Commission on Security and Cooperation in Europe (U.S. Helsinki Commission)

Hearing "Energy and Democracy: Oil and Water?"

July 23rd, 2007

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Thank you, Mr. Chairman and members of this esteemed Commission, for the opportunity to share my views on the critical issue of oil and corruption and how we can put a stop to it. This is not a remote problem, but one that affects us squarely here at home. For when a kleptocrat in a region like Central Asia decides to exact higher bribes, angers the local population, kicks out Western companies, cuts off energy supplies, and provokes local insurgencies, oil prices jump up and U.S. energy security is suddenly threatened.

When I started working on this issue over ten years ago, oil-related corruption seemed like a problem that we would never solve. After all, real thieves will find a way around any system of safeguards – particularly if the payoff is hundreds of millions of dollars in oil revenues. But in those ten years, I have been surprised at how many steps forward we've actually taken – from criminal bribery investigations to transparency of payments schemes. But the problem is far from solved, Mr. Chairman, particularly at a time when oil prices are at an all-time high, and political leaders in autocratic and energy-rich nations are using their windfall profits to consolidate power and undermine democracy. We need to inject new lifeblood into solutions now, and the key is transparency.

My testimony will outline the key problems of oil and corruption, how it affects us in the U.S., what solutions have been tried to combat it, and what the U.S. role should be in preventing it.

1. The Facts

Mr. Chairman, the reality is that energy-related corruption involves huge sums of money, is bad for the people in oil-rich countries, and is worse for U.S. energy security. Let me present three key facts that illustrate this point.

Fact One: *Six of the top ten sources of U.S. crude oil imports rank in the bottom third of the world's most corrupt countries, according to Transparency International's latest global survey.*

This is a very disturbing development, and three major energy suppliers in Central Asia: Kazakhstan, Turkmenistan, and Uzbekistan rank as three of the most corrupt. All three fall in the bottom third of the 'most corrupt' list. Corruption in these nations not only affects the citizens of those countries, but it comes back to us squarely here in the U.S. and Europe in terms of energy security. The linkage works along the following lines: corruption and kleptocracy in resource-rich countries lead to political instability, drive up oil prices, and present significant risks to U.S. investments. As citizens in oil-producing countries become disgruntled with governments and foreign investors whom they believe to be corrupt, such citizens can foster political unrest and threaten oil supplies.

Energy security mainly refers to the security of supply – a stable, reliable energy supply at affordable prices. As such, the insecure political climate described above has led to disruptions of energy supply in several nations. Gas from one of Europe's main suppliers – Turkmenistan – was shut off twice over the past two years because of non-transparent squabbles and dealings with intermediary companies, including the Russian-Ukrainian RosUkrEnergo. Or to take an example from outside the OSCE, between 500-800,000 barrels of oil a day are lost from Nigeria alone – the U.S.' fifth largest importer of crude oil – due to attacks by rebel groups angry at the corruption of oil revenues and the secrecy of government budgets, made up mainly of oil revenues.

As President Bush stated in 2006, "Some of the nations we rely on for oil have unstable governments, or agendas that are hostile to the United States. These countries know we need their oil, and that reduces our influence, our ability to keep the peace in some areas. And so energy supply is a matter of national security. It's also a matter of economic security." Simply put, non-transparent, unaccountable, autocratic governments are unreliable sources of oil over the long term.

Fact Two: *Turkmenistan is Central Asia's main exporter of gas, which flows through Russia to Ukraine and on to Europe. In Turkmenistan 75% of the gas revenues are kept off-budget, and Deutsche Bank still keeps a $2 billion Turkmen bank account which ex-Turkmen leader Saparmurat Niyazov maintained personal control over.*

Turkmenistan holds the 6th largest natural gas reserves in the world but has a track record of bad governance, poverty, and mismanagement of public assets. These factors make it an unreliable energy supplier. Nearly 60 percent of its population lives below the poverty line despite $2 billion in annual gas revenues, freedom of the press is ranked as the 3rd lowest in the world, just behind North Korea; and it has been labeled as "one of the worst totalitarian systems in the world". Under President Saparmurat Niyazov, who passed away last December, schooling was actually cut by a year, while Niyazov ordered a multi-million dollar ice rink to be built in the desert and constructed a number of golden statues of himself across the country, one of which rotates with the direction of the sun.

Between two and three billion US dollars of Turkmenistan's public funds are currently held by the Turkmen Central Bank at Deutsche Bank in Frankfurt. The existence of these bank accounts was confirmed to Global Witness by Germany's banking regulator Bafin and later, by Deutsche Bank itself. Further billion-dollar foreign reserve funds of oil, gas, and cotton revenues, which were under the sole control of Niyazov, are also believed to be held at Deutsche Bank. Evidence suggests that many of Niyazov's bizarre prestige projects, including golden statues and palaces, were paid for out of these funds.

Deutsche Bank claims it is living up to the anti-corruption and pro-human rights principles of the UN Global Compact. But without a proper system for checking what its members like Deutsche Bank are doing in places like Turkmenistan, the Global Compact is little more than a marketing tool. Its members may only be paying lip-service to the principles they claim to support. I call on the Helsinki Commission to write to Deutsche Bank to explain its dealings with the former Turkmen regime and to Germany's banking regulatory office, the Bafin, to explain how such a situation can happen in the first place.

Fact three: *80-90% of Russian and Central Asian gas transits through Ukraine, but these supplies were cut off in 2006 because of a pricing dispute between Russia and Ukraine. The solution – the involvement of mysterious intermediary company RosUkrEnergo – raises alarming questions of transparency and good governance.*

On New Year's Day 2006, Russia cut off gas supplies to Ukraine, demanding an increase in the price Ukraine was paying. The solution involved a new private company, RosUkrEnergo (RUE), who agreed to supply gas to Ukraine at a lower price than what Gazprom was demanding from Ukraine. However, it was unclear why RosUkrEnergo was needed in the first place: Gazprom delivers Turkmenistan's gas to the Ukrainian border. Why did Gazprom not simply hand it over to Ukraine's state oil and gas state Naftohaz Ukrainy? Defenders of the scheme state that RUE was needed because it paid on time, unlike Naftohaz, and could maintain relations between the two sides, while keeping the gas relatively price low for Ukraine. However, for the first two years of existence, the owners of 50% of the company were not disclosed, raising concerns that RUE had ties to the ruling elites of Russia and Ukraine. The then-U.S. Ambassador to Ukraine, Carlos Pascual, highlighted news reports that linked the company to figures in Russian organized crime. Though RUE has denied all such links, the U.S. Department of Justice is now investigating RUE.

Recent revelations show a close personal friendship between Ukraine's current energy minister Yuri Boiko and RUE's 45% private shareholder Dmitri Firtash. Boiko was even for a time on a key RUE committee at the behest of Firtash. Boiko has yet to explain this apparent conflict of interest. I would urge the Commission to pursue this matter further.

Fact four: *Kazakhstan is a major energy exporter with over 1.2 million barrels of oil per day, but it ranks in the bottom third of the world's most corrupt countries (111/163) and is implicated in a $78 million Foreign Corrupt Practices Act legal case in New York.*

Lack of energy transparency has led to corruption scandals in a number of oil-producing countries in recent years, both tainting energy companies and seriously retarding economic development. Kazakhstan, which produces over 1.2 million barrels of oil per day, is a case in point. In 2003, the largest-ever foreign corruption investigation in U.S. legal history uncovered a major international corruption scandal that "defrauded the

Government of Kazakhstan of funds to which it was entitled from oil transactions and defrauded the people of Kazakhstan of the right to the honest services of their elected and appointed officials". The scheme was based around Kazakh President Nursultan Nazarbayev and Oil Minister Nurlan Balgimbayev demanding that international oil companies such as Chevron (now Chevron-Texaco) and Mobil (now ExxonMobil) pay a series of fees to middleman James Giffen on behalf of the Republic of Kazakhstan. This arrangement, the indictment alleges, helped Giffen to skim money from the deals and send some US$78 million in kickbacks to President Nazarbayev and others through dozens of overseas bank accounts in Switzerland, Liechtenstein and the British Virgin Islands. The case is currently awaiting trial in New York.

