Private and Confidential

Ministry of Justice of the Republic Of Kazakhstan
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Kazakhstand, 010000

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For the attention of Ms Dr Patricia Nacimiento and Mr Albert Marsman

19 August 2019

Dear Ms Dr Nacimiento and Mr Marsman,

STATIS VS THE REPUBLIC OF KAZAKHSTAN

Background

1. We understand that HSF and De Brauw represent the Republic of Kazakhstan (represented by the Ministry of Justice of the Republic of Kazakhstan) in a series of legal proceedings related to a dispute between Anatolie[1] Stati, Gabriel Stati, Ascom Group S.A. and Terra Raf Trans Traiding Ltd. (referred to as the "**Stati Parties**", together with other companies known to be affiliated to Anatolie and Gabriel Stati); and the Republic of Kazakhstan, under the Energy Charter Treaty (the "**ECT Arbitration**").

[1] Also spelled as "Anatol".

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Use of this memorandum

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2. The dispute relates to the Stati Parties' Kazakhstan-based companies Tolkynneftegaz LLP ("**TNG**") and Kazpolmunay LLP ("**KPM**"). Amongst other things, TNG was involved in construction of a liquefied petroleum gas plant ("**LPG Plant**") in Kazakhstan. We understand that construction of the LPG Plant stalled in 2009, and it was never completed.[2]

3. On 19 December 2013, the Stati Parties obtained an arbitral award issued by a tribunal of the Arbitration Institute of the Stockholm Chamber of Commerce (the "**Tribunal**") of around USD 500 million against the Republic of Kazakhstan (the "**Award**" and the "**Awarded Amount**"). The Tribunal awarded USD 199 million in damages to the Stati Parties in respect of the LPG Plant ("**LPG Quantum**").

4. Since the date of the Award, the Stati Parties have commenced proceedings for enforcement of the Award in a number of jurisdictions (the "**Enforcement proceedings**"), including in the Netherlands (the "**Dutch proceedings**").

5. The Republic of Kazakhstan is contesting the enforcement of the Award claiming that it had been procured by the Stati Parties by fraud. The Republic of Kazakhstan refers to, inter alia, the costs allegedly incurred in relation to the construction of the LPG Plant in Kazakhstan by TNG, which it submits were significantly and fraudulently inflated.

6. In determining the LPG Quantum of USD 199 million, the Tribunal relied on an indicative bid submitted in a controlled auction by a state owned entity KazMunaiGas Exploration Production JSC ("**KMG**" and the "**KMG Indicative Bid**") on 25 September 2008.[3] The KMG Indicative Bid represented a "*preliminary non-binding offer*" "*contingent upon further due diligence*" in respect of the acquisition of 100% of the ordinary shares in KPM and TNG.[4] It determined the bid value attributable to the LPG Plant (USD 199 million) "*as an arithmetical average between the matrix of comparative method value and cost method value. ... Historical costs of US $193 million were used as a base for cost method valuation.*"[5]

[2] See for example Tristan Oil Annual Report for 2009, page 14.

[3] Which it considered to be "*the relatively best source of information for the valuation*", Award, paragraph 1747.

[4] KMG Indicative Bid, page 1.

[5] KMG Indicative Bid, points d and f.

7. The above LPG historical costs of USD 193 million were based on:[6]

- The Information Memorandum dated August 2008 prepared by Renaissance Capital at the instruction of the Stati Parties for the purpose of the sale of KPM and TNG (the "**Information Memorandum**");[7]

- The financial information in the Information Memorandum was, in turn, derived from TNG's interim financial statements as of 30 June 2008.[8]

8. Both the Information Memorandum and TNG's interim financial statements[9] referred to USD 193 million as representing TNG's total capital investment in respect of the LPG Plant as of 30 June 2008.[10] During the ECT Arbitration the Stati Parties submitted that the total construction cost for the LPG Plant amounted to USD 245 million (including costs incurred after 30 June 2008).[11]

9. Following the date of the Award, we understand it has come to your attention, that the Stati Parties implemented a number of questionable related-party transactions at TNG, which resulted, inter alia, in the artificial inflation of the reported capital investments in respect of the LPG Plant.

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[6] The KMG Indicative Bid refers to relying on the "*Information Memorandum and publicly available information*" at page 2. It is not clear from the bid letter whether or not KMG had access to the financial statements of TNG as part of "*publicly available information*", or relied solely on the analysis thereof contained in the Information Memorandum.

[7] The purpose of the Information Memorandum is defined as follows: *"This confidential information memorandum (the "Information Memorandum") is being furnished to a limited number of parties who have expressed an interest in obtaining further information in relation to and submitting proposals to acquire the Assets (as defined in the "Transaction summary" below) and who have signed and returned a confidentiality agreement with Kazpolmunay LLP ("KPM") and Tolkynneftegaz LLP ("TNG," and together with KPM, the "Companies").*

[8] The Information Memorandum refers to the following financial information it was based upon: "*The financial information presented in this Information Memorandum is derived from the unaudited interim combined balance sheets and statements of income, cash flows and changes in shareholders' equity of KPM, TNG and Tristan Oil, as of and for the six months ended 30 June 2007 and 2008, and the audited combined balance sheets and statements of income, cash flows and changes in shareholders' equity of KPM, TNG and, with effect from its incorporation on 24 October 2006 and Tristan Oil, as of 31 December 2005, 2006 and 2007. In addition, financial information presented in this Information Memorandum is derived from the individual interim unaudited balance sheets and statements of income, cash flows and changes in shareholders' equity of KPM, TNG and, Tristan Oil, as of and for the six months ended 30 June 2007 and 2008, and the audited individual balance sheets and statements of income, cash flows and changes in shareholders' equity of KPM, TNG and, with effect from its incorporation on 24 October 2006, Tristan Oil for the years ended 31 December 2005, 2006 and 2007 KPM and TNG are in the process of restating their financials for the years ended 31 December 2005 and 2006 and Tristan Oil, with effect from its incorporation on 24 October 2006, for the year ended 31 December 2006.*"

[9] See analysis of the various financial statements further below.

