



## **Private and Confidential**

Ministry of Justice of the Republic of Kazakhstan  
Mangilik El avenue, 13 Entrance, House of Ministries, Nur-Sultan,  
Kazakhstan, 010000

Herbert Smith Freehills LLP  
Neue Mainzer Straße 75  
60311 Frankfurt am Main  
Germany

For the attention of Dr Patricia Nacimiento

**21 January 2020**

Dear Dr Nacimiento

## **STATIS Vs THE REPUBLIC OF KAZAKHSTAN<sup>1</sup>**

### **Introduction and overview**

1. We understand that Herbert Smith Freehills LLP (“**HSF**” or “**you**”) represents 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 Stati (“**Mr Stati**”), Gabriel Stati, Ascom Group S.A. and Terra Raf Trans Trading 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**”). The dispute relates to the Stati Parties' alleged investment in Kazakhstan through Kazakhstan-based companies Tolkynneftegaz LLP (“**TNG**”) and Kazpolmunay LLP (“**KPM**”). Amongst other things, TNG was involved in the construction of a liquefied petroleum gas plant (“**LPG Plant**”) in Kazakhstan.

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<sup>1</sup> This letter has been prepared in accordance with the Letter of Engagement between PricewaterhouseCoopers LLP (“**PwC**”) and HSF dated 2 August 2019 and the Variation Letter dated 9 January 2020. This letter has been prepared only for HSF acting on behalf of the Ministry of Justice of the Republic of Kazakhstan and solely for the purpose and on the terms agreed in the Letter of Engagement. Neither Tim Allen nor PwC accepts any liability (including for negligence) to anyone else in connection with this letter, and it may not be provided to anyone else except as stated in the engagement letter.

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*PricewaterhouseCoopers LLP, 7 More London Riverside, London, SE1 2RT  
T: +44 (0) 2075 835 000, F: +44 (0) 2072 127 500, [www.pwc.co.uk](http://www.pwc.co.uk)*



2. We understand that 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**”). We understand that the Awarded Amount was based, in respect of the value of the LPG Plant, on an indicative bid which had been submitted for that plant. This indicative bid was based on a combination of TNG’s historical costs allegedly spent on the LPG Plant and TNG’s reported levels of earnings (referred to as “**EBITDA**”<sup>2</sup>), as shown by the TNG interim financial statements for the six months to 30 June 2008.
3. After the date of the Award, the Republic of Kazakhstan initiated annulment proceedings in the Svea Court of Appeals in Stockholm, at the seat of the ECT Arbitration. During the course of the annulment proceedings, a new set of facts was discovered by the Republic of Kazakhstan that allegedly reflected that the Award and the Awarded Amount had been fraudulently obtained. We understand that the Svea Court of Appeals in Stockholm did not decide on the merits of Kazakhstan's fraud arguments and did not annul the Award.
4. In parallel to the annulment proceedings in Sweden, the Stati Parties commenced proceedings for enforcement of the Award in the United Kingdom, where following an exchange of written and oral submissions in a two day hearing, on 6 June 2017 the English High Court decided that *"there is a sufficient prima facie case that the Award was obtained by fraud"* (the “**Prima Facie Fraud Judgement**”).<sup>3</sup> The Prima Facie Fraud Judgement is attached as **Exhibit 1**.
5. Immediately after the English High Court issued the Prima Facie Fraud Judgement, the Stati Parties initiated new enforcement proceedings in seven jurisdictions and subsequently discontinued the English High Court proceedings. The Republic of Kazakhstan is contesting the enforcement of the Award, claiming that it had been procured by the Stati Parties by fraud. We understand that the Republic of Kazakhstan’s challenge reflects further information which has come to light through to late 2019, including (as we explain further below) the withdrawal of previously issued audit and review opinions by KPMG Audit LLC (“**KPMG**”) on the financial statements of various companies owned by the Stati Parties.
6. We have previously prepared a letter (dated 19 August 2019) for HSF in relation to these legal proceedings (the “**August 2019 PwC Letter**”, a copy of which is included in **Exhibit 2** to this letter). In that letter we concluded that, inter alia, based on the information we had reviewed, TNG’s financial

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<sup>2</sup> Being Earnings Before Interest, Taxation, Depreciation and Amortisation.

<sup>3</sup> Judgement of Mr Justice Knowles CBE in the High Court of Justice dated 6 June 2017, Case No CL-2014-000070 between the Stati Parties and Kazakhstan, Exhibit 1.



statements for the years ended 31 December 2006 to 2009, as well as TNG's interim financial statements for the period ended 30 June 2008 were materially misstated. Further, we concluded from the information that we had reviewed that the Stati Parties appeared to have provided false representations to its auditors, KPMG and that to the extent this was the case and these misrepresentations were intentional this would seriously impair the integrity of TNG's management.

7. As explained further below, since the date of the August 2019 PwC Letter, you have provided us with a number of additional documents, including copies of certain correspondence between KPMG and the Stati Parties. For the purpose of this letter, you have asked us to review and comment upon this additional information. For context, we first set out below an overview of our understanding of the Republic of Kazakhstan's case on fraud against the Stati Parties. We then set out an overview of the additional information that has now been provided to us, before commenting on the additional information provided to us.

#### **Overview of our understanding of the Republic of Kazakhstan's case on fraud**

8. We set out below our understanding of the Republic of Kazakhