclude that improper links existed between Itera and Gazprom, and stated that neither company had acted illegally. Yet the report did express surprise that credits had been granted despite the fact that Gazprom and Itera were nominal competitors and noted that Gazprom had granted credits to Itera while itself being in a difficult financial situation. The audit manager, Mikhail Beskhmelnitsyn stated: 'I will not confirm that all the credits and guarantees extended by Gazprom to Itera were justified. I am not in position to answer this question.'251 Global Witness wrote to Igor Makarov with guestions concerning his company's relationship with Gazprom. He is yet to reply.

Itera's ownership 'revealed'

Itera itself decided to release some information concerning its shareholder structure at the time of the ongoing audits in April 2001. It was revealed that Igor Makarov owned 26% of the main holding company Itera Group NV (registered in the Dutch Antilles) through organisations serving as trustees. Other named individuals owned 13%, with the remaining 61% of shares held in two trusts for unnamed top managers and employees. Dutch Antilles law states that even the government is not entitled to know who the ultimate beneficiaries under a trust-type arrangement are. 252

Though PwC investigated Itera's shareholding structure, 19 Gazprom employees, including three members of the management body, refused to confirm or deny whether they or their families owned shares in Itera. Former Gazprom chairman Viktor Chernomyrdin did not reply, and Aleksandr Pushkin, the man in charge of the gas markets in former Soviet countries and perhaps the person best equipped to explain Gazprom's business relationship with Itera, was taken ill and could not meet with PwC staff.²⁵³

Mikhail Beskhmelnitsyn of the Russian audit chamber's office declared meanwhile that he knew 'for sure' that there were no Gazprom managers, their relatives or their namesakes within Itera's structure. 254 However, as noted earlier, Itera shares were held in trust-type arrangements which did not reveal their ultimate owners.

Information concerning Itera's many affiliates was not disclosed; Itera said this would have been too 'labour-intensive'.255 Itera's ownership structure changed following the audits. In March 2003, Makarov stated he had increased his share to 46%. Two months later, former Turkmen deputy prime minister Valery Otchertsov stated that he owned 7% of Itera.256

Itera loses its contract

The appointment of Vladimir Putin as president of the Russian Federation brought major reforms at Gazprom. Putin was keen to improve the management of the company, stating in 2001, 'we know that enormous amounts of money were misspent [by Gazprom], '257 though he did not refer to any particular case.

By this time, Viktor Chernomyrdin had already left Gazprom, stepping down as the chairman of its board in June 2000. At the time of the Gazprom-Itera audits in 2001, Rem Vyakhirev and his close associates Vvacheslav Sheremet and Aleksandr Pushkin left Gazprom. At this point, according to a list of wealthy Russians in Forbes magazine, all of them had sizeable fortunes.²⁵⁸ According to Itera chairman Igor Makarov. speaking to Russky fokus, Vyakhirev, Sheremet and Pushkin cooperated with Itera following their departure from Gazprom, with Sheremet acting as a consultant to Makarov. 'We have signed contracts with many experts who left Gazprom,' said Makarov.²⁵⁹

The new Gazprom team under its new chairman Alexei Miller restructured the company's management and started to take back assets and markets it had previously ceded to Itera. More money started to flow into Gazprom and it seemed too that the company's new management would take over the Turkmen gas transit business.

In November 2002, Gazprom reduced the amount of gas Itera was allowed to supply to Ukraine. At the end of November, Gazprom deputy chairman Aleksandr Ryazanov stated that 'the transit contract of Central Asian gas to Ukraine may be fulfilled by Gazprom itself. We will supply Turkmen gas to Ukraine on the same terms as Itera, and maybe even better ... Why should Itera make super-profits using the facilities of Gazprom?'260 His words, questioning Itera's involvement in Gazprom's business, seemed to echo minority shareholders' concerns that Gazprom was foregoing profits from a business that it could be controlling. Gazprom then terminated Itera's transit contract altogether.

One commentator told Global Witness that Putin was wary of the power Itera had gained in Russia and looked to reduce it.261 Later, comments made by current Naftohaz chairman Oleksei Ivchenko suggested that Ukraine too was looking to remove Itera as the intermediary, because it had been taking business away from Naftohaz by selling gas to customers within Ukraine.262

Yet the events of 2003/4 quickly dispelled any hope engendered by Ryazanov's words that the Turkmen-Ukraine gas trade would become more transparent and comprehensible.



Global Witness

3. Eural Trans Gas

Origins

Following Itera's loss of the contract, both Naftohaz Ukrainy and Gazprom intended to participate in a joint venture company for the transit of Turkmen gas, starting 1st January 2003. This is confirmed by a document seen by Global Witness (below), signed 5th December 2002, between both parties 'on the creation of a joint venture between OAO Gazprom and NAK Naftohaz Ukrainy' to transport Central Asian gas to Ukraine: Gazprom and Naftohaz 'will participate on a basis of parity in a company which possesses the contract for the transit of Turkmen gas.'264 Though Gazprom controlled the pipeline from Turkmenistan to Ukraine, Naftohaz's participation in this joint venture was probably intended to mitigate any concerns Gazprom had about Ukraine not paying for its gas and reflected the mutual dependency between the two countries: Naftohaz needed Gazprom to supply gas to Ukraine, Gazprom needed Naftohaz to get gas through Ukraine's territory to customers in Europe.



The joint venture vehicle was not given a name in the document, yet on the same day as it was signed (5th December 2002), Gazprom signed a contract with Eural Trans Gas (ETG), a new company, registered the previous day in Budapest, concerning Turkmen gas supply to

Eural Trans Gas is about transit and transparency

Eural Trans Gas Press Release 263

Ukraine.²⁶⁵ The idea, therefore, seemed to be that this company was the joint venture vehicle to be controlled by both Naftohaz and Gazprom. Yet ultimately neither company managed to take hold of the structure, leading to many questions about who actually was controlling it.

Much remains unclear concerning ETG to this day. How did a company originally conceived as a joint venture between the state gas companies of Russia and Ukraine end up being controlled, as this section will demonstrate, by a complex network of offshore companies, whose beneficiaries are unknown? What role did ETG perform in the gas trade to justify large profits that would otherwise have gone to the Russian or Ukrainian states – and why did both Gazprom and Naftohaz later downplay their involvement with it? These questions remain unanswered.

Who is Eural Trans Gas?

Forging a close relationship with Gazprom, Itera had grown into an international gas trader with its own gas reserves, transportation equipment, storage facilities and over 8,000 employees. This was not true of ETG, which was created just a month before it started operations and had a workforce of about 30 people.²⁶⁶

Gazprom made no public announcement that a new intermediary company was taking over the gas transportation from Turkmenistan to Ukraine. It was not until the end of February 2003 that Gazprom spoke for the first time to *Vedomosti*, a Russian business paper, about the existence of ETG, although the company had been operating since January of that year, following its December contract.²⁶⁷

The ETG website states that its Managing Director, Andras Knopp, 'founded' the company,²⁶⁸ and it was he who signed the contracts with Naftohaz and Gazprom on behalf of ETG.²⁶⁹ After serving as a state secretary for culture in communist Hungary,²⁷⁰ Knopp had become a businessman, selling cigarettes through a German-based company named Reemtsva,²⁷¹ which possessed factories in Russia and Ukraine. The short curriculum vitae given on ETG's website concerning Knopp does not mention any previous links he had to the gas industry.²⁷²

According to foundation documents seen by Global Witness, ETG was registered by an Israeli lawyer named Zeev Gordon with start-up capital of 3 million Hungarian forints, some US\$12,000.²⁷³ In phone interviews with Global Witness, Zeev Gordon stated that he had been asked to register the company by a Ukrainian businessman called Dmytro Firtash (see section: *The mysterious Mr D.V. Firtash*). In a



first interview conducted in August 2005 Gordon said that he was Firtash's lawyer, though in a second conversation in Feb-2006. Gordon ruarv stated that he was simply asked by Firtash to register the company and was not representing him at the time of ETG's registration.²⁷⁴

Gordon told Global Witness in the second interview that his involvement with ETG had been minimal; he went to Hungary in December 2002, signed the paperwork and flew home the next day: 'I understood that pretty soon the shares would be transferred from me to someone else.' Later in December 2002, according to Hungarian registry documents seen by Global Witness, some of Gordon's shares were transferred to three Romanian citizens. This was done, according to Gordon, by Andras Knopp, on whom he had conferred power of attorney.²⁷⁵

A journalist in Romania located the three new shareholders and discovered that they had no involvement in the gas industry. One of them, an actress named Louise Lukacs, told the journalist that she had contacted the two other share-



Actress Louise Lukacs lent her name to Eural Trans Gas in return for help with her phone bill. Clujeanul News

holders, a couple, Anca Negreanu and Mihai Savu, after a Hungarian friend, a lawyer, had contacted her. The couple were told that if they visited Hungary to register as the shareholders of ETG they would be given some money. Lukacs said that she herself had agreed to the scheme because she needed some extra money to pay her phone bill.²⁷⁶

A source familiar with the company told Global Witness that the transfer of some shares to the three Romanians was necessary because a Hungarian offshore company had to have more than one non-Hungarian citizen as its registered owners.²⁷⁷ Thus it appears that the three Romanians were brought into ETG at short notice, purely to fulfil a requirement for foreign shareholders. It is safe to assume, since the Romanians were being paid for this service, that they were shareholders in name only, and that the beneficial ownership of the company was held somewhere else.

Why was ETG founded in Hungary? According to thencompany spokesman Boris Shestakov, speaking to the Kyiv Post, ETG benefited from Hungarian tax privileges for all newly registered companies which were valid until the end of 2005.²⁷⁸ This was confirmed by Andras Knopp, who explained to a Hungarian newspaper that ETG was founded in Hungary to take advantage of a better tax environment; ²⁷⁹ tax for companies registered by foreigners in Hungary was 3% in 2003 - compared to 24% in Russia and 30% in Ukraine. 280 If this is accurate then Russia gave up tax revenues of an estimated US\$184 million²⁸¹ by allowing a non-Russian company, rather than Russia's Gazprom, to control the gas transit from Turkmenistan across its territory.

Gazprom or Naftohaz: who's the daddy?