[10] For example the Information Memorandum, page 10; Company Interim Statements of TNG, Note 15.

[11] Refer to, for example, the Award at paragraph 879.

10. In particular, a large proportion of the LPG costs claimed to have been incurred by the Stati Parties were charged to TNG under Sale and Purchase Agreement No 01/01_TNG_PRK between Perkwood Investment Limited and TNG dated 17 February 2006 (the "**Perkwood SPA**").

11. We understand that in the legal proceedings the Republic of Kazakhstan has put forward that Perkwood (presented by the Stati Parties as an independent third party) was in fact a related-party vehicle, with no employees, conducting no genuine business.[12] We understand that the Republic of Kazakhstan has specifically contended that *"... Perkwood was a creature of the Statis. It was a post-box company with nominee directors, which filed dormant company accounts for the relevant years, yet received substantial sums purportedly in respect of services provided"* and that it *"was used to inflate the actual costs incurred in connection with the construction of the LPG Plant, and to channel substantial sums to other Stati Companies in offshore Jurisdictions."*[13]

12. We understand in the legal proceedings the Republic of Kazakhstan has also put forward that using Perkwood "[t]*he Statis (and the Stati Companies) utilised a number of schemes to inflate fictitiously the true construction costs that had actually been incurred in respect of the LPG Plant*"[14], including via the following arrangements[15]:

- **Management fee under the Perkwood SPA.** Charging of an unexplained "management fee" of USD 44 million by Perkwood to TNG under the Perkwood SPA.

- **Annex 2 to the Perkwood SPA.** 'Resale' to TNG, at a significant and unexplained mark-up, of certain LPG equipment ("**TGE Equipment**") acquired from a third party equipment manufacturer and supplier, Tractebel Gas Engineering GmbH ("**TGE**"), through "*a series of sham transactions*"[16] through Azalia LLC ("**Azalia**") and Perkwood Limited ("**Perkwood**"),

[12] And it is your case that Perkwood's nature as a related party came to light only after the Award was issued, when the Republic of Kazakhstan received evidence in the form of powers of attorney issued to Anatolie Stati on behalf of Perkwood.

[13] Defendant's Points of Claim in the English High Court, paragraph 2(2).

[14] Defendant's Points of Claim in the English High Court, paragraph 10.

[15] We consider these in more detail further below.

[16] Expert opinion on transfer pricing aspects of intercompany transactions between Azalia, Perkwood and TNG, paragraphs 17 and 109.

both entities at all material times controlled by the Stati Parties (the "**Perkwood transaction**");[17]

- **Annex 14 to the Perkwood SPA.** Purported 'sale' of further equipment for the LPG Plant by Perkwood to TNG on the basis of Annex 14 (dated 2 December 2008) to the Perkwood SPA that was not (and/or could not legitimately have been) required for the construction of the LPG Plant, based on your claims. The total value of Annex 14 is approximately USD 31 million.

- Over-recognising capitalised interest in respect of questionable "costs" above.

13. We understand that the Republic of Kazakhstan has further put forward in the legal proceedings that the Tribunal has awarded the LPG Quantum to the Stati Parties based on these artificially inflated costs, whereby the Stati Parties, inter alia:

    - relied on false evidence to claim in the ECT Arbitration that they had invested over USD 245 million in the LPG Plant, when such sums were not in fact invested in the LPG Plant;

    - concealed the relevant information in respect of the inflated LPG construction costs from their auditors, and thereby obtained unqualified audit opinions in respect of misstated financial statements;

    - submitted the misstated financial statements to bidders for the LPG Plant, including KMG, and that KMG relied on the misstated financial statements when making the KMG Indicative Bid in the amount of USD 199 million; and

    - in the ECT Arbitration relied upon the KMG Indicative Bid, and the misstated financial statements, which were used by the Tribunal to award the LPG Quantum.

14. The Republic of Kazakhstan believes that the auditors and the users of the financial statements were misled by the Stati Parties materially misrepresenting the information in the financial statements since Perkwood and transactions with Perkwood were not appropriately disclosed and/or recorded in the audited financial statements of TNG. As a result, inter alia, the Tribunal in the ECT Arbitration had relied on financial statements which were materially misstated and/or not prepared in accordance

[17] With respect to control: Perkwood: Claimants' Points of Defence in the English High Court, paragraph 11 – with reference to the Defendant's Points of Claim, paragraph 9. Azalia: Claimants' Points of Defence in the English High Court, paragraph 16.1.

with International Financial Reporting Standards (“**IFRS**”) and/or on documents that were based on these misstated financial statements.

Scope and purpose

15. You have asked us to analyse the audited financial statements of TNG for the years ending 31 December 2006, 2007, 2008 and 2009 (the “**Period**”) and its interim unaudited financial statements as of 30 June 2008, and other relevant supporting documents (as set out in Annex 1) and consider whether the transactions with Perkwood were recorded and disclosed in these financial statements in accordance with applicable financial reporting standards. You have also asked us to consider the implications of any identified breaches of the relevant financial reporting standards on the reliability of the above financial statements, and consider who may have relied on the financial statements and the impact thereof.

16. We note that our work does not constitute an audit. To the extent that we provide comments on the application of international accounting standards, these should be considered in the context of the specific circumstances of this case, and in light of the documents and information provided to us (which we have not independently verified). We have not been instructed to quantify the precise amount of the various misstatements referred to in this memorandum. As a result, we have not reviewed primary accounting records of TNG or any other Stati Parties. The documents provided to us, and relied upon are listed in Annex 1.

17. Our analysis is set out under the following headings:

    - Relevant financial statements;
    - Relevant financial reporting standards: IFRS;
    - Recording and disclosure of the Perkwood transactions in TNG’s financial statements;
    - Breach of IAS 24 “Related Party Disclosures”;
    - Breach of IAS 16 “Property, Plant and Equipment”;
    - Materiality of misstatements (IAS 1 “Presentation of Financial Statements”), and users affected;

- False representation provided to the auditors;
- Conclusion as to the overall reliability of the audited Company Statements and Combined Statements.

Relevant financial statements

18. During the Period, TNG produced both individual stand-alone financial statements (the "**Company Statements**"), as well as combined financial statements together with KPM and Tristan Oil Ltd[18] ("**Tristan**") (together with TNG referred to as the **"Companies**", the combined financial statements being referred to as the "**Combined Statements**"). TNG also produced stand-alone interim financial statements ("**Company Interim Statements**") and combined interim financial statements together with KPM and Tristan ("**Combined Interim Statements**"). Both sets of statements contain materially the same information on the costs incurred in relation to the LPG Plant, and so unless otherwise specified, references to the information in TNG's financial statements are to both Company and Combined Statements prepared during the Period.

19. The Combined Statements and Company Statements for 2006 were audited by Deloitte Audit SRL (Romania) ("**Deloitte**"), and for 2007, 2008 and 2009 by KPMG Audit LLC (Kazakhstan) ("**KPMG**"), and:

- Deloitte gave qualified audit opinions on TNG's Company Statements and the Combined Statements for 2006 (due to the inability to verify opening inventory balances);
- KPMG gave unqualified audit opinions on the Combined Statements and the Company Statements for 2007 and 2008; and
- KPMG disclaimed its audit opinion for 2009 for both the Combined Statements and the Company Statements on the basis of uncertainty surrounding the ability of TNG to continue as a going concern.

20. The Company Interim Statements and Combined Interim Statements as of 30 June 2008 were reviewed, but not audited, by KPMG, and the auditor did not raise any issues with the fair presentation of the financial statements.

[18] Which we understand to be a BVI-based company used as a financing vehicle by the Stati Parties.

Relevant financial reporting standards: IFRS

21. The audited Company Statements and Combined Statements as of 31 December 2006, 2007, 2008 and 2009, and the Company Interim Statements and Combined Interim Statements as of 30 June 2008 are all stated to be prepared in accordance with IFRS.

22. We note that for the years 2007, 2008 and 2009, Kazakhstan-based companies employing over 250 employees and/or having a turnover of over 325,000 times the token value set by Republican Budget Law as of 1 January of the relevant year, were required by Kazakhstan law "On Accounting and Financial Reporting" to prepare financial statements in accordance with IFRS.[19]

23. TNG's turnover in 2007, 2008 and 2009 significantly exceeded 325,000 times the token value set by the Republican Budget Law for those years, and as such TNG would have met the above requirement to produce financial statements in accordance with IFRS.[20]

24. On this basis, we consider IFRS to be the relevant basis for our analysis. In our analysis, we have considered the version(s) of the relevant accounting standards that were valid at the time of the preparation and audit of the relevant financial statements.

Recording and disclosure of the transactions with Perkwood in TNG's financial statements

25. Construction costs incurred in relation to the LPG Plant were capitalised and reported within the "Property, Plant and Equipment" ("**PPE**") asset class on TNG's balance sheet in the years to 31 December 2006 (when construction started), 2007, 2008 and 2009 (when the construction is said to have been discontinued).[21]

26. TNG's financial statements record the following total capitalised cost (recognised as a PPE asset) in respect of the construction of the LPG Plant:

[19] Kazakhstan law No 234-III dated 28 February 2007 "On Accounting and Financial Reporting", Clause 2: "*Large corporates and public interest entities are required by law to prepare their financial statements under international standards*". The same law defines international standards as IFRS at Clause 16. Large corporates are defined in Kazakhstan Law No 124-III dated 31 January 2006 "On private enterprises".

[20] See Table 3 at Annex 2.

[21] See Annex 2, Table 1 for detail.

- USD 193 million as of 30 June 2008 (being the date of the interim accounts relied upon by KMG);[22]

- USD 248 million as of 31 December 2009 (being the latest date for which TNG's financial statements are available to us).[23]

27. TNG thus recorded significant capital costs in relation to the construction of the LPG Plant in the Period (which are material compared to TNG's total PPE, and to its total assets).[24] TNG's financial statements do not provide a breakdown of the capitalised amount of the construction costs of the LPG Plant, nor disclose how much of the capitalised costs relate to transactions with Perkwood, nor disclose Perkwood as one of the related parties of TNG. However, a breakdown is provided:

    - as of 30 June 2008 in the Vendor Due Diligence Report prepared by KPMG at the instruction of Tristan dated 29 August 2008[25] (the "**VDD Report**"); and

    - as of 31 December 2009 in an expert report by Charles River Associates dated 11 October 2013[26] (the "**CRA Report**").

28. Both the VDD Report, and the CRA Report, identify that a significant proportion of TNG's capitalised LPG costs as of both dates result from transactions with Perkwood. The capitalised costs according to these two reports also include, amongst other things, significant capitalised interest in respect of the construction costs.

Breach of IAS 24 "Related Party Disclosures"

29. Disclosure of transactions with related parties is required under IFRS in accordance with IAS 24 "Related Party Disclosures".[27] The objective of IAS 24 "*is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial*

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[22] TNG's Company Interim Statements as of 30 June 2008, Note 16.

[23] TNG's Company Statements as of 31 December 2009, Note 16.

[24] See Table 1 in Annex 2.

[25] KPMG's instructions are provided at Appendix 1 of the VDD Report.

[26] Prepared at the instruction of the Stati Parties (Ascom) in a different arbitration not involving the Republic of Kazakhstan as a party and not submitted in the ECT Arbitration. Expert instructions are set out in paragraph 1.1.1*: "I have been instructed by King & Spalding International LLP ("King & Spalding"), on behalf of its client, Ascom Grup S.A. ("Ascom" or "the Claimant"), to provide forensic accounting assistance in connection with arbitration proceedings brought by Ascom against Vitol FSU B.V."*

[27] Analysis below is in respect of the version of IAS 24 that was relevant during the Period, a version issued in 2004.

position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties".[28]

30. IAS 24 defines a related party as follows: *"A party is related to an entity if: (a) directly, or indirectly through one or more intermediaries, the party: (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries) …"*[29] IAS 24 clarifies that transactions need to be considered by their substance rather than their legal form.[30]

31. Perkwood and TNG meet the above definition of "related parties" under IAS 24:

- We understand that the Stati Parties admitted in writing (some years after the Award was issued) that "[a]*t all material times, Perkwood was under the ultimate ownership and/or control of the Statis*". [31]

- The Combined Statements confirm that TNG, KPM and Tristan were at all relevant times during the Period under the control of Anatolie Stati.[32]

32. Transactions between TNG and Perkwood in respect of the LPG Plant therefore meet the definition of a "related party transaction" under IAS 24:

- IAS 24 defines a related party transaction as "a *transfer of resources, services or obligations between related parties, regardless of whether a price is charged"*.[33]

- As set out above, TNG incurred significant capital costs in relation to the construction of the LPG Plant in the Period in respect of transactions between TNG and Perkwood.

33. IAS 24 requires that where there has been a relationship between related parties during the period in question, *"an entity shall disclose the nature of the related party relationship as well as information*

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[28] IAS 24 "Related Party Disclosures" (2004), paragraph 1.

[29] IAS 24 (2004), paragraph 9.

[30] IAS 24 (2004), paragraph 10.

[31] Claimants' Points of Defence before the English High Court of Justice dated 26.09.2017, paragraph 11 – with reference to the Defendant's Points of Claim before the English High Court of Justice dated 01.08.2017, paragraph 9.

[32] Audited Combined Financial Statements for the years ended December 31 2007, 2008 and 2009, Note 2(b).

[33] IAS 24 (2004), paragraph 9.

about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements."[34]

34. Neither the Combined Statements, nor the Company Statements for the Period, nor the Company Interim Statements or Combined Interim Statements as of 30 June 2008, disclose Perkwood as a related party to TNG:

- Perkwood is not mentioned in TNG's financial statements as of 31 December 2006, 2007 and 2008 (Company Statements or Combined Statements), nor in its interim financial statements as of 30 June 2008 (Company Interim Statements or Combined Interim Statements) – neither in the "Related Party transactions" section of these financial statements,[35] nor elsewhere in the financial statements.

- Perkwood is mentioned in TNG's financial statements for 2009 as a party involved with the LPG project, but the related-party nature of the transactions with Perkwood and the impact on the financial statements, is not disclosed.[36]

35. As such, TNG's audited Combined Statements and Company Statements as of 31 December 2006, 2007, 2008 and 2009, and TNG's Combined Interim Statements and Company Interim Statements as of 30 June 2008 <u>do not meet the requirements of IAS 24</u> in all years where transactions between TNG and Perkwood took place, and outstanding balances to/from Perkwood existed.

36. Our conclusion is confirmed by the information in the representation letters that we have been provided with[37] and the deposition testimony of Artur Lungu ("**Mr Lungu**"), the former Chief Financial Officer of Tristan and Vice President at Ascom Group S.A.,[38] who, when asked about the

[34] IAS 24 (2004), paragraph 17.

[35] Each of the financial statements considered contains a separate section for "Related Party transactions" disclosure, which does not include Perkwood.

[36] Combined Statements, Note 34 (c) and TNG Company Statements, Note 31 (c) "Events subsequent to the reporting date" disclose that "[i]*n the view of the expected sale of the Companies, owners of the Companies decided to stop construction of the LPG plant and agreed with Perkwood Investments Ltd. to cancel the delivery of the necessary equipment and to return the advance paid in the amount of USD 36,800,212.*"

In the TNG Company Statements, Note 27 "Financial Instruments" discloses that "*due to financial difficulties experienced by the Company the repayment of the interest was extended until demanded without any penalties. Subsequent to the balance sheet date the interest was repaid by means of offset of…advances paid to Perkwood Investments Ltd.*"

[37] See list in Annex 1.

[38] Mr Lungu described his position as Vice President at Ascom Group S.A. and Chief Financial Officer at Tristan (Deposition transcript of Mr Artur Lungu dated 03.04.2019, page 39, lines 20–21) from 2004 – February 2014 (Deposition transcript of Mr Artur Lungu dated 03.04.2019 page 41, line 17).

relationship between TNG and Perkwood in the context of IAS 24, confirmed that "*all of the transactions between TNG and Perkwood should have therefore been disclosed as related party transactions*".[39]

Breach of IAS 16 "Property Plant and Equipment"

37. IAS 16 "Property Plant and Equipment"[40] contains the following recognition criteria for items of PPE (such as the LPG Plant) ("**IAS 16 Qualifying Costs**"):

"An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost."[41]

"*The cost of an item of property, plant and equipment comprises:*

a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Examples of directly attributable costs are:

a) costs of employee benefits (as defined in IAS 19 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

b) costs of site preparation;

c) initial delivery and handling costs;

d) installation and assembly costs;

e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

f) professional fees."[42]

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[39] Deposition transcript of Mr Artur Lungu dated 03.04.2019, page 133, lines 17-25.

[40] IAS 16 (2003).

[41] IAS 16 (2003), paragraph 15

[42] IAS 16 (2003), paragraph 16-17

"If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is recognised in the carrying amount of the item in accordance with the allowed alternative treatment in IAS 23."[43]

38. As set out above, based on the financial statements and breakdowns provided in the VDD Report and the CRA Report, TNG capitalised material costs in respect of 'transactions' with Perkwood. In addition, significant borrowing costs (i.e., interest) were capitalised in relation to the LPG costs.

39. We understand that the Republic of Kazakhstan has put forward in the legal proceedings that the various transactions with Perkwood were fraudulent, the costs charged by Perkwood to TNG did not represent genuine costs relating to the LPG Plant, and Perkwood was a related-party vehicle used solely *"to inflate fictitiously the true construction costs that had actually been incurred in respect of the LPG Plant"*.[44]

40. You have provided us with a number of documents supporting your position, including in respect of the following unsubstantiated and questionable charges by Perkwood to TNG:

41. **The unexplained "management fee"**. Part of the capitalised costs relate to the charging by Perkwood to TNG of a management fee in the amount of approximately USD 44 million.[45] We understand that Republic of Kazakhstan has put forward in the legal proceedings that the Stati Parties have provided no contractual documents or other documentation to explain or substantiate this fee, and that:

- Perkwood was a company that was not operational, with no personnel or knowledge in relation to the oil and gas industry, and that filed dormant company accounts[46], during the period that the LPG Plant was under construction.

- The CRA Report explains that USD 44 million of the capitalized Perkwood costs in relation to construction of the LPG Plant related to a "*project management fee*" charged by Perkwood. The CRA Report states that this amount does not represent the "*original cost of the services and*

[43] IAS 16 (2003), paragraph 23
[44] Defendant's Points of Claim in the English High Court, paragraph 10.
[45] As set out in, for example, the CRA Report.
[46] Defendant's Points of Claim in the English High Court, paragraph 2(2).

equipment" and "*must be deducted from TNG's total capital expenses reflected in its financial systems and statements*".[47]

- An expert report prepared by TGE dated 17 January 2017 (the "**TGE Report**")[48] notes that the Perkwood SPA does not provide for any project management fees.[49]

- In proceedings between the Stati Parties and Vitol, the English High Court ruled that "*it appears therefore that this "fee" was simply paid at will.*"[50]

42. **TGE Equipment mark-up (Annex 2 to the Perkwood SPA)**. Part of the capitalised costs relate to the arrangement whereby the TGE Equipment was 'resold' through a series of undisclosed related-party transactions resulting in an unexplained mark-up of approximately USD 58 million, as follows:

- Annex 2 of the Perkwood SPA relates to an alleged delivery by Perkwood to TNG of the *"[p]arts of the technological machine complex 'Liquefied petroleum gas unit'"*, for a total price of USD 93.1 million.[51]

- We understand that the Stati Parties admitted that the equipment specified in Annex 2 of the Perkwood SPA (at a price of USD 93.1 million) is the TGE Equipment, i.e., the same equipment that was agreed to be delivered by TGE, the third-party manufacturer, for EUR 29.0 million based on the "**TGE Contract**".[52]

- We have been provided with the explanations provided by the Stati Parties in respect of the nature and substance of the above mark-up, and these appear different:

    - The Stati Parties' Points of Defence in the English High Court state that the difference related to: delivery costs, loading, unloading, transportation, storage, insurance, and the difference in USD and EUR prices.[53]

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[47] CRA Report, paragraph 61.
[48] Instructed by the Republic of Kazakhstan, submitted in the English High Court.
[49] TGE Expert Report on the LPG Plant construction on the Borankol field dated 12.01.2017, paragraph 103.
[50] Vitol FSU B.V. vs Ascom Grup SA [2014] EWHC Commercial Division, [2014] 506, par. 39.
[51] Perkwood SPA, Annex 2.
[52] Claimants' Points of Defence before the English High Court of Justice dated 26.09.2017, paragraph 16, with reference to the Defendant's Points of Claim before the English High Court of Justice dated 01.08.2017, paragraph 11.
[53] Claimants' Points of Defence before the English High Court of Justice dated 26.09.2017, paragraphs 16.2.3 – 16.2.5.

- The Stati Parties' submission in the Dutch proceedings stated on 22 June 2018 that the mark-up of USD 58 million could be explained by transport costs and *"costs for storage and insurance*".[54]

- The Stati Parties' later submission in the Dutch proceedings dated 16 April 2019 explained the mark-up as "*the budgeted costs for freight, insurances and services, calculated by companies related to Stati et al. that had staff on their books; the EUR/USD currency conversion of the prices for the TGE components; and the mark-up on the "management fee*"".[55]

- We understand that the Stati Parties agree that "*costs of freight, storage and insurance*...[of] *USD 4.9 million* [were] *paid by TNG for <u>all components</u> which had been, or were being, installed as of December 2009.*"[56]

- The TGE Report concluded that "[t]*he difference in purchase price of 58 million USD is considerable and impossible to explain*".[57]

43. **Amounts in respect of "additional equipment" (Annex 14 to the Perkwood SPA)**. A further unexplained mark-up appears to be factored in in Annex 14 (dated 2 December 2008) to the Perkwood SPA. Annex 14 of the Perkwood SPA is in respect of the purchase of certain equipment, and:

- Republic of Kazakhstan has put forward in the legal proceedings that equipment 'sold' by Perkwood to TNG pursuant to Annex 14 to the Perkwood SPA was not (and/or could not legitimately have been) required for the construction of the LPG Plant and this remains unexplained by the Stati Parties.[58] The total value of Annex 14 is approximately USD 31 million.