Another $1 billion of Kazakh oil money has also been uncovered offshore and out-of-sight under Nazarbayev's direct control in a secret fund in Switzerland. Despite the country's vast oil wealth, Kazakhstan's economy grew an average of only 0.3% from 2000-2005. Today, 19% of the population lives below the poverty line and one in three people die before age 60. The corruption scandals have tainted not only the Kazakh government, but also U.S. oil companies trying to foster a better global business reputation.

2. Solutions

With energy security growing in significance over the coming years, fostering better, more transparent investment climates in oil-producing countries is quickly assuming a new, more prominent role. The foremost step in promoting such an environment and combating corruption is through energy revenue transparency. Energy revenue transparency works through four main measures, but the progress made to date on this issue has in reality only been drops in the bucket rather than a glass that is half full.

A. A Reporting requirement on transparency

The most significant of these measures would be through a reporting requirement for corporations to regularly report payments made to all foreign governments for oil, gas, and mineral extraction on an annual and quarterly basis. Setting up such a requirement is a critical role the U.S. should play, and I will go into this in more detail shortly.

B. The Extractive Industries Transparency Initiative (EITI)

A second transparency policy measure is the Extractive Industries Transparency Initiative (EITI), which serves to improve investment climates through the audited disclosure of revenue payments. In this process, all oil companies operating in an EITI implementing country, including state-owned companies and non-western companies, first disclose all payments to governments, including production sharing agreement payments, taxes, royalties, and signature bonuses. Then governments disclose the revenues they receive, and the two sets of figures are independently audited by an auditing company and publicly examined by civil society.

Launched in September 2002, EITI has produced concrete results in two countries (Azerbaijan and Nigeria), where independently audited and reconciled reports have been published. In Azerbaijan, GDP growth per capita increased from 10.4% in 2000 to 25% in 2005, and following its participation in EITI, Azerbaijan has had the world's 12th most improved business environment score from 2001 to 2006, according to the Economist magazine.

But much remains to be done in the other 51 resource-rich countries. Of the 27 countries that have signed on to EITI, only ten have formulated a work plan, and a further eight have not taken the first step of appointing an official to lead the EITI process. Moreover, 33 resource-rich countries – including all OPEC members excluding Nigeria – have not signed up to EITI.

C. Budget transparency

The next step, once there is transparency about revenues flowing into the public finances, is transparency about how the money is spent. Civil society groups in developing countries are often most concerned about transparency in spending, because they can see the oil money that is meant to go to schools and healthcare being drained away by vested interests. For example, despite progress on the revenue transparency side with EITI, civil society groups in Azerbaijan cite continued corruption despite the EITI process. They have called for budget expenditure transparency as a means to significantly further reduce poverty and eliminate corruption. Oil-producer governments and donors can partner to establish transparency of budgets, either through special aid arrangements or the conditioning of aid on progress in budget transparency.

D. Accountability through civil society

Transparency alone will not solve the oil-corruption problem. Critically, it also requires accountability, which is a longer term process but one which we can influence. In other words, getting the revenue and budget numbers out in the public is a key first step. But if citizens do not understand these numbers, or civil society groups and the media do not have the capacity to analyze the figures and put pressure on the government to come clean on any discrepancies, then the revenue numbers alone will not combat corruption. Likewise, if there are not a key group of reformers in the government – a critical mass who can influence policy – then the voices of civil society groups will go unheard. So we also need to influence these figures, the policy decision makers within the governments of the oil-rich countries.

For example, the Kazakhstan coalition of Publish What You Pay, comprised of many Kazakh civil society groups and led by the Open Society Institute of Kazakhstan, has achieved a number of advocacy successes over the past several years. Most recently, the coalition convinced the government to sign the EITI decree in December 2006, in which the government obligated all extractive companies to endorse EITI and made endorsement of EITI a condition for awarding of any future energy contracts. We need to ramp up support for these type of watchdog civil society groups, to ensure they have the capacity they need to promote accountability.

3. The U.S. role

Now is the time for the U.S. to make transparency a key element of a reinvigorated energy policy. The U.S. should play a lead role in this policy drive, given the U.S. nationality of many of the largest international oil companies, and join other governments such as Norway and the UK who have taken a number of lead initiatives already. Doing so would save U.S. taxpayer money by making resource-rich countries use their oil, gas, and mining revenues for development, and make them less dependent on foreign aid.

Two targeted policy measures should make up the U.S. energy revenue transparency strategy.

- **First and foremost, we call on Congress to pass legislation on the statistical reporting of oil, gas, and mining revenue payments.** And when I say we here, I represent the voice of the entire Publish What You Pay coalition, made up of over 300 nongovernmental organizations worldwide dedicated to energy revenue transparency. The legislation should require extractive industry companies to publicly disclose payments to all governments on a country-by-country basis, as a small additional element to the information that is already routinely disclosed by these companies through SEC filings and their foreign equivalents. The U.S. should take the lead on this issue, but other major securities market regulators should follow suit, including the U.K., Hong Kong, Japan, and India, so as to level the playing field for all companies.

Companies often disclose revenue payments to governments but these payments are not reported by country. This would be a simple addition to existing disclosure, which should not be unduly burdensome since companies need country-by-country financial data for their own internal accounting purposes. Nonetheless, this form of disclosure would be a powerful tool for increasing transparency because even the most opaque of oil-producing countries, which may impose strict confidentiality requirements on U.S. oil companies, typically waive these requirements for disclosures that are required by regulators in a company's home jurisdiction.

More than any other measure, this would introduce transparency as an international standard to be practiced widely. While EITI covers a small handful of oil-producing countries, a legislative statistical reporting requirement and the other relevant regulation bodies would be comprehensive – able to capture all payments made to all governments by every major oil and gas company listed in the U.S. and other global securities exchanges. Full revenue payment disclosure is already normal guideline practice in the Alternative Investment Market in the U.K., as well as among several oil and mining companies, including Talisman Energy and Newmont Mining.

- **Second, the U.S. should ramp up with a much more significant diplomatic push for EITI.** This should involve three separate components.

First, EITI is coming up to a crucial moment in September. Since the end of last year, there has been a new validation mechanism in place which determines whether or not a country is truly making its revenues more transparent. This system was agreed by governments, civil society and oil companies, so it has consensus support. To qualify as an EITI member, a country has to take four basic steps which show its commitment to the process, including talking to industry and civil society, appointing a government official to steer the process and drawing up a workplan.

This September is the deadline for countries that claim to be in EITI to show that they have completed these four basic steps. A number have not. If EITI does not get rid of the free-riders, those countries who sign up with no real intention of reform, its credibility will collapse. These countries will have to be firmly told that they are not in EITI, and the U.S. should play an especially key role in this. I'm optimistic that together all of us in EITI will make the right decisions.

Second, it is vital that the U.S. more actively support EITI implementation in Kazakhstan. Kazakhstan will soon become a top ten oil producer with geopolitical importance. Yet a number of companies have not signed up or publishing their payments under EITI, particularly TengizChevroil, a Joint Venture between Chevron, ExxonMobil, Kazakhstan's state oil concern. For EITI to prove itself a truly global initiative that improves transparency and reduces corruption, it has to be shown to be working in Kazakhstan. Kazakhstan's current bid for OSCE chairmanship provides just such an opportunity. The U.S. should require commitments and significant progress on EITI from Kazakhstan in exchange for any consideration to chair the OSCE in 2009.

Third, the U.S. should increase financial support to EITI focused on enabling civil society to interpret revenue data and to be protected in the case of civil harassments. This is the other diplomatic push – to work out a mechanism whereby civil society can participate. Journalists and civil society representatives have been threatened, arrested, and beaten across Central Asia for merely being interested in oil revenue issues. But this cannot go on. There is no point in delivering revenue transparency in order to create accountability of governance if civil society doesn't have the space or protection to monitor accountability. The EITI is a key mechanism for getting this civil society protection right, and the U.S. has to be more fully behind it.

Overall, Mr. Chairman, we ignore the close link between oil and corruption at our own peril. Gone is the day when we could simply look the other way when foreign leaders ask for bribes, and it would not come back around to us. Global oil is in shorter supply by the day, Mr. Chairman, so we cannot afford to play games with our energy security. While alternative energy may be the future, transparency is the key to both helping secure our energy for the present and ensure that oil actually benefits the people of energy-rich countries. Thank you.