As mentioned above, Naftohaz Ukrainy and Gazprom had signed a document to create a joint venture to supply Turkmen gas to Ukraine, and in an interview with the *Kyiv Post*, Andras Knopp indicated that ETG was to be this venture: 'ETG does not act independently from them [Gazprom and Naftohaz]. They created ETG ... Obviously the four [original owners, the three Romanians and Zeev Gordon] are nominal – the restructuring process of ETG's ownership is ongoing and both Gazprom and Naftogaz Ukrainy will have some share in ETG.'282

As time progressed, both Naftohaz and Gazprom started to distance themselves from ETG as controversy started to mount. In May 2003, the US ambassador to Ukraine told a conference in Kyiv of his concern over media reports that linked the company to organised crime.²⁸³ These links were denied by ETG in many press interviews.²⁸⁴

Through 2003 and 2004 Naftohaz and Gazprom made comments that were inconsistent with each other concerning ETG's creation. Naftohaz emphasised that Gazprom was the driving force behind ETG; in late 2003, the company's then-spokesman Konstantin Borodin told the *Moscow Times*: 'All the agreements with Eural Trans Gas were made by Gazprom. It is a contractor for Gazprom.'²⁸⁵ And a further Naftohaz source told the *Moscow Times* that it did not care who received the gas transit concession. ²⁸⁶

But Gazprom's Aleksandr Ryazanov, who had earlier questioned the role of Itera as an intermediary in the Turkmen-Ukrainian gas trade, stated to *Vedomosti* in 2003 that the creation of this new company was 'a compromise between Gazprom and Naftohaz Ukrainy.'287 Later in June 2004, Ryazanov stated that it was Ukraine who had made the decision to use ETG,²⁸⁸ a view corroborated by other Gazprom managers, who had earlier reportedly complained that they had been forced into the arrangement with ETG by Ukraine: 'In September 2003, the situation with ETG was discussed by the Gazprom board of directors ... The management agreed that the current situation damaged the reputation of the company; however they said that they "were not within their powers to do anything"'. 289

Despite this fact, Gazprombank and another major Russian bank provided ETG with loans exceeding US\$227 million in 2003, according to ETG's website.²⁹⁰ This was highlighted by Gazprom minority shareholders, including Hermitage Capital, which again noted that Gazprom was never a shareholder in the company, but was giving up business to this third party;²⁹¹ ETG went on to sell gas in markets that Gazprom should have been controlling (see section: *How much money?*). Russian energy expert Jonathan Stern suggested to Global Witness that this money would have been used for ETG's storage in Ukraine, and as such, it was in Gazprom's interest to provide loans in order to promote gas supply within Ukraine.²⁹²

The Russian side continued to distance itself from ETG. Statements in June 2004 to *Vedomosti* by Gazexport director Aleksandr Medvedev suggested that Naftohaz was not calling the shots as regards ETG, but higher powers in Ukraine: 'ETG is the nominated agent for the transit of Turkmen gas to Ukraine, it was nominated not by Naftohaz Ukrainy but by the Ukrainian government; the reasons why the Ukrainian government selected ETG are beyond our competence as is the system of mutual payments between these parties.'²⁹³

The 'joint venture' goes awry

In an interview with Kyiv-based weekly *Zerkalo nedeli*, Knopp reiterated that ETG's 'real "parents" were Gazprom and Naftohaz Ukrainy: 'The complicated process is underway of finding an ownership structure that will reflect the real situation and will meet legal requirements.'²⁹⁴

Confirmation that Naftohaz and Gazprom intended to take control of ETG came in early 2003 from Naftohaz's chairman Yuri Boiko. *Zerkalo nedeli* reported that he had said: 'The decision was taken concerning the direction of the purchase of the first shares of ETG and we are now conducting talks with the Russian side so that they too can do that. ETG itself is an instrument. Tomorrow it could be NAK [Naftohaz], Gazprom or another legal entity.'²⁹⁵

Despite Naftohaz and Gazprom's intention to create a joint venture for the supply of Turkmen gas to Ukraine, neither company ever became direct shareholders in ETG. Andras Knopp himself stated that, at the time of ETG's creation, neither Naftohaz nor Gazprom had received permission from their respective central banks to purchase shares in ETG. He also said there were other legal complications, including the requirement that registered owners of a Hungarian offshore company do not possess other businesses in Hungary, of which Gazprom already had several. One industry analyst suggested to Global Witness that Gazprom might not have realised this obstacle because ETG had to be created quickly, before the start 2003, in order to qualify for better tax concessions.

Despite these initial problems, it appears that Naftohaz and Gazprom continued to talk about becoming share-holders in ETG, but these plans were shelved in summer 2003. Naftohaz's then-spokesman, Konstantin Borodin, told the *Kyiv Post* in July 2003 that talks had broken down because of Gazprom: 'It is no longer planned that Nafto[h]az Ukrainy will become a shareholder in [Eural Trans Gas]... There were talks with Gazprom to jointly become shareholders, but Gazprom did not support this, and we can not become a shareholder without Gazprom's support.'²⁹⁸

Yet a source from Gazprom told *Vedomosti* that: 'We wanted to have a minimum 50% in Eural Trans Gas. But the Ukrainian side suggested a different variant: 40% each to Gazprom and Naftohaz and the remaining 20% to some incomprehensible structures, possibly to ETG management. This didn't suit us and we refused.'²⁹⁹

The mysterious Mr D.V. Firtash



As noted earlier, Eural Trans Gas was originally registered by Zeev Gordon, an Israeli lawyer. Gordon initially told the press that he could not reveal on whose behalf he had done so, but he later told Global Witness that he was acting for Dmytro Vasylevich Firtash, a Ukrain-

ian businessman.³⁰⁰ The role of Firtash is one of the central mysteries of the ETG story. The company was registered on the very same day that Naftohaz and Gazprom agreed to create a new joint venture, but according to Gordon, Firtash was acting as a private businessman and not on behalf of either the Ukrainian government or Gazprom. So why was it Firtash who had ETG created, rather than someone acting for one of the two state companies? What was his relationship to Naftohaz and Gazprom, and was he acting on anyone's behalf other than his own? Global Witness has been unable to contact Firtash to ask him these questions.

Although Firtash had ETG registered, his exact relationship to the company is unknown. His name does not appear on any of the shareholding documents seen by Global Witness that pertain to ETG; when Global Witness asked Gordon whether the fact that Firtash asked him to register the company meant that Firtash owned shares in it, Gordon replied: 'You know you could assume such a thing but ... I don't think there was a document which said "I am holding the shares and the holder is Mr Firtash."'301

Nor is Firtash listed as a director of ETG or a shareholder in any of the companies that took over its ownership in April 2004 (see below). The relationship between Firtash and Andras Knopp, the managing director of ETG, has also yet to be clarified. Global Witness asked Gordon whether it was his understanding that Knopp was working with Firtash. He replied, 'That is what I understood, but I don't know exactly what was the situation.'302 Global Witness wrote to the company and to Knopp, asking them to clarify the role of Firtash: ETG's lawyers, responding on behalf of the company and Knopp, refused to answer specific questions.³⁰³

Little is known about Firtash's involvement in the gas industry. Official company records from Cyprus show Firtash to be the director of Highrock Holdings, registered in Nicosia. It is believed that this company was involved in supplying Turkmenistan with barter goods, dating back to when Itera held the gas transit contract. Gordon said 'I think he [Dmytro Firtash] was, if I'm not mistaken, involved [in business] with Itera.'304 Global Witness wrote to Itera concerning its past relations with Firtash; it has yet to reply.

Highrock Holdings has no website, and phone numbers obtained by Global Witness of Highrock's office in Moscow did not work. One source familiar with the Ukrainian gas industry told Global Witness that the company might have folded.305

There is scattered information about Firtash's other business dealings. He is the board chairman of Nitrofert, the only fertiliser factory in Estonia, whose website states that the plant alone uses 'as high as 25% of total amount of natural gas sold within Estonia annually.'306 It has also been reported that he is the owner of a Ukrainian basketball club, BC Kviv³⁰⁷ and Ukrainian cable television channel K1.³⁰⁸

Global Witness rang the Nitrofert plant and was told by a secretary that she was not allowed to provide any contact information for Firtash. Global Witness also asked Zeev Gordon how to contact Firtash in order to shed some light on ETG: the lawyer replied that he thought Firtash was not answering any questions at the time.³⁰⁹

Rural England: an unusual connection to Ukraine's state oil and gas company

Information from Ukraine suggests that Highrock Holdings, a company directed by Firtash, was involved in a joint venture with Naftohaz Ukrainy at the time when part of the Turkmen contract was still being paid in barter. A document from Ukraine's state tax administration gives details of a limited company registered in late 2002 called the ZAO Clearing Goods Company Naftohaz Ukrainy. According to the document, the company had a base capital of 210,000 hrvvnia (US\$40,000), 51% of which was provided by Naftohaz Ukrainy and 49% by a UK-registered company called Highrock Textiles Limited.³¹⁰

An Interfax-Ukraine press article, which was citing the government commission on Ukraine's stock market and securities, stated that barter payments with Turkmenistan were arranged through NAK Clearing Goods Company Naftohaz Ukrainy, until the company was liquidated in December 2004.311 A source familiar with the company said it was liquidated a little later in around June 2005.312

The relationship between Naftohaz Ukrainy and Firtash remains unclear; Global Witness wrote to Konstantin Borodin, Naftohaz press secretary at the time when Naftohaz Clearing Goods Company was operating, about the company's relationship with Firtash. Borodin has yet to reply.

According to UK Companies House records, Highrock Textiles Ltd was registered in June 2002. Both its shareholder and director are given as Highrock Holdings. Another director of this company until June 2003 is given as Marios Tzortzis, Global Witness discovered that Tzortzis works for a Cypriot-based firm called One World Services which took over from Tzortzis as Highrock Textiles' director in June 2003.313 One World Services has an office at the same registered address of Highrock Holdings in Nicosia, Cyprus. Global Witness rang Tzortzis to ask him about Highrock Textiles. He said: 'I would prefer not to answer questions ... I'm not aware about this. I'm just a nominee director.' He also said he didn't know anything about Highrock Holdings, or its director Dmytro Firtash.

Highrock Textiles and another company owned by Highrock Holdings named Highrock Oil are registered in the quaint market town of Tiverton in Devon, deep in the English countryside: the address given for both is 22. The Avenue. It is unclear why the state oil company of Ukraine formed a joint venture with a company based in an English town of 20,000 people that is better known for its provincial market and its lace than for links to barter trade in the former Soviet Union.

Global Witness went to Tiverton and discovered that 22, The Avenue is currently a shelter for homeless people and had previously been an old people's home. Other registry records for both Highrock Textiles and Highrock Oil demonstrate that both companies were administered by McKenny's, an accounting firm in Tiverton: a representative from this firm told Global Witness that he was not prepared to answer questions on specific clients, but added that he had never heard of Dmytro Firtash. Concerning his



22 The Avenue, Tiverton, Devon: hub of the Ukrainian oil industry?

Global Witness

firm, he said: 'We provide a registered office to various different companies ... We deal with professional intermediaries ... professional accountancy firms, firms of lawyers who want companies established for them. We do our own due diligence but it doesn't involve necessarily the activities of the company.'314 The registered address of both Highrock Textiles and Highrock Oil has since moved from Tiverton to an address in London.

New owners for Eural Trans Gas?

In April 2004, 15 months after the creation of Eural Trans Gas, its shares changed hands. But once again, neither Naftohaz Ukrainy nor Gazprom became a shareholder in what had apparently been intended as a joint venture between the two companies. The complicated new ownership structure actually raised even more questions about the identity of ETG's ultimate beneficiaries.

According to Zeev Gordon, who returned to Budapest for the occasion, the shares in ETG changed hands on a single day.315 The new owners were a British company called Atlantic Caspian Resources, which became the owner of 44.67% of ETG shares, a Dutch company called JKX Gas BV, owning 30%, and an Austrian firm, DEG Handels, which became the owner of the remaining 25.33% of the shares. 316

This change of ownership made it appear that ETG had been taken over by savvy energy companies looking to invest in a booming market. But investigations by Global Witness show that two of the new shareholders were ultimately controlled by the same two holding companies in Cyprus – Dema Trustees Limited and Dema Nominees Limited, and that the third shareholder was also indirectly linked to the Dema companies. The ultimate beneficiaries of Dema Trustees and Dema Nominees are unknown. This complicated structure obscures the beneficial ownership of ETG behind several layers of what appear to be mostly shell companies, often directed by proxies, and created or bought shortly before the takeover was effected.

Throughout the web of offshore companies owning ETG, some of the same names reappear: a group of British businessmen who share an office in London and a firm of Cypriot accountants based in Nicosia. Although ETG was

[Eural Trans Gas] has also started to introduce Western-style transparency into the region

Eural Trans Gas Press Release

apparently created at the behest of a Ukrainian, Dmytro Firtash, and made huge profits from its role in the transportation of Turkmen gas through Russia to Ukraine (see section: How much money?), not one of the people named in the new ownership structure was Russian, Turkmen or Ukrainian.

The shareholders in depth

A. Atlantic Caspian Resources

In April 2004, ETG appointed Cedric Brown as its non-executive chairman.³¹⁸ Brown, a former head of the privatised UK gas monopoly, British Gas, had became a controversial figure in Britain in the mid-1990s for accepting what was seen as an excessive pay rise. At the time of his appointment at ETG, he stated that the company aimed 'to achieve the highest standards of transparency.'319

Cedric Brown was also the chairman of one of ETG's three new owners, a small British oil company named Atlantic Caspian Resources. In November 2003, Atlantic Caspian had been facing bankruptcy with only £300 left in the bank. In December 2003, it was rescued by a Cyprus-based company called Denby Holdings, which bought out Atlantic Caspian's debt in return for its shares.³²⁰ In this same month, another Cyprus-registered company was set up, called Sanilia Ventures Ltd.

At some time before February 2004, Sanilia Ventures became the 44.67% owner of ETG via another holding company, though exactly how this happened is unclear.³²¹ Denby Holdings and Sanilia Ventures then both became owners of Atlantic Caspian in March 2004 while the latter became the owner of 44.67% of ETG.322 Denby Holdings and Sanilia Ventures are jointly owned by the same two companies, Dema Nominees and Dema Trustees. 323 This is the first of the indirect links from ETG to the two Dema companies in Cyprus.

Denby Holdings operates out of an office in central London that is also the address of a company called Belgravia Business Services. 324 Three British men who work from this office have been associated in various ways with companies that own ETG - Robert Shetler-Jones (see box: An Englishman in Ukraine), David A.H. Brown and Howard G. Wilson. Company documents seen by Global Witness show that Shetler-Jones and David Brown (who is not related to Cedric Brown), are directors of Denby Holdings.³²⁵ David Brown is also a director of Atlantic Caspian Resources.³²⁶ In a striking development, the same three men would go on to have an association with the company that eventually took Our aim is to achieve the highest standards of transparency Cedric Brown, speaking as non-executive chairman of Eural Trans Gas317

over the lucrative gas middleman slot from ETG, the similarly controversial RosUkrEnergo (see section: Links between RosUkrEnergo and Eural Trans Gas).

B. JKX Gas BV

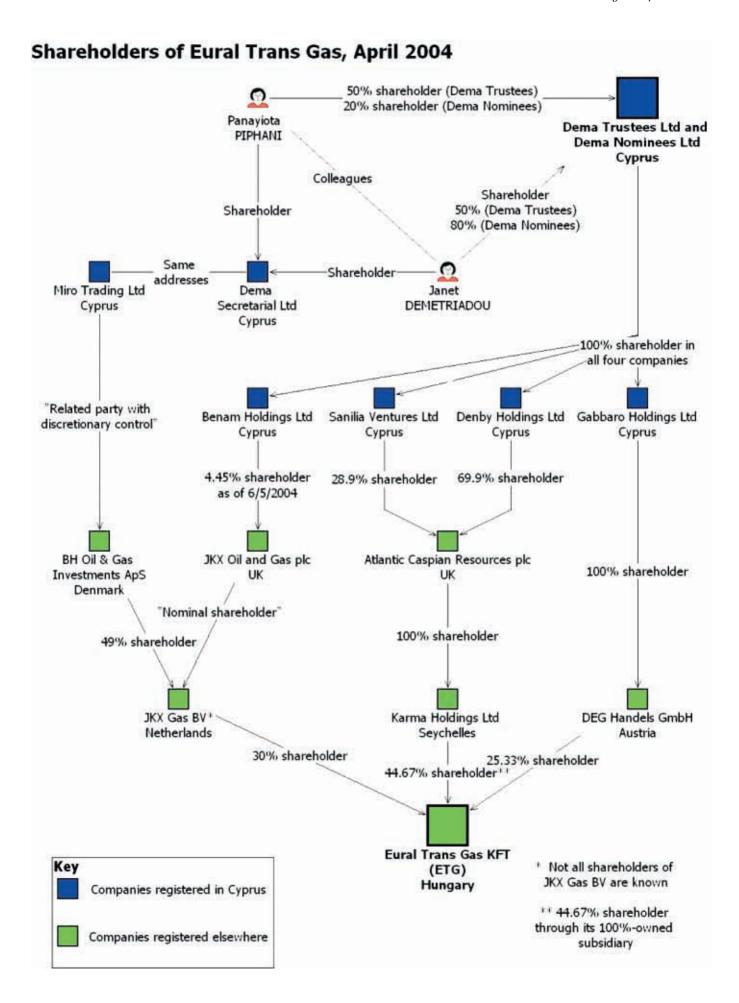
Another new shareholder in Eural Trans Gas was a Dutch company called JKX Gas BV, whose history also gives rise to unanswered questions.

This part of the story starts with JKX Oil & Gas Plc, a publicly listed British company with operations in Russia, Ukraine, Georgia and other countries. In mid-2003 this British company was reportedly offered a shareholding in ETG by Naftohaz Ukrainy, Ukraine's state oil and gas company. The Financial Times reported that: 'Naftohaz said it hoped JKX's involvement would improve the image of Eural [Trans Gas].'327 But it is not clear how Naftohaz could make this offer, given that the Ukrainian company did not own any shares in ETG at the time. 'What was strange was how Naftohaz spoke as if it controlled ETG,' said Tom Warner, the author of the article who has been covering the story of the intermediary companies for more than three years, to Global Witness.328

Around the same time, JKX Oil & Gas Plc announced an agreement in principle with a company called Benam Holdings to 'seek a participation in Eural Trans Gas.'329 Benam Holdings owned just under 5% of JKX Oil & Gas at this time³³⁰ and one of its directors was Robert Shetler-Jones of Denby Holdings.³³¹ Like Denby Holdings, Benam Holdings was jointly owned by Dema Nominees and Dema Trustees in Cyprus.332

Shetler-Jones has an association with JKX Oil & Gas: he told a Ukrainian journalist that he worked as a consultant for the British company and originally got involved in the Ukrainian gas industry through his friendship with one of its directors.³³³ The company described its relationship with Shetler-Jones to Global Witness as 'confidential.'334

JKX Oil & Gas Plc did not become a direct shareholder in ETG but did acquire an indirect interest via a Dutch offshore company called JKX Gas BV, which was founded in September 2003 and later became the owner of 30% of ETG. A spokeswoman for JKX Oil & Gas Plc told Global Wit-



ness that the British company did own shares in JKX Gas BV but this 'was always a nominal investment'. 335 However, it appears that the British company, far from being a purely nominal investor, actually created the Dutch company and wholly owned it for the first three months of its existence, from September to December 2003.336 Global Witness asked JKX Oil & Gas Plc to explain this apparent inconsistency, but received no reply.³³⁷

At the end of 2003 or soon afterwards, there was a change in the ownership of JKX Gas BV, although not all of the new owners have not been disclosed.338 The directors also changed. One of the new directors was Howard Wilson, the associate of Robert Shetler-Jones and David Brown at Denby Holdings.

JKX Oil & Gas Plc remained a shareholder in JKX Gas BV until mid-2005.339 Another shareholder in JKX Gas BV was a Danish company called BH Oil and Gas Investments ApS which, as of mid-2003, owned 49% of JKX Gas BV.340 If neither the British company (with its 'nominal' shareholding) nor the Danish company were majority shareholders in JKX Gas BV at this point it would imply that there have been other shareholders in JKX Gas BV whose names have not come into the public domain. JKX Gas BV changed its name to BH Gas BV in 2005, with Howard Wilson remaining as one of the company's directors.³⁴¹

So who owns BH Oil & Gas Investments ApS? Its records name three parties with 'discretionary control of the company', two men and one company.342 One is a man who works for a Danish company that provides corporate services and is therefore likely to be a nominee director: he declined to respond to questions from Global Witness in March 2006. Global Witness has not been able to track down the second person, who seems to be of Greek origin.

The third controlling party of BH Oil & Gas Investments ApS is a Cypriot company, Miro Trading, whose address is 24 Ayias Varvaras Street, Nicosia. 343 This is also the address of Dema Secretarial Limited, a company directed by Dema Nominees' and Dema Trustees' owners.344 Global Witness has not confirmed who owns Miro Trading. Global Witness has sought to obtain comment on matters related to Eural Trans Gas from three Cypriot accountants associated with the Dema companies, without success (see section: All roads lead to Cyprus).

There is no reason to believe that JKX Oil & Gas Plc has done anything wrong in relation to its involvement with ETG, but the British company has not answered an obvious question. ETG had earlier been the subject of allegations that it was linked to organised crime figures, allegations which were denied by ETG, but were of sufficient concern to be cited in a public forum by a senior US government official.345 Against this background, what was the commercial rationale for this UK public company to allow its brand to be associated with ETG, even though the former had only a 'purely nominal' and indirect interest in the latter? Global Witness asked JKX Oil & Gas Plc to respond to this point. It replied: 'JKX Oil & Gas Plc has no comment.'346

The other striking aspect of the JKX story is that, like Atlantic Caspian Resources, JKX Gas BV was ultimately linked to the Dema companies in Cyprus (though the exact nature of this link, through Miro Trading, remains unclear). A similar link also exists for the third company that became a shareholder in ETG, DEG Handels.

C. DEG Handels

The third company that bought into ETG in April 2004 with a 25.33% shareholding was an Austrian firm, DEG Handels. Originally set up in 1990 as a company that rents machinery,347 DEG Handels was bought by Gabbaro Holdings, another Cypriot company in early 2004, shortly before ETG announced its new owners.348 Once again, Gabbaro Holdings is owned by Dema Trustees and Dema Nominees, each with a 50% stake. 349 This is the fourth indirect link between ETG and the Cypriot Dema companies.

DEG Handels also provides a curious link to RosUkrEnergo, the company that took over ETG's role as intermediary company in 2005: DEG Handels' registered address in Vienna is the same as CentraGas AG, which owns half of RosUkrEnergo (see section: Links between RosUkrEnergo and Eural Trans Gas).

All roads lead to Cyprus

So who are Dema Trustees and Dema Nominees? Cypriot company records name their owners as Janet Demetriadou and Panayiota Piphani.350 Global Witness has established that Demetriadou and Piphani both work for a Nicosiabased accounting firm called Demetriades Shakos Piphanis,³⁵¹ which specialises in 'international tax planning' and sets up offshore companies in Cyprus in partnership with a firm that they direct called Dema Services, which has the same phone number as the accounting firm.³⁵² Global Witness faxed questions to Demetriadou and Piphani, asking them about their involvement in the Dema companies, but neither replied.³⁵³ Few other details are available about the companies, other than that Dema Nominees was previously called Byron Computer Products Ltd. 354

Another accountant at Demetriades Shakos Piphanis, Andreas Mavromatis, is a director of Denby Holdings and Benam Holdings, both of which also have Robert Shetler-Jones as a director.355 Global Witness called Mavromatis at his office to seek comment on the Dema companies, his relationship with Shetler-Jones³⁵⁶ and whether Mavromatis has any relationship with Dmytro Firtash, the man behind the registration of ETG. When Global Witness mentioned the words 'Ukrainian gas industry', Mavromatis abruptly passed the call back to a secretary who first claimed that he was 'on other business', then suggested he had passed the call back to her because he did not speak good English.357 Global Witness then faxed questions to Mavromatis, Demetriadou and Piphani. A Greekspeaking contact of Global Witness later phoned Mavromatis seeking comment on our questions. His secretary stated that the company would not be helping Global Witness with its research and asked us not to bother them again.³⁵⁸

There is a business connection between the Dema companies, Ukraine and Dmytro Firtash, the founder of ETG. Dema Nominees and Dema Trustees are joint owners of a company called ACI Trading Ltd, whose director is Andreas Mavromatis. ACI Trading trades in chemicals and has a representative office in Ukraine. ACI Trading to Global Suppliers Online, a business website, ACI Trading's clients include the Crimean Soda Plant, which is 89% owned by RSJ Erste, Shetler-Jones' Hamburg-based company (see box: *An Englishman in Ukraine*) and the Nitrofert fertiliser plant in Estonia, whose chairman is Dmytro Firtash (see section: *The mysterious Mr D.V. Firtash*). 360

These connections indicate that the Dema companies have indirect relationships, via ACI Trading, with companies controlled by Robert Shetler-Jones and Dmytro Firtash. In an interview with the *Kyiv Post* in 2005, Shetler-Jones said 'I have met Mr Firtash on several occasions and we are acquainted',³⁶¹ adding that Firtash was not a shareholder in Shetler-Jones' company, RSJ Erste.

'We will not be replying to your questions' (David A.H. Brown)

Global Witness also made extensive efforts to seek comment from Shetler-Jones about his connections to ETG and RosUkrEnergo by email, by phone and in person at his house in Devon. Although Shetler-Jones agreed in November 2005 to respond to questions by email, he did not reply to these questions when they were sent by Global Witness. Attempts to reach Shetler-Jones, David Brown and Howard Wilson, the director of JKX Gas BV, by phone at the Denby Holdings office in London were unsuccessful: a secretary indicated that they were either unavailable or unwilling to



Shetler-Jones and David Brown work out of this London office.

Global Witnes

respond. Global Witness then visited the office, which is on the top floor of a building in the smart London district of Belgravia, to hand-deliver letters to Shetler-Jones and Brown, asking for comment on the issues raised in this report. A middle-aged British man at the office took the letters but refused to give his name.

Global Witness then received a letter from David Brown, written on behalf of himself and Shetler-Jones, which stated: 'We will not be replying to your questions.' He added: 'We have no idea why you should have the need or right to ask us questions which have nothing to do with you. To the extent you refer to various companies, they all appear to be private companies where revelation of any information over and above that which you have obtained, is not required by law.' However, Brown confirmed that he had been a friend of Howard Wilson since 1960 and that they had gone to school together.³⁶²

In summary, the tangled story of Eural Trans Gas, its origins and its changing shareholders is one that leaves a trail of unanswered questions. Gazprom and Naftohaz agreed in late 2002 to share control of the gas transit trade from Turkmenistan to Ukraine, so why was this role taken by ETG, a private company never owned by either party? Why was the company created, according to one of its founders, at the behest of Ukrainian businessman Dmytro Firtash, whose name does not appear on any of the available company documents?

The ownership of ETG then passed into the hands of several companies which were based in different jurisdictions but linked back, via overlapping shareholdings and directorships to two holding companies in Cyprus. Why was it necessary to create this opaque and complicated structure, what was its commercial rationale, and who ultimately profited from it?

As the next section will show, there was plenty of profit involved. What is less clear is exactly how ETG earned it.

An Englishman in Ukraine

Robert Shetler-Jones is a British businessman. who first came to prominence working in real estate in Ukraine and Russia.363 Though he owns a cottage in Devon, he is mainly resident abroad.

2004 was a big year for Shetler-Jones. from his involvement in Eural Trans Gas, he invested heavily in other industrial enterprises within Ukraine. In February 2004, he bought an 89% controlling share for US\$70 million in Krymsoda, Ukraine's largest industrial soda plant,

through his Hamburg-based company RSJ Erste. 364 Later in the year, President Kuchma decreed that the state property fund should set up a joint venture involving Crimean Titan, Ukraine's largest producer of titanium oxide, with a foreign investor. RSJ Erste was chosen as the partner. 365 It is unclear exactly where Shetler-Jones garnered the capital to purchase these investments. In unpublished extracts from an interview with a Kyiv Post journalist in 2005 which have been seen by Global Witness, Shetler-Jones stated that he was bound by confidentiality agreements on the source of his funding and would only say that it came from 'various European sources. The money is a mix of debt and equity.' He also stated that, as he had to operate through a European bank, the source of the income and the ultimate beneficial owners of the funds had to be clear to the bank.³⁶⁶

Elsewhere in the interview. Shetler-Jones said that he first met Ukrainian businessman Dmytro Firtash around early 2003. This would have been when JKX Oil & Gas Plc was considering participation in Eural Trans Gas. According to Shetler-Jones, he had done some consultancy work for JKX Oil & Gas Plc, and was on close terms with one of its directors. He said: 'I have met Mr Firtash on several occasions and we are acquainted' and added that Firtash was not a shareholder in Shetler-Jones' company, RSJ Erste. According to Shetler-Jones, he did not know at the



British businessman Robert Shetler-Jones has his fingers in many pies in the Ukraine. Kylv Post

time that Firtash was the director of Highrock Holdings, and was meeting him because Firtash knew how the gas system worked in Ukraine. 367 The interview took place before Zeev Gordon told Global Witness that he had registered ETG on behalf of Dmytro Firtash.

Robert Shetler-Jones also owns 75% of AG für chemische Industrie, a chemical industry company registered in Hamburg. A man named Hans Peter Moser is the vice chairman of the board. Companies House records show Moser to be the head of the governing board of a Swiss company named Bothli. A news report on a website for a Hungarian gas trader that employs some former ETG officials states that, in 2004 Hungary acquired two billion m³ of gas from ETG, via Bothli.³⁶⁸ Little is known about Moser, but it has been reported that he was involved in a company called Falkon Capital that was used to pay Russia's debt to the Czech Republic. 369

Global Witness sought to interview Shetler-Jones and at his request sent him a series of questions about his involvement in the Ukrainian gas trade and his relations with Dmytro Firtash. Global Witness later contacted Shetler-Jones and his business associate, David Brown, via their London office, but both refused to answer our questions through a letter sent by Brown. (See section: We will not be replying to your questions).

How much money? And for what? And to whom?

Eural Trans Gas was an intermediary company in the purest sense: without its own pipelines and, at the moment of its creation, without any gas supplies. It is not clear what services the company was intended to provide given that, according to the contract, Gazprom itself was to move the gas through its own pipelines. In an interview with Zerkalo nedeli, a Ukrainian weekly, Knopp spoke about ETG's services: 'Here [at the Russian-Ukrainian border] we hand [the gas] over to Naftohaz. It seems so simple, but on all stages of the journey our specialists from local representatives follow the flow of gas, participating in the preparation of many things, completing other necessary formalities.' Knopp added: 'In other circumstances we even arrange barter procedures for local specialist firms.'371 Global Witness wrote to Knopp, asking him to clarify what ETG's services entailed. Through his legal representation, Knopp declined to answer questions.

In unpublished comments to a Ukrainian journalist, which were later provided to Global Witness by the latter, Knopp stated that: 'ETG is probably necessary because you sometimes need an outsider to keep peace between the spouses.' If Knopp's understanding of ETG is correct, Ukraine was depending on a 'peacekeeper' whose ultimate beneficiaries were not known to the general public, and one which deprived Gazprom of potential revenues by selling gas in European markets, detailed below.

Global Witness has seen a copy of the contract signed by Gazprom's Aleksandr Ryazanov and ETG's Andras Knopp, agreeing terms for the supply of Turkmen gas to Ukraine via Russia from 2003. The contract states that ETG paid Gazprom US\$425 million for transportation services in 2003.³⁷³ As payment for its services as an intermediary company, ETG received from Ukraine 13.4 billion m³ of gas out of the total 35.4 billion m³ that it delivered. This gas was then resold in Ukraine and other European countries by ETG.

Only snippets of information about ETG's sales in European markets are available. ETG's website speaks of an agreement to sell three billion m³ of gas to Gazexport's German subsidiary ZMB, signed in May 2003.³⁷⁴ In unpublished material from an interview with the *Kyiv Post* obtained by

Our existence benefits everybody Andras Knopp, ETG managing director³⁷⁰

Global Witness, Andras Knopp spoke of an agreement between ETG and a UK-based Gazprom subsidiary.³⁷⁵ Polish press reports state that Poland's state gas company, PGNiG, purchased at least 2.5 billion m³ of gas from ETG between October 2003 and the end of 2004. The price was not disclosed due to 'business confidentiality.'376 ETG chairman Cedric Brown said in an interview with Platts in 2004 that ETG would be selling its 13 billion m³ of gas to state companies in Poland, Hungary, Slovakia and to customers in Germany.377 A March 2004 press release from JKX Oil & Gas Plc, the British company with an indirect interest in ETG, stated that following an agreement with Benam Holdings Ltd in June 2003, a three-year gas export sales contract was negotiated with ETG for JKX's subsidiary (Poltava Petroleum Corporation) to supply 720 million m³ of gas to Slovakia.378 An internal audit of Naftohaz, seen by Global Witness, showed that the Ukrainian state company received 4.15 billion m³ of Turkmen gas into underground storage in 2004.379

ETG was a small company dealing with large sums of money: its workforce totalled just 30 people, according to Andras Knopp, speaking to the *Kyiv Post* in 2003.³⁸⁰ For its services, ETG earned US\$220 million in 2003 alone, on a turnover of US\$2 billion, according to its own figures published on its website.³⁸¹ No other financial reports from ETG's two years of operation have been made public. Docu-

ments seen by Global Witness show that ETG held a bank account at a branch of Raiffeisen Bank in Budapest.³⁸²

If ETG's profits for 2003 are subtracted from its turnover, the remaining sum is US\$1.78 billion. Aside from the payment of US\$425 million to Gazprom for transportation services, it is not clear what other costs ETG incurred that would account for this sum. One expert who examined the deal for Global Witness said that the costs would have included the storage of ETG's 13.4 billion m³ of gas in Ukraine

and the shipping of portions of this gas sold to European countries; ETG would be paid for its gas and its transportation to other countries, but would have to pay the owners of the pipelines for their use.³⁸³ With ETG providing so few figures about its operations, it is difficult to understand exactly how the company worked.





ETG's Andreas Knopp: communist official turned gas executive. Kviv Post

Some critics, such as Gazprom minority shareholder Hermitage Capital, believed that ETG might have been expected to make a larger profit than US\$220 million by selling its 13.4 billion m³ of gas in Ukraine and the rest of Europe. This gas would have been worth over US\$1 billion, depending on where it was sold. The expert who examined ETG's financial figures for Global Witness stated that ETG's gas prices may not have been that high due to constraints imposed by Naftohaz and Gazprom. He added: 'The profit looks probably smaller than one would have expected, given even that the prices were enforced and [given ETG's] likely costs.'384 Global Witness wrote to ETG concerning its stated profit, but the company declined to answer our questions.

Though Gazprom was getting a substantial sum for guaranteeing transit for ETG, critics of the deal, including Hermitage Capital, argued that with no interest in the company, Gazprom lost lucrative earnings, ceding the 13.4 billion m³ to ETG, which it sold to Gazprom markets in European countries. Gazprom would have lost more business in 2004, when ETG sold more amounts of gas in European markets than in 2003, according to figures from Russian energy expert Jonathan Stern.³⁸⁵

It is also unclear where ETG's profits went. In 2003, ETG's share structure was still in transition and ETG released no information on its dividends. In interviews with journalists, ETG's managing director, Andras Knopp, stated that the first dividends were to be used to increase the base capital with the aim of financing ETG's investment projects.³⁸⁶ Global Witness wrote to ETG for clarification on what these projects were and how much they cost. The company declined to answer our questions.

No financial information was given by ETG in 2004. As the analyst who examined the ETG deal for Global Witness stated: '[ETG's] finances aren't transparent – that's a problem.'387 It is clear that ETG was making a lot of money, but without Naftohaz or Gazprom as direct shareholders, the beneficiaries of the scheme remain unknown. The role of the mysterious Dmytro Firtash has yet to be fully explained, as has the involvement of the Cypriot Dema companies, and a group of British businessmen whose names will reappear in the next section concerning RosUkrEnergo.

ETG's contract specified that it was supposed to supply Turkmen gas to Ukraine until 2006; this was confirmed in June 2004 by Gazprom.³⁸⁸ Yet on 26th July 2004, President Putin met President Kuchma in Yalta 'with businessmen from the two countries. The parties achieved an accord to jointly scheme gas deliveries to the Ukraine,' according to a report on Gazprom's own website. 389 Three days later, Gazprom signed various documents 'identifying terms and conditions of the Russian-Ukrainian cooperation in natural gas supplies and transit up to 2028' via a joint venture named RosUkrEnergo, owned 50%-50% by subsidiaries of Gazprombank and Raiffeisen Zentralbank.³⁹⁰

No reason was given by Gazprom for the cessation of ETG's contract. According to Zeev Gordon, speaking with Global Witness in a phone interview in August 2005, the ETG contract was terminated because 'there was a lot of bad publicity. In such a sensitive business, even a rumour is already not good for business.'391 Literature on the subject suggests that Gazprom's failure to buy into ETG and the latter's increasing sales in Europe resulted in Gazprom terminating ETG's contract.³⁹² This may be borne out by a comment made by a source in Gazprom to a Russian newspaper in late 2003, expressing concern about ETG's European sales: 'The most unpleasant thing is that we ourselves actually gave up a part of the Polish market to Eural TG.'393

4. RosUkrEnergo

So Eural Trans Gas, like Itera before it, had been ousted from the highly profitable middleman role in the Turkmenistan-Ukraine gas trade. The company which replaced it, RosUkrEnergo, has been the subject of growing controversy since it came onto the scene in 2004. Part of this controversy stems from the geopolitical and commercial dispute between Russia and Ukraine over gas prices, which literally sent shivers through Europe in the winter of 2005/6 after Russia briefly blocked gas supplies to Ukraine, leaving some European importers short of energy at the coldest time of year and waking the wealthier part of the continent to the unpleasant possibility that its gas supplies from the former Soviet Union might not be as secure as they had seemed.

The other reason for the controversy is that, as with ETG, there are questions about the beneficial ownership of RosUkrEnergo that have never been answered. There is an enduring mystery about the identities of a group of investors who own half the company, though the shares are actually held for them by Raiffeisen Investment, a subsidiary of Austria's Raiffeisen Zentralbank. Another mystery is the exact relationship between these investors and senior energy officials in Ukraine.

RosUkrEnergo apparently became the object of a criminal investigation in Ukraine which focused, according to the security official who led it, on allegations of official corruption, criminal links and huge financial losses to the Ukrainian state. But as this report will show, that official has since resigned and Ukraine's current security chief has denied that the investigation ever took place. No wrongdoing has been established on the part of RosUkrEnergo or its shareholders, but the questions about its ownership remain.

Despite the controversy, RosUkrEnergo's importance has actually grown since the end of the Ukraine-Russia gas price row in early 2006: the company is not only the sole importer of gas into Ukraine but is also involved in a joint venture with Naftohaz Ukrainy, the state oil and gas company, which allows the intermediary to dominate the domestic gas market within Ukraine. In short, the energy supply of a country of nearly 50 million people, and a vital route for gas imports into the European Union, appears to flow through this one mysterious company.

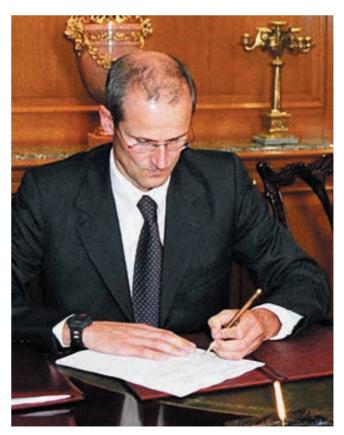
RosUkrEnergo's share structure

Sergei Kupriyanov, the press secretary of Gazprom's chairman, stated in August 2004: 'We hope that cooperation

with RosUkrEnergo will make the business for supplies of Central Asian gas to Ukraine more transparent.'395 But if anything, the questioning in Ukraine has intensified.

RosUkrEnergo was registered in Zug, Switzerland on 22nd July 2004: four days later, Presidents Putin and Kuchma met in Yalta and oversaw the signing of contracts between the new company, Gazprom and Naftohaz.³⁹⁶ RosUkrEnergo is different from previous intermediary companies in one important way: Gazprom, which had never owned shares in Eural Trans Gas, owns half of RosUkrEnergo through an Austrian firm called ArosGas Holding AG, which is owned by Gazprombank.³⁹⁷

The other half of RosUkrEnergo is owned by another Austrian company, CentraGas Holding AG, which is a wholly-owned subsidiary of Raiffeisen Investment. Wolfgang Putschek, an executive at Raiffeisen Investment, told Global Witness that his company was managing the CentraGas shareholding on behalf of 'a consortium of Ukrainian businessmen and companies, very knowledgeable in the gas trading business, very well-connected in the Ukraine.' He said these were people who 'know about the local background, local politics' but do not want to be named. 'All I can say,' Putschek added, 'is that everyone we have contractual obligations with has undergone the strictest compliance [procedures]'. 399



Raiffeisen Investment's Wolfgang Putschek represents a mysterious consortium of investors who refuse to be named. www.gazprom.ru

Putschek told Global Witness that RosUkrEnergo was registered in Zug for tax reasons. The rate for multinationals there is a comparatively low 13%. Putschek added that Raiffeisen Investment was involved because of its 'extremely good knowledge of the Eastern European market' and because of what it brought to the table in making 'the structure more transparent'. 400 He added that Raiffeisen Investment provided financing for the company and also made investments, notably in gas fields in Russia. He said that Raiffeisen Investment was looking for an investor who may enter RosUkrEnergo at a future date, and that talks had been conducted in this regard with British firm Centrica, though these had been put on hold in mid-2005 because of the political situation in Ukraine. 401

Putschek told Global Witness that RosUkrEnergo was not a transit company, as Eural Trans Gas had described itself, but a trading company dealing with what he described as coordination and strategic issues in Ukraine. According to Putschek, Gazprom is the controlling force RosUkrEnergo: the Russian company needed a reliable way to get gas from Turkmenistan to customers in Ukraine. Gazprom buys the gas directly from Turkmenistan, he said, and transports it to the Russian-Ukrainian border. RosUkrEnergo then buys the gas from Gazprom and resells it to Ukraine, Poland, Slovakia and Hungary.

But why involve RosUkrEnergo at all? Why didn't Gazprom just sell the gas directly to Naftohaz Ukrainy, the Ukrainian state oil and gas company? Offering what he described as his own personal interpretation, Putschek said this was because Gazprom found it difficult to work directly with the Ukrainians; there had been problems with non-payment of debts on the Ukrainian side that had led to accusations from both sides: 'Gazprom just decided that they didn't want to deal with this particular case of business and so subcontracted it to partners who knew about the local background, local politics, who knew how to handle local gas trading in the Ukraine.' Yet Gazprom's chairman, Alexei Miller, stated on Russian television in January 2006 that 'Russia has said several times over that it would be right if the founders of this joint enterprise [RosUkrEnergo] were to be Gazprom and Nafto[h]az Ukrainy.'402

The management of Naftohaz also seems to think that the Ukrainian state, rather than private investors, should be controlling Ukraine's share of RosUkrEnergo. In an interview with Gas Matters in July 2005, Oleskei Ivchenko stated that he wanted Naftohaz to buy into RosUkrEnergo: 'If Ukraine becomes a real owner of the structure that manages the [gas supply] contract, then that scheme [with RosUkrEnergo] can continue. If not, then we will look for

Very open, very very transparent Raiffeisen's Wolfgang Putschek³⁹⁴

ways of changing it.'403 But even if both Gazprom and Naftohaz support this idea, the fact is that, for reasons unknown, Naftohaz has not become a shareholder in RosUkrEnergo.

Was Gazprom right to give up half the revenues from this business to Raiffeisen Investment and its unknown investors? Putschek suggested that Global Witness ask Gazprom, adding: 'Obviously they [Gazprom] decided that this 50% was a fair share to give to these partners.'404 Global Witness wrote to Gazprom in December 2005, asking this and many other questions. Gazprom is yet to reply.

Who's behind CentraGas?

As with Eural Trans Gas, the intermediary role played by RosUkrEnergo appears to be highly profitable. Putschek told the *Moscow Times* in January 2006 that the company had made US\$500 million in 2005, and that the figure could increase in 2006 due to the new contract signed in January that granted RosUkrEnergo a major role in the Ukrainian gas sector. 406 Putschek told Global Witness that the money would remain in the company to be invested in gas fields and renovation of gas pipelines, including the Central Asia-Centre pipeline, the pipe that runs from Turkmenistan to Ukraine. 407 It is unclear whether work on this by RosUkrEnergo has begun, and how much money has been invested in it so far. With big profits likely to be made, attention has understandably focused on who ultimately owns CentraGas and how it came to own half of RosUkrEnergo.

As in the case of ETG, Russian and Ukrainian officials have offered conflicting opinions about whether the Russian or Ukrainian side was responsible for creating RosUkrEnergo. Gazprom spokesman Denis Ignatyev told the Financial *Times* that it was the responsibility of Ukraine to screen the owners of CentraGas: 'If the [Ukrainian] government signs something saying these are our representatives, we don't ask further questions.' He added that Gazprom probably did know who these people were, but would have no right to disclose their identities.408

After RosUkrEnergo was contracted to supply gas to Ukraine following the January gas crisis, Ukraine's president, Viktor Yushchenko, speaking on television in January 2006, asserted that Gazprom created RosUkrEnergo. He admitted that he did not know who stood behind the CentraGas shareholding in RosUkrEnergo, even though the company had become the sole supplier of gas to his country: 'They may have been Ukrainians but I really don't know who these people are. When it was set up two years ago, the founders of RosUkrEnergo could have been anybody... anybody.'⁴⁰⁹

Russia's President Vladimir Putin had a different take. Asked by a Spanish journalist in January 2006 who was behind RosUkrEnergo, he said: 'Ask Viktor Yushchenko. Gazprom has a 50% stake and the Ukrainian side has 50%. I said to Viktor Yushchenko, "we would welcome it if your 50% is held directly by Naftohaz Ukrain[y] [the Ukrainian state company]. But this was not our decision. It was the Ukrainian side's decision. Who the names are behind the 50% stake held by Raiffeisen Bank, I don't know any more than you do and Gazprom does not know either, believe me ... It was they [the Ukrainian side] who proposed that RosUkrEnergo supply gas to Ukraine instead of Gazprom. We agreed.'410

It seems strange that Russia would not know who owned the other half of RosUkrEnergo, since the implication would be that Gazprom has gone into business, in a profitable and economically strategic field, without knowing who its business partners are.

When Global Witness turned to Putschek in March 2006 for clarification on some of his statements concerning Centra-Gas, he agreed to a phone conference arranged via Centra-Gas' PR firm, Merlin Corporate Reputation Management. The firm asked to see the questions in advance. After receiving the questions, Merlin wrote to Global Witness saying that Putschek had nothing further to add to his earlier interviews. However, Merlin did give Global Witness a statement concerning CentraGas' involvement in Ukraine: 'CentraGas is firmly behind the development of a liberalised, competitive and market-based system of gas supply and distribution

in and around Ukraine. The process that has taken place over the last few months is part of a challenging, but necessary transition towards a market-based pricing mechanism.'411 Global Witness does not see how this commitment to a liberalised and competitive Ukrainian gas market can be squared with CentraGas' resolute refusal to name its ultimate owners.

A conflict of interest? Ukrainian officials and RosUkrEnergo

There is something opaque and unexplained in the relationship between RosUkrEnergo and Naftohaz Ukrainy, the Ukrainian state oil and gas company. When RosUkrEnergo was set up in July 2004, a report on Gazprom's website said that: 'The company will be managed by a coordination committee representing Gazprom, Naftohaz Ukrainy, Gazprombank and Raiffeisenbank.'413 RosUkrEnergo's managing director later said that this committee 'takes all the major decisions' for the company. 414 But why would Naftohaz have been represented on this committee, given that the Ukrainian half of RosUkrEnergo was not controlled by the Ukrainian state but by a group of private Ukrainian investors?

Global Witness has seen a document showing that two top Naftohaz officials were in fact appointed to the committee, but it was not the Ukrainian state that put them there. The document is a record of the minutes of RosUkrEnergo's inaugural meeting on 29th July 2004: all of its significant points have been confirmed by other sources. The document lists the names of the eight members of the committee. Four of the eight are senior people from Gazprom or Gazprombank, which makes sense given that the Russian company owned half of RosUkrEnergo, via ArosGas Holding. 415



RosUkrEnergo's Chuichenko (left) and Palchikov: the first speaks for Gazprom, but whom does the other serve? AFP/Sergel Supinsky

The record also shows that four people were nominated by CentraGas Holding, a private company, to be on the coordination committee. 416 One of them is Putschek himself, an executive of CentraGas. Two other names are those of Yuri Boiko and Ihor Voronin. At the time the committee was set up they were the chairman and deputy chairman, respectively, of Naftohaz Ukrainy, the Ukrainian state oil and gas company. So what were two such senior public officials doing on a key committee of a private company, at the behest of private investors? The conflict of interest is clear.

Global Witness has been unable to answer this question because neither Boiko nor Voronin has responded to repeated requests to comment on this document and its implications. Following the revelation of the document in early 2006, Global Witness asked Putschek about Boiko and Voronin's role on the committee: Putschek declined to comment. He agreed to talk to Global Witness again in March 2006 but after being sent a list of questions, including a question on Boiko and Voronin, CentraGas' PR company replied that: 'They [Putschek and his colleagues] have done their best to answer all these points, and that they have nothing further to add to their responses.'

Both Boiko and Voronin are no longer on RosUkrEnergo's coordination committee, according to Ukraine's prime minister, Yury Yekhanurov. In January 2006, he told a press conference that he had seen a letter from RosUkrEnergo, dated June 2005, which stated that Voronin had left the committee. 417 The timing of this letter would have coincided with the announcement of a Ukrainian criminal investigation into RosUkrEnergo (see section: The Ukrainian criminal investigation that never was?). The prime minister added that a similar letter existed for Boiko, though he himself had not seen it. 418

The situation is further complicated by the internal politics of Ukraine. Both Boiko and Voronin were fired from Naftohaz at different times in 2005 after the Orange Revolution, which brought Viktor Yushchenko to power. 419 Yet at some point later in the year, Voronin was rehired as Naftohaz deputy chairman. 420 As far as Global Witness can ascertain, Voronin's rehiring was not announced, but a source familiar with the company told Global Witness that Voronin was rehired sometime after September 2005, when President Yushchenko dismissed his former ally, Yulia Tymoshenko, as prime minister. 421 Voronin's rehiring would have implications for the investigation into RosUkrEnergo, and the negotiations with Russia in early 2006 which saw RosUkrEnergo become the sole supplier of Turkmen gas to Ukraine. The head of Naftohaz, Oleksiy Ivchenko, said in January 2006 that Voronin had been involved in talks beIf you want to look at the internal structure of RosUkrEnergo, once again, it's not a secret Wolfgang Putschek⁴¹²

tween Russia and Ukraine in late 2005.422 The fact that, in early January 2006, RosUkrEnergo was granted a concession to supply large amounts of Turkmen gas to Ukraine can only raise questions concerning Voronin's earlier involvement on RosUkrEnergo's coordination committee.

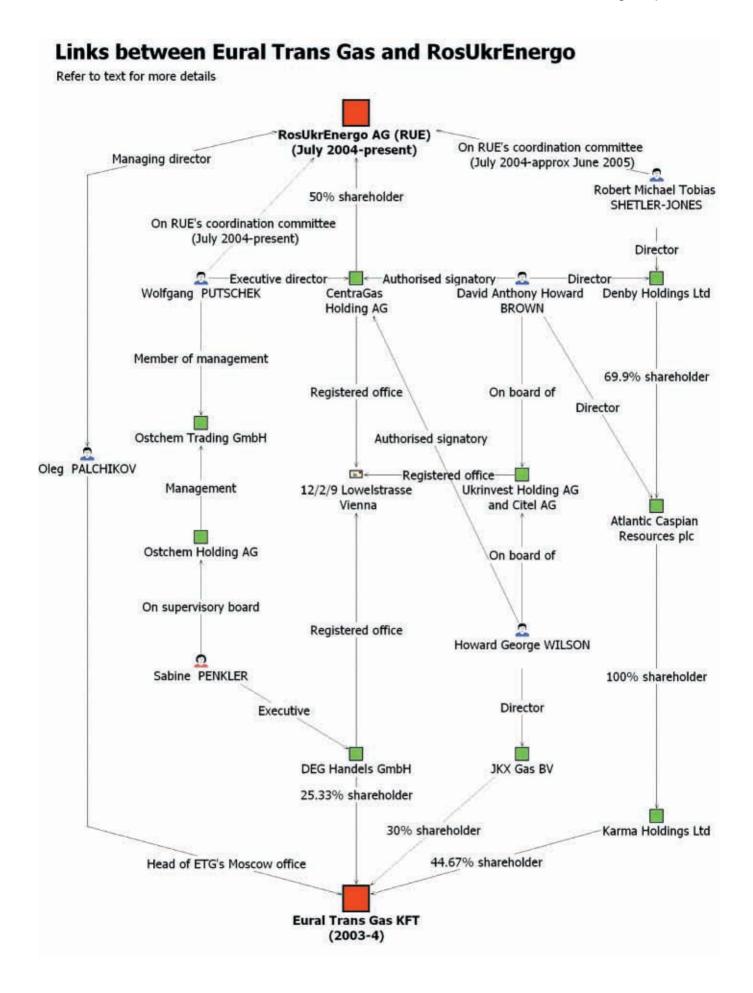
The fourth of the CentraGas nominees to the coordination committee is a name that featured prominently in the story of Eural Trans Gas: Robert Shetler-Jones.

The fourth man: Robert Shetler-Jones

The RosUkrEnergo document reveals that the fourth man on the Ukrainian side of the company's original coordination committee was Robert Shetler-Jones. This was confirmed in June 2005 by Raiffeisen's Putschek, speaking to Global Witness. His inclusion on the committee seems at odds with original press reports that stated the committee consisted of officials from Gazprom, Naftohaz Ukrainy and Raiffeisen. As a private businessman, it is not clear how Shetler-Jones would represent the interests of any of these entities.

Global Witness asked Putschek whether Shetler-Jones was part of the mysterious consortium of businessmen who own CentraGas and are represented by Raiffeisen Investment. Putschek would neither confirm nor deny whether Shetler-Jones was part of this consortium; this topic was off limits because the individuals did not want to be revealed, he said. He went on to explain Shetler-Jones' involvement on RosUkrEnergo's coordination committee by saying to Global Witness, 'he knows what went on in the past and can talk to Gazprom about this,' adding that his perfect Russian language skills were a key asset in such a complex business: 'He's bilingual'.423

At Global Witness' meeting with Putschek in late June 2005, he said that Shetler-Jones was being replaced on the committee, though he was unclear as to whether this had been achieved: 'He was... actually yes... he was on the coordination committee, he will be removed, he was removed, I don't know if he has been formally removed, but definitely the decision has been made to replace him with someone from Raiffeisen.' This was because, according to Putschek, Shetler-Jones was not needed anymore, following the company's initial 'transition period'. In a phone interview con-



ducted by a Global Witness contact a week after our meeting with him, Putschek stated that Shetler-Jones had voluntarily quit and that Raiffeisen was suggesting a new representative to Gazprom. 424 In a third interview at the end of July 2005, Putschek stated to Global Witness that Shetler-Jones had left the committee 'months ago'. 425 Global Witness wrote to Shetler-Jones for clarification on his work for RosUkrEnergo. Via a letter sent by his associate David Brown, Shetler-Jones said he would not be answering our questions.

As noted above, there is some evidence that Voronin and Boiko stepped down from RosUkrEnergo's coordination committee in June 2005. Global Witness met Putschek at the end of June 2005 and spoke to him again in July. The coordination committee was discussed in both conversations, but at no point in his conversations with Global Witness did Putschek mention that Boiko and Voronin had been on the committee and had apparently been replaced just weeks before. He said in late June: 'Each of the parties brings four people to the committee ... four people representing Gazprom ... and then there are four people from Raiffeisen – one of them is me, one is them is our resident director in Moscow, one of them is directing Raiffeisen Zentralbank - and the fourth we will have to agree with Gazprom,' following Shetler-Jones' departure. 426

Links between RosUkrEnergo and Eural Trans Gas

Putschek told Global Witness in June 2005 that he knew little about Eural Trans Gas, the company which had preceded RosUkrEnergo. He said: 'What we see now is a transitional phase. We have the old ETG structure and I know practically nothing about it as I was never involved. But I did have all the contracts to the end of 2005.'427

Investigations by Global Witness show, however, that there are actually many links between RosUkrEnergo and ETG and it seems strange that Putschek claims to know 'practically nothing' about ETG. One link is through DEG Handels, the Austrian company which, as described earlier, was one of the shareholders in ETG. Austrian corporate records, accessed by Global Witness in early 2006, give the Vienna address of DEG Handels as 12 Loewelstrasse, Floor 2/9. This is also the address of CentraGas Holding, which owns half of RosUkrEnergo.

One of the executives of DEG Handels is listed in Austrian corporate records as Sabine Penkler, who is also on the supervisory board of a company called Ostchem Holding AG, which is registered at the same address in Vienna: 12 Loewelstrasse, Floor 2/9.428 Putschek is a manager of a com-



The registered Vienna office of Centragas & Zangas. And DEG Handels. And Ostchem Holding. And Citel. And Ukrinvest. Global Witness

pany called Ostchem Trading, registered in Zug, Switzerland. Apart from Putschek, this company's management (geschaeftsfuehrung in German) is listed as Ostchem Holding AG and a man called Lars Haussmann, 429 an accountant who was RosUkrEnergo's sole director before the company appointed two managing directors in November 2004. 430 Ostchem Trading's business is listed as 'pharmaceutical production trade with chemical products'. As noted above, various people associated with RosUkrEnergo's predecessor ETG have also been involved in the chemical industry.

There are other links between RosUkrEnergo and the group of British businessmen connected to ETG besides Robert Shetler-Jones' stint on the RosUkrEnergo coordination committee. One of the prokurists (German for 'authorised signatory') for CentraGas Holding is David A.H. Brown, Shetler-Jones' fellow-director at Denby Holdings which, as noted earlier in this report, was an indirect shareholder in Eural Trans Gas. Putschek told Global Witness that Brown assisted RosUkrEnergo in legal matters concerning the purchase of gas fields. Howard Wilson, who featured earlier in this report as a director of JKX Gas, another ETG shareholder, is also a prokurist for CentraGas. Putschek told Global Witness in July 2005 that Robert Shetler-Jones was no longer involved with RosUkrEnergo, though he added that his associate David Brown was still involved. 431

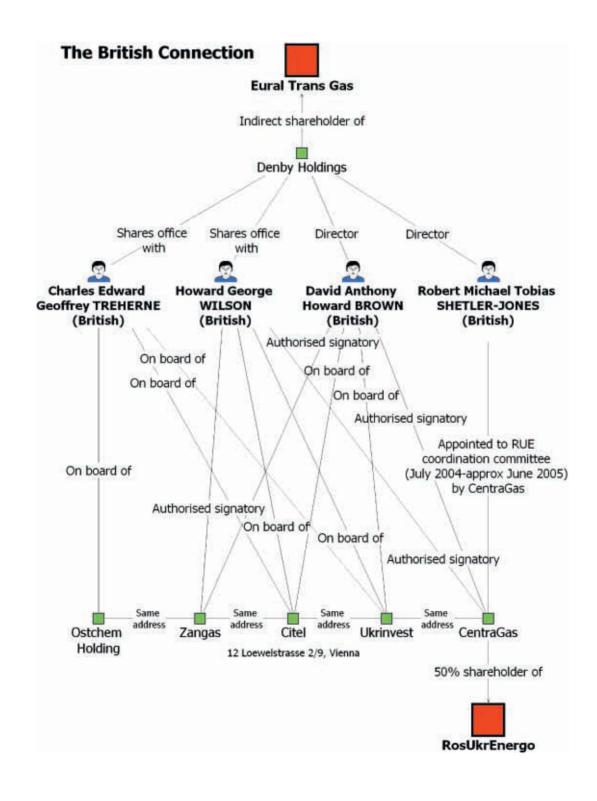
Two other companies that have been registered at the same Vienna address as CentraGas and DEG Handels - 12 Loewelstrasse, floor 2/9 – are Ukrinvest Holding and Citel AG. David A.H. Brown, Howard Wilson and a man named Charles Treherne are all listed as board members for both companies. 432 Treherne is another associate of Shetler-Jones and David Brown at Denby Holdings; he is also listed as a board member of Ostchem Holding.

A Global Witness contact went to 12 Loewelstrasse in Vienna and discovered that currently two companies share this office: CentraGas Holding AG and ZanGas Hoch-Und Tiefbau GmbH. ZanGas features David Brown as a board member⁴³³ and was contracted in 2005 to build a gas pipeline in Turkmenistan, for which ZanGas was to be paid in gas, according to Turkmenistan's state website.⁴³⁴

Another figure to reappear from the ETG story is Oleg Palchikov, who formerly headed the Moscow branch of the company. A document seen by Global Witness shows that Palchikov was appointed a co-director of RosUkrEnergo in November 2004,⁴³⁵ representing CentraGas. His co-director

is Konstantin Chuichenko, who is head of Gazprom's legal department⁴³⁶ and represents Gazprom's 50% interest.

Putschek told Global Witness that Eural Trans Gas did not have any bank accounts with Raiffeisen Bank: 'What is true is that ETG applied for a bank account but it was turned down.'437 Global Witness later saw a document indicating that one of ETG's bank accounts was at Raiffeisen Bank in Budapest. Having been told this by Global Witness, Putschek said that he would have to check to see if such a



bank account existed, but added that if one did, it would not have held a lot of money. 438 After its opening two transfers, this account contained US\$5.76 million on 12th March 2003.439

In September 2003, before RosUkrEnergo came into existence, Raiffeisen Investment bought a 54% share of Rivneazot, a Ukrainian factory that produces mineral fertilisers and other products. 440 According to an online annual report, two of Rivneazot's board members are Alim Svergunenko and Aleksandr Shuklin.441 These two men also work for Nitrofert, whose chairman is Dmytro Firtash, according to its website.442 Firtash was the man who got Israeli lawyer Zeev Gordon to register ETG, according to the latter. Global Witness asked Putschek in 2006, via Centra-Gas' PR firm Merlin, if Raiffeisen Investment had purchased Rivneazot on behalf of Firtash, or had any other business relationship with him. The executive declined to answer questions through Merlin. In an interview in June 2005, Putschek had told Global Witness that Raiffeisen had no business with Highrock Holdings, the Cypriot company directed by Firtash.443

It was noted earlier in this report that ETG was indirectly controlled, after April 2004, by Dema Trustees and Dema Nominees of Cyprus, which also owned a chemicals company called ACI Trading. The latter's clients included Firtash's Nitrofert and Shetler-Jones' Krymsoda plant, as well as Rivneazot. 444 ACI Trading also had a banking relationship with Raiffeisen Zentralbank, the parent of Raiffeisen Investment: ACI Trading's records show a 'charge on deposit' of the amount of U\$27,000,000, with the Austrian bank as the beneficiary.445

The Ukrainian criminal investigation that never was?

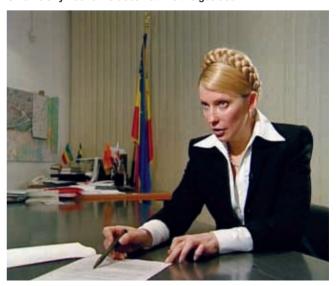
In June 2005, the Ukrainian Security Service, which was then headed by Oleksandr Turchynov, an ally of then-prime minister Yulia Tymoshenko, launched a criminal investigation into Eural Trans Gas and RosUkrEnergo. Tymoshenko went so far as to call RosUkrEnergo a 'wart on the body of the Naftohaz company' on Ukrainian television. 446

The investigation was confirmed by the Security Service's press secretary Marina Ostapenko, who said to the *Moscow* Times in June 2005: '[The Security Service] is currently investigating a number of criminal cases in the fuel and energy complex ... As part of this investigation, the service has launched a probe into former and current intermediaries involved in deals supplying gas from Turkmenistan to Ukraine, including into their possible ties with international organised crime groups.'447 In August, Naftohaz spokesman Dmitry Marunich told the Moscow Times that the Security Service had recently searched Naftohaz's offices, and that the search was related to the company's former management. 448 The investigation also seemed to provoke a largescale purge of top government officials in Turkmenistan (see above section: Chaos at the Central Bank) after the Ukrainian security service had turned to its Turkmen counterpart for information concerning possible money laundering in Turkmenistan from gas-transportation schemes, according to Turchynov.449

In September 2005, Viktor Yushchenko sacked his government, including Prime Minister Yulia Tymoshenko. Her political ally. Turchynov, who had launched the investigation into the intermediary companies, resigned. Political analysts cited the in-fighting between Tymoshenko and the head of the Security and Defence Council, Petro Poroshenko, as one of the reasons for Yushchenko's actions, though other reports suggested that the investigations themselves were causing friction within the cabinet and amongst the president's aides.

Following his resignation from the post of security chief, Turchynov told Global Witness in January 2006 that he had written to Yushchenko, stating that RosUkrEnergo posed a dangerous threat to Ukraine's energy security, but his concerns were ignored. He had previously told *Ukrain*skaya pravda in September 2005: 'I have to say that as soon as the SBU [Ukrainian Security Service] started investigating this scheme, it came under pressure ... I had a conversation with President Yushchenko himself. He accused me of persecuting his people, he said the SBU was working against his team. I explained to him that we were working against criminals, not against his team.'450

Ukraine's Tymoshenko does not like the gas deal.



Turchynov added that he received a telephone call from one of Yushchenko's aides, Oleksandr Tretyakov, asking him to halt the investigation.

Tretyakov denied this allegation in a later interview with *Ukrainskaya pravda* in which he said: 'I didn't call him even once concerning RosUkrEnergo. Oleksandr Valentinovich [Turchynov] is an experienced politician and a strong person. I could not pressure him while he was head of Ukraine's state security service! As assistant to the president, I don't have any means to put pressure on him.' In the same interview Tretyakov denied having any shares in RosUkrEnergo.

Following Turchynov's dismissal, one of his assistants, Ihor Dryzhchany, took over as the head of the Security Service. Global Witness called the Security Service in February 2006 to ask about the progress of the investigation and was surprised to be told that there had never been such an investigation. The person who said this to Global Witness was Maria Ostapenko, the press secretary of the Security Service and the very same person who had spoken about the investigation to the *Moscow Times* eight months previously. 452

Had Turchynov gone outside his remit as security chief in launching an investigation of RosUkrEnergo? Or is it possible that, after the January 2006 deal between Russia and Ukraine which put RosUkrEnergo in an even stronger market position than before, there were powers within Ukraine who wanted the criminal investigation to be stifled?

Turchynov's allegations and their rebuttal

While he occupied the position of Ukrainian Security Service head, Oleksandr Turchynov made it clear that in his opinion intermediary companies posed a threat to Ukraine's energy security. In an extensive interview with *Zerkalo nedeli* in June 2005, he stated: 'The presence of this middlemen structure looks strange, given that there exists a fairly strong state company, Naftohaz Ukrainy.' He went on to express concern over the intermediaries' barter deals: 'There were serious abuses, including ones engendered by the process of barter payment for Turkmen gas' and highlighted the fact that, 'activity on such a scale could not have been carried out without authorization at the highest state level both in Ukraine and in the Russian Federation.'⁴⁵³

In another interview with the *Financial Times* conducted during his time as security chief, Turchynov stated that part of the investigation concentrated on whether a man named Semion Mogilevich was behind such companies as

RosUkrEnergo. Mogilevich is a controversial Ukrainian businessman, formerly resident in Budapest, now in Moscow, who is currently wanted by the United States authorities in connection with an alleged fraud scheme set up in America. Turchynov stated: 'The surname Mogilevich isn't in the [gas trade] agreements or in the ownership documents [of the companies involved] but there are many indications that a group of people under his control could be involved.'

Mogilevich's lawyer, Zeev Gordon, told Global Witness in a phone interview in August 2005 that people often used the name of his client to 'discredit things' and 'break contracts' – that is, to inaccurately associate him with particular business deals in order to try and create controversy about them. Gordon said that Mogilevich was not involved in any way with companies used to transport Turkmen gas to Ukraine and added in a second interview that he thought that talk of an investigation had been intended to create a political effect: 'the announcement was more important than the investigation.' ⁴⁵⁶

Gordon stated in August 2005 to Global Witness that, though Mogilevich knows Dmytro Firtash, the man who had got Gordon to register Eural Trans Gas, he was not familiar with what business, if any, they had together. However, he added that Mogilevich had assured him that he was not involved in ETG or RosUkrEnergo. Wolfgang Putschek told Global Witness that his company had not been approached by any investigators and that the investigation was purely political. He stated that Mogilevich was not involved in RosUkrEnergo, and all ultimate owners had undergone the strictest compliance. Global Witness asked Putschek in 2006 what these 'compliance' procedures involved. Putschek's PR firm Merlin wrote to Global Witness saying that Putschek had nothing further to add to previous answers he had given.

Former chairman of Naftohaz Ukrainy, Yuri Boiko, who signed the ETG and RosUkrEnergo contracts on behalf of Naftohaz, defended the deals on Ukrainian television in August 2005. He stated: 'We received the gas on time and it was the cheapest.' In the same interview he accused his critics of pursuing personal interests in attacking him. Boiko is now involved in Ukrainian politics, forming the 'Republic Party of Ukraine' in 2005.

When Gazprom's chairman Alexei Miller was asked by a British journalist about the criminal investigation of RosUkrEnergo in June 2005, his rather terse reply was: 'If someone in Ukraine wants to go fishing in murky waters then let them – in the Ukraine.'

The gas dispute, January 2006

On New Year's Day 2006, Russia cut gas supplies to Ukraine in a highly publicised move that followed Ukraine's refusal to meet a sharp hike in gas prices. As a result, various countries around Europe experienced a loss in gas supply. International media concentrated on the issue of European energy security and its reliance on Russia. The stand-off was resolved on 4th January, when Gazprom and Naftohaz signed a supply agreement that gave a major role to RosUkrEnergo. The company was contracted to buy 41 billion m³ of Turkmen gas from Gazexport at an undisclosed price and 17 billion m³ of Russian gas at US\$230 per 1000 m³. The contract also stipulated that RosUkrEnergo would sell to Ukraine 34 billion m³ of gas at US\$95 per 1000 m³ in 2006. The contract was signed by the chairmen of Gazprom and Naftohaz, Alexei Miller and Oleksiv Ivchenko, and the managing directors of RosUkrEnergo, Oleg Palchikov and Konstantin Chuichenko.

Without Russia, Ukraine can only meet a third of its gas needs from domestic sources. With this in mind, did the chairman of Naftohaz have the authority to sign an agreement giving a monopoly on gas imports to a private company? This was the question raised by many commentators



The founders of RosUkrEnergo could have been anybody... anybody Ukrainian President Viktor Yushchenko⁴⁰⁵

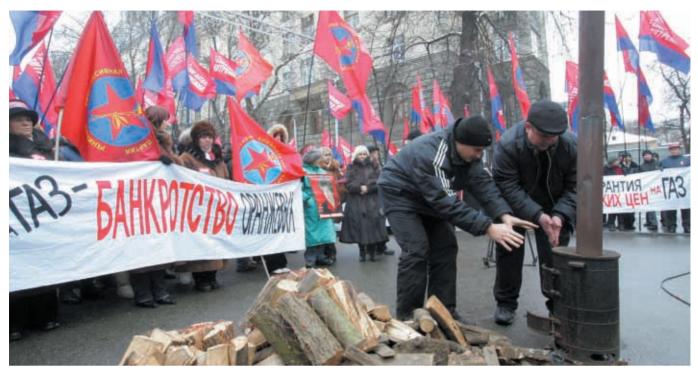
in Ukraine following the agreement. The question is particularly acute when the company concerned has refused to disclose its ultimate beneficiaries and was possibly, according to former security chief Oleksandr Turchynov, the subject of a criminal investigation.

The contract itself, which is less than two pages long, also left many unanswered questions. Firstly, it seemed to override an existing contract between Ukraine and Turkmenistan, which was supposed to operate until the end of 2006. It is unclear what formula has been used to produce a price of US\$95 per 1000 m³ for gas sold to Ukraine, when Turkmenistan sells the same gas to Gazexport for US\$65: there is presumably a transportation cost but no details about this have been made public. It is also unclear whether any of the more expensive Russian gas would make its way to Ukraine. Naftohaz chairman Oleksiy Ivchenko has stated that none of this gas would be sold to Ukraine. 462 However, former prime minister Yulia Tymoshenko highlighted the fact that the 34 billion m³ of Turkmen gas to be sold to Ukraine by RosUkrEnergo would not be enough to fulfil Ukraine's energy demands. 463 The lack of clarity over pricing and volumes is deeply troubling because without knowing exactly where the gas is coming from, it is not possible to work out what the ultimate cost of the gas deal will be for Ukraine.

Furthermore, the contract's operational term is only six months, with the possibility that gas prices may rise later in the year. RosUkrEnergo stated that the agreement can be renegotiated, depending on what happens to gas prices.⁴⁶⁴ However, Naftohaz spokesperson Dmitri Marunich insisted that the price is set for five years at US\$95.465 Turkmenistan may well decide to seek higher prices for its gas, judging by comments by President Niyazov, which would result in a knock-on effect of still higher costs to Ukraine. In effect, the agreement does not guarantee any security for any substantial period of time.

Global Witness contacted Raiffeisen's Wolfgang Putschek in February 2006 in order to clarify the issues raised by the new contract. CentraGas' PR firm responded that Putschek did not want to comment further.

Once again, both Naftohaz and Gazprom rely upon an intermediary to supply Turkmen gas to Ukraine. Gazprom now controls 50% of the latest company, RosUkrEnergo. Yet despite declared intentions to the contrary, Naftohaz has neither rid Ukraine of the use of an intermediary in its gas supply from Turkmenistan, nor acquired a share in such a company. Instead, as Global Witness goes to press, Naftohaz has granted RosUkrEnergo even more of a share of its market.



Protesters' banners ask if the gas deal has bankrupted the Orange Revolution. AFP/Sergel Supinksy

RosUkrEnergo & Naftohaz create a joint venture

On 2nd February 2006, Naftohaz Ukrainy issued a press release stating that a joint venture named UkrGazEnergo had been created between Naftohaz and RosUkrEnergo.⁴⁶⁶ A Russian oil and gas industry paper reported that Gazprom deputy chairman Aleksandr Ryazanov was appointed its chairman.⁴⁶⁷

This new company would be in charge of supplying natural gas in Ukraine's internal markets. This enterprise therefore places more income that was formerly going to the state via Naftohaz into the hands of RosUkrEnergo, a company halfowned by a group of unnamed Ukrainian businessman and companies. Gazprom benefits through its 50% ownership of RosUkrEnergo.

With so much confusion concerning the new contract, the gas prices and how long they are guaranteed for, the fate of Ukraine's energy supplies depends on Gazprom and the mysterious men who control the other half of RosUkr-Energo. With Turkmenistan's erratic President Niyazov likely to demand higher prices and the threat that Russia may assert its dominance once again, Ukraine faces a difficult future and some troubling questions about the governance of its gas trade.

As described earlier, there have been conflicting views about the commercial benefits of these arrangements. Some Gazprom shareholders and industry analysts have criticised them on the grounds that Gazprom has been giving away chunks of its business to others. Another expert view is that such arrangements help to negotiate the volatile conditions of the gas business and the complex relationship between Ukraine and Russia. Israeli lawyer Zeev Gordon, the man who registered Eural Trans Gas, speaking to Global Witness as an interested observer of the RosUkrEnergo situation in February 2006, said that the trade could not work without a middleman who can guarantee that Ukraine pays for its gas, and who should be entitled to big profits for taking on the risk of this guarantee: 'If someone is risking [big money] they are expecting therefore to have big profits. There is no other way to make these deals, this is what I understand ... But when you are not in power, you can knock down any plan.'

Naftohaz Ukrainy's current management policy originally seemed to be against such intermediaries. In June 2005, the head of Naftohaz, Oleksei Ivchenko, stated that intermediary companies such as RosUkrEnergo would be a thing of the past: 'You know the position of NAK [Naftohaz] is clear and understood and transparent. We consider that there should be no intermediaries in relations between NAK [Naftohaz] and Turkmenistan, between NAK [Naftohaz] and Russia's Gazprom. We are perfectly capable of handling these relations independently and directly.'⁴⁶⁹

The people of Ukraine thus have a right to know why Naftohaz has yet to rid itself of an intermediary in its gas import system or why, if one needs to exist, Naftohaz has yet to buy into this structure. If this proves impossible, it is not only in Ukraine's interest but that of Europe as well, that the undisclosed 50% ownership of RosUkrEnergo be finally revealed.

Conclusion: Plus ça change, plus c'est la même chose?



Over a quarter of Europe's gas comes from Turkmenistan and Russia. AFP/Stringer

The transit of gas from Turkmenistan to Ukraine has, for the last 15 years, been characterised by opacity surrounding a complex web of intermediary companies with largely unknown beneficiaries and high-level decisions made in Russia and Ukraine whose economic justification is often unclear. These intermediary companies have come out of nowhere, parlaying tiny amounts of start-up capital into billion-dollar contracts of vital economic consequence to Russia and Ukraine.

Turkmenistan earns huge sums from gas exports, most of which ends up not in the national budget, but overseas, controlled by its increasingly despotic President Niyazov, while the public services of his country deteriorate and his people slip into deeper poverty. Given the risks of instability in Central Asia and the region's geostrategic importance, it seems extraordinary that an out-of-control dictator should be able to prop up his personality cult with the willing support of European gas buyers, European exporters and European banks. It is time for Europe to stop sitting on its hands and think about such measures as revising banking laws, for example by tightening the due diligence requirements for politically exposed persons who wish to become bank customers, to stop dictators like Niyazov from using the European financial system as a convenient piggy-bank.

Gazprom, the major corporate player in this cross-border trade, has repeatedly promised greater transparency, yet a group of unidentified Ukrainian businessmen continues to play a central role in Central Asian gas transport. At a time

when Gazprom is planning to expand its international operations, with talk in February 2006 of new pipelines to Europe and possible acquisitions in Britain, it is in everyone's interests that Gazprom be as transparent as possible, not only in its own operations but also in its dealings with third parties.

The Russian government also has an interest in promoting transparency in the energy sector, not just because energy security is Russia's chosen theme for its presidency of the G8 countries in 2006, but also to allay the fears about security of supply that were aggravated in Europe after Russia's dispute with Ukraine last winter.

Ukraine remains at the heart of the controversy surrounding this gas trade. Information revealed in this report suggests that the state oil and gas company Naftohaz Ukrainy has been so badly managed from the tenure of Ihor Bakai onwards that it is unable to rid itself of the use of intermediaries. Instead, it finds itself becoming ever more dependant on them. This report has shown that key figures involved in the Eural Trans Gas deal are or have been also involved in RosUkrEnergo, the current intermediary company whose role in Ukraine's gas industry is expanding.

The use of such intermediaries represents the private ownership of state resources, an all-too apparent story in former Soviet countries since the fall of the Union, where natural resources have been controlled by a select few people. Very little information is available on these private individuals

and the qualifications they possess in controlling such fundamental business as a country's energy supply.

How is it in the interests of Ukraine, or indeed of Europe, to have such a vital country's gas supply controlled by complex and opaque private business structures? It is in the public interest to know who exactly stands behind these intermediaries and who ultimately benefits from their operations. This report hopefully acts as a starting point for further enquiries, as a step towards a more open and accountable trading system.

Ukraine needs to establish and disclose, once and for all, who actually owns RosUkrEnergo and permit a fully informed debate as to whether it is in the country's best interests to allow this company to occupy such a central role in the import and internal supply of gas which, as the recent cut-off in Russian deliveries in the middle of winter has shown, is literally essential to Ukraine's survival.

Endemic corruption and the mire of allegation and counter-allegation in the 1990s has besmirched the names of people on all sides of Ukraine's political debate and tainted confidence in the economic management of the nation. The public is entitled to know who controls the gas industry and where and how its revenues are appropriated. Without this information there is an obvious risk that corruption could undermine Ukraine's democracy.

Ukrainian president Viktor Yushchenko himself is in a difficult position. He has promised to tackle corruption but investigating allegations in a sustained and serious way could bring his government into conflict with powerful vested interests. The relationship with Russia also remains highly sensitive and the Ukrainian government must be keenly aware of the possibility of another cut-off in gas supplies from Russia. That said, the alternatives are likely to be worse if Ukraine cannot put behind it the legacy of misrule and financial impropriety bequeathed by former president Leonid Kuchma by investigating any possible improprieties in Naftohaz Ukrainy, publishing full audits of its financial results, and adopting the principles of the best practice initiatives like the international Extractive Industries Transparency Initiative to promote openness and public oversight of the Ukrainian gas industry. If Ukraine is to join the EU, it must conform to freedom of information principles.

The intermediary companies which trade or have traded Turkmen gas - RosUkrEnergo, Eural Trans Gas, Itera and others – may have come into being as an attempt to solve the problems that Russia and Turkmenistan faced in getting payments out of Ukraine in the 1990s. But they may simply have created another set of problems and posed another set of risks. It is not clear why they have to be opaque and complex offshore structures, featuring unknown beneficiaries. And the use of barter schemes led to huge debts for the Ukrainian state but fortunes for individuals. Gazprom is essential to the trade because it owns the pipelines, without which gas cannot move from Turkmenistan to Ukraine. Gazprom's willingness over the years to allow the intermediary companies to take over some of its own markets overseas has never really been satisfactorily explained.

Although there is a certain amount of mutual dependency between Russia and Ukraine - Russian gas must go through Ukraine to reach customers in the rest of Europe – the tangled maze of companies described in this report is hardly a solid foundation for a trade of such commercial and geostrategic importance. Top officials from both Gazprom and Naftohaz Ukrainy have stated on various occasions that they want the use of intermediary companies in the gas trade between Turkmenistan and Ukraine to come to an end: this would be a very positive step, and should be carried out as soon as possible.

The turbulence and uncertainty of the Turkmen-Ukraine gas trade, which is an integral part of the wider gas trade between Europe and the former Soviet states, raises a guestion for the European Union and its member states which needs to be answered sooner rather than later: can Europe ensure stability and good governance in the ring of countries, from Algeria in the south to Ukraine in the northeast, which are either sources or transit zones for a growing part of Europe's energy supplies?

A Gazprom representative once said 'soon we will be so transparent you won't even be able to see us'. 470 At the moment the opacity of the Turkmen-Ukraine gas trade is all too visible.



'Gas! Danger!' Europe should heed the warning. AFP/Sergei Supinsky

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