- The TGE Report concludes that "[t]*he above mentioned equipment* [some of the equipment listed in Annex 14] *is already covered by Annex 2 of the Perkwood Agreement. From a technical point of view, it does not make sense to purchase this equipment as redundant spare parts. Also, in*

[54] The Stati Parties pleading notes to the Amsterdam Court of Appeal Civil hearing, dated 22.06.2018, paragraph 88.
[55] The Stati Parties' motion after interim judgement dated 16.04.2019 in the Dutch proceedings, paragraph 28 and 455.
[56] The Stati Parties' motion after interim judgement dated 16.04.2019 in the Dutch proceedings, paragraph 438.
[57] TGE Expert Report on the LPG Plant construction on the Borankol field dated 12.01.2017, paragraphs 60 and 105.

[58] We understand that the Stati Parties argue (see the Stati Parties' pleading notes dated 22.06.2018 in the Dutch proceedings, paragraph 90) that the advance payment made by TNG to Perkwood in respect of Annex 14 to the Perkwood SPA were part of an alleged set-off arrangement that was executed in February 2010 and therefore after the reporting date of 31 December 2009.

comparison to the overall price TGE charged for entire equipment, the purchase price of items 1-3 of Annex 14 of the Perkwood Agreement (21 million USD) is excessively high for being spare parts."[59]

44. A core principle of IFRS is that transactions need to be reported by their substance, and not just by their legal form. This is explained in, for example, the Conceptual Framework for Financial Reporting:

"*In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon*"[60]

45. Assuming that the transactions with Perkwood were capitalised by TNG, including all the various markups (as suggested for example, by the analysis in the CRA Report which concludes that the management fees of USD 44 million was capitalised by TNG in respect of Perkwood) we conclude the following.

46. Based on the information above, the substance and nature of a significant proportion of the costs capitalised by TNG in relation to the Perkwood transactions remains in our view unexplained (and where explanations are provided, these differ and are unsubstantiated). In the absence of explanations and substantiations these various mark-ups (the unexplained management fee, TGE equipment mark-up and "additional equipment" per Annex 14 of the Perkwood SPA) would not qualify as IAS 16 Qualifying Costs (i.e. would not represent a *"purchase price"* or *"costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating"*[61]) and should not have been capitalised as part of the LPG Plant construction costs on TNG's balance sheet. In addition borrowing costs in respect of these inflated costs should not have been capitalised.

47. Accordingly, TNG's audited Combined Statements and Company Statements as of 31 December 2006, 2007, 2008 and 2009, and TNG's Combined Interim Statements and Company Interim Statements as of 30 June 2008 <u>would not meet the requirements of IAS 16</u> by including unexplained material "mark-ups" that do not represent IAS 16 Qualifying Costs (and capitalised interest thereon).

Materiality of misstatements (IAS 1 "Presentation of Financial Statements"), and users affected

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[59] TGE Report, paragraph 107.

[60] Conceptual Framework for Financial Reporting 2018, paragraph 2.12.

[61] IAS 16 (2003), paragraph 15.

48. According to IAS 1 "Presentation of Financial Statements":

"Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor".[62]

49. We have been provided with, inter alia, the following documents relying on (or explicitly referring to) the construction costs of the LPG Plant reported in TNG's financial statements:

- The Information Memorandum;
- The VDD Report;
- KMG Indicative Bid;
- The Award (to the extent it relied on the KMG offer in turn relying on the Information Memorandum and the financial statements).

50. In relying on TNG's financial statements, both the preparers, and the users of the above documents:

- were not informed that Perkwood was a related party of TNG. IAS 24 does not have a materiality threshold, and this misrepresentation is material to the financial statements.
- were not informed of the nature and substance of the various mark-ups charged by Perkwood to TNG as set out above, which you claim are fraudulent and unexplained and do not relate to the actual costs of the LPG Plant.

51. On this basis, the financial statements are materially misstated and contrary to the audit opinions, the financial statements have not therefore "*presented fairly, in all material respects, the financial position … and … financial performance*"[63] of the company. The users seeking to rely on these financial statements would be relying on information that is materially misstated.

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[62] IAS 1(2003), paragraph 11.

[63] Audit opinion by Deloitte dated 27 March 2007, and Audit opinion by KPMG dated 31 March 2009.

False representations provided to the auditors

52. Based on the information contained in the representation letters that we have been provided with[64] and on the deposition testimony of Mr Lungu, TNG's auditors were provided with false representations as to Perkwood's status as an unrelated party., According to Mr Lungu, due to these false representations *"KPMG doesn't include Perkwood's contracts in the list of transactions with…other related parties"*[65] in the financial statements.

53. For example, in the management representation letter addressed to KPMG in respect of TNG's Combined Interim Statements and Company Interim Statements as of 30 June 2008 (which did not disclose Perkwood as a related party), management confirmed that "*Appendix 2 to this letter is a complete list of the Company's direct and indirect subsidiaries and associates, and other related parties* [per IAS 24]", and "*[w]e confirm the completeness of the information provided to you regarding the identification of related parties and regarding transactions with such parties that are material to the financial statements*".[66] Appendix 2 to the letter does not include Perkwood as a related party. The same or very similar wording is included in other management representation letters provided to us in respect of TNG's Company Statements or Combined Statements.[67]

54. Mr Lungu confirmed in his deposition that in providing such management representations to the auditors, "*the failure to disclose Perkwood as a related party renders…the confirmations…to be materially false*".[68]

Conclusion as to the overall reliability of the audited Company Statements and Combined Statements

55. Based on the documents and information provided to us, TNG's audited Combined Statements and Company Statements as of 31 December 2006, 2007, 2008 and 2009, and TNG's Combined Interim Statements and Company Interim Statements as of 30 June 2008, inter alia:

- Do not meet the requirements of IAS 24 "Related Party Disclosures". The financial statements are materially misstated on this basis.

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[64] See list in Annex 1.

[65] Lungu deposition transcript, page 157, lines 14-18.

[66] Management representation letter in respect of TNG's interim financial statements as of 30 June 2008.

[67] Refer to Annex 1.

[68] Lungu deposition transcript, page 200, lines 16-25, page 201, lines 1-4.

- Would not meet the requirements of IAS 16 “Property, Plant and Equipment” if the various mark-ups remained unexplained and unsubstantiated, and therefore, did not represent by substance (rather than legal form), costs related to the LPG construction. This means that the requirements of IAS 16 “Property, Plant and Equipment” would also be breached. Based on the value of the various mark-ups (as set out above), the misstatement is material in respect of each such mark-up.

56. Based on the information contained in the management representation letters and on Mr Lungu’s deposition, false representations were given to the auditors at the time of the audit(s) during the Period[69] in respect of the related-party nature of Perkwood. Such false representations, especially to the extent these were intentional, seriously compromise the integrity of TNG’s management (and management of the Companies in respect of the Combined Statements) and the extent to which an auditor would be prepared to rely on representations by TNG’s management.

57. Taking into account the matters above and based on the documents and information provided, each of the material misstatements and the serious impairment of the integrity of TNG’s management would render TNG’s audited Combined Statements and Company Statements,[70] unreliable.

Yours faithfully

Anastasia Malyugina
Director, PricewaterhouseCoopers LLP

Timothy J Allen
Partner, PricewaterhouseCoopers LLP

The Curriculum Vitae of Timothy J Allen is provided in Annex 3.
The Curriculum Vitae of Anastasia Malyugina is provided in Annex 4.

[69] Based on the list of Management Representation letters provided to us, set out in Annex 1.
[70] Which are prepared by management.

Annex 1. List of documents provided

TNG's financial information

- TNG's audited Company Statements and audited Combined Statements for the years ending 31 December 2006, 2007, 2008 and 2009 prepared under IFRS together with the respective Independent Auditors' Reports by Deloitte (2006) and KPMG (2007, 2008 and 2009).
- TNG's Company Interim Statements and Combined Interim Statement for six months ending 30 June 2008, together with a review by KPMG Audit LLC dated 25 August 2009.

Management Representation Letters

- Management representation letter in respect of TNG's Company Statements as at 31 December 2007.
- Management representation letter in respect of TNG's Company Statements as at 30 June 2008, dated 05 August 2008.
- Management representation letters in respect of TNG's Company Statements as at 30 June 2009, dated 25 August 2009.
- Management representation letter in respect of TNG's Company Statements as at 31 December 2009, dated 25 May 2010.
- Management representation letters in respect of the Combined Statements as at 31 December 2007, dated 07 April 2008.
- Management representation letter in respect of the Combined Statements as at 30 June 2008, dated 15 August 2008.
- Management representation letters in respect of the Combined Statements as at 30 September 2008, dated 11 November 2008.
- Management representation letter in respect of the Combined Statements as at 31 March 2009, dated 10 June 2009.
- Management representation letter in respect of the Combined Statements as at 30 September 2009, dated 17 November 2009 to clarify the going concerns prospects of the company.

- Management representation letter in respect of the Combined Statements as at 30 September 2009, dated 14 December 2009.

Legal submissions, witness statements and records of deposition

- SCC Arbitration V (116/2010) Award dated 19 December 2013.
- Fifth Witness Statement of Patricia Nacimiento, dated 13 January 2017, on behalf of the defendant, The Republic of Kazakhstan in the Arbitration proceedings CL-2014-000070.
- Claimant's Points of Defence, dated 26 September 2017, in the Arbitration proceedings CL-2014-000070.
- Defendant's Points of Claim dated 1 August 2017, in the English High Court of Justice CL-2014-000070.
- Claimants' Dramatis Personae, in the ECT Arbitration proceedings CL-2014-000070.
- Submission after Interim Judgement, dated 16 April 2019, to the Amsterdam Appeal Court in the proceedings 200.224.067/1.
- Affidavit of Matthew Kirkland dated 9 May 2019 in relation to the Deposition of Mr. Artur Lungu on 3 April 2019.
- Witness Statement of Artur Victor Lungu dated 11 October 2013 in the matter of *Ascom Grup S.A. v Vitol FSU B.V.*
- Transcript of the Oral Videotaped Deposition of Artur Lungu, dated 3 April 2019.
- Reasons for Judgement, dated 29 August 2014 in the matter of *Ascom Grup S.A. v Vitol FSU B.V.*
- Pleading notes for the Amsterdam Court of Appeal Civil hearing, dated 22 June 2018.

Perkwood

- Sale and Purchase Agreement No. 01/01_TNG_PRK, dated 17 February 2006 including Annex 1 – 16 and Additional Agreements 1- 11.
- Certificate of Incorporation under the Companies Act 1985 for Perkwood Investment Limited, dated 14 September 2005.

- Powers of Attorney issued to Mr Gabriel Stati and Mr Anatolie Stati by Perkwood Investment Limited for one year from the issue date, dated 02 November 2005.
- Powers of Attorney issued to Mr Gabriel Stati and Mr Anatolie Stati by Perkwood Investment Limited for one year from the issue date, dated 14 September 2006.
- Powers of Attorney issued to Mr Gabriel Stati and Mr Anatolie Stati by Perkwood Investment Limited expiring 14 September 2008, dated 22 August 2007.
- Powers of Attorney issued to Mr Gabriel Stati and Mr Anatolie Stati by Perkwood Investment Limited expiring 14 September 2009, dated 26 August 2008.
- Powers of Attorney issued to Mr Anatolie Stati by Perkwood Investment Limited expiring 14 September 2010, dated 20 August 2009.
- TGE Contract NO.1960/06 between Azalia Ltd, Ascom Grup S.A. and TGE, dated 31 January 2006.

Expert reports, memorandums, letters

- KPMG Kazakhstan Tax & Advisory LLC Draft Vendor Due Diligence Report, dated 29 August 2008.
- Expert Report of Charles River Associates in the matter of Ascom Grup S.A. v Vitol FSU B.V., dated 11 October 2013.
- Expert Report of Dipl. Ing. Ernst Kallweit of TGE, on behalf of the Defendant, The Republic of Kazakhstan in the Arbitration proceedings CL-2014-000070, dated 12 January 2017.
- Deloitte Expert Report, dated 12 January 2017.
- Expert Opinion with respect to transfer pricing aspects of the legal proceedings in connection with the arbitration by Deloitte GmbH, dated 19 June 2018.
- Expert Opinion of Steef Huibregtse by TPA Global, dated 6 February 2019.
- Confidential Information Memorandum prepared by Renaissance Capital, dated August 2008.
- Letter from KMG forming the Indicative Bid, dated 25 September 2008.

Accounting standards

- Conceptual Framework for Financial Reporting 2018
- IAS 1 (Revised 2005) Presentation of Financial Statements.
- IAS 16 (2004) Property, Plant and Equipment.
- IAS 24 (2004) Related Party Disclosures.

Laws of the Republic of Kazakhstan

- The Law of the Republic of Kazakhstan dated February 28, 2007 N 234 “On accounting and financial reporting”.
- The Law of the Republic of Kazakhstan dated November 22, 2005 No. 88-III “On the Republican Budget for 2006”.
- The Law of the Republic of Kazakhstan dated December 8, 2006 No. 194-III “On the Republican Budget for 2007”.
- The Law of the Republic of Kazakhstan dated December 6, 2007 No. 8-IV “On the Republican Budget for 2008”.
- The Law of the Republic of Kazakhstan dated December 4, 2008 No. 96-IV ЗРК "On the Republican Budget for 2009-2011".
- The Law of the Republic of Kazakhstan dated January 31, 2006 No. 124-III “On Private Enterprise”.

Exchange Rates

- Official rates of the National Bank of the Republic of Kazakhstan at December 31, 2006.
- Official rates of the National Bank of the Republic of Kazakhstan at December 31, 2007.
- Official rates of the National Bank of the Republic of Kazakhstan at December 31, 2008.
- Official rates of the National Bank of the Republic of Kazakhstan at December 31, 2009.

Annex 2. Supporting tables

Table 1: Disclosure of the LPG asset class in the financial statements

Year	Combined Statements Additions (US$)	Combined Statements Balance (US$)	TNG Company Statements Additions (US$)	TNG Company Statements Balance (US$)
2006[71]	7,383,819		7,383,819	
2007	135,146,220	142,530,039	135,146,220	142,530,039
2008	80,635,646	223,165,685	80,635,646	223,165,685
2009[72]	21,327,427	244,493,112	24,918,428	248,084,113
Total	**244,493,112**		**248,084,113**	

Source: Audited Combined Financial Statements for the years ended December 31 2007, 2008 and 2009, Note 18 and Tolkynneftegaz LLP Audited Financial Statements for the years ended December 2007, 2008 and 2009, Note 16.

Table 2: LPG as a proportion of PPE and total assets in 2009

	Combined Statements		**TNG Company Statements**	
	USD	***LPG as % of***	***USD***	***LPG as % of***
LPG "under construction" (at historic cost)	244,493,112		248,084,113	
Total PPE	619,413,051	**39%**	518,922,084	**48%**
Total Assets	1,031,267,429	**24%**	674,954,746	**37%**

Source: Audited Combined Financial Statements for the year ended December 31 2009 and Tolkynneftegaz Audited Financial Statements for the year ended December 31 2009.

[71] This amount is included as a comparable in the 2007 TNG Company Statements and Combined Statements. We note that the 2006 statements do not present this amount as an addition in the PPE Note to the 2006 Combined Statements or TNG Company Statements. The 2006 Combined Statements and TNG Company Statements include advance payments of USD 79,119,153 for the construction of a liquid petroleum gas plant.

[72] We note that the Company Statements and Combined Statements disclose different amounts in 2009 in relation to the LPG asset class. The accounts do not contain an explanation for this difference.

Table 3. Criteria for the legal requirement of the application of IFRS in Kazakhstan

	2006	2007	2008	2009
Total Assets (USD)	577,404,179	601,997,876	728,469,041	674,954,746
National Bank of the Republic of Kazakhstan, exchange rate (USD:KZT)[73]	127.00	120.30	120.77	148.36
Total Assets (KZT)	**73,330,330,733**	**72,420,344,483**	**87,977,206,082**	**100,136,286,117**
Monthly calculation index (KZT)	1030[74]	1092[75]	1168[76]	1273[77]
Criteria (Monthly calculation index times 325 000) (KZT) [78]	**334,750,000**	**354,900,000**	**379,600,000**	**413,725,000**

Source: Tolkynneftegaz Audited Financial Statements for the years ended December 31 2006, 2007, 2008 and 2009; Official rates of the National Bank of the Republic of Kazakhstan; The Law of the Republic of Kazakhstan.

[73] Official rates of the National Bank of the Republic of Kazakhstan.

[74] The Law of the Republic of Kazakhstan dated November 22, 2005 No. 88-III “On the Republican Budget for 2006”.

[75] The Law of the Republic of Kazakhstan dated December 8, 2006 No. 194-III “On the Republican Budget for 2007”.

[76] The Law of the Republic of Kazakhstan dated December 6, 2007 No. 8-IV “On the Republican Budget for 2008”.

[77] The Law of the Republic of Kazakhstan dated December 4, 2008 No. 96-IV ЗРК "On the republican budget for 2009-2011".

[78] The Law of the Republic of Kazakhstan dated January 31, 2006 No. 124-III “On Private Enterprise”, Chapter 2, Article 6, Paragraph 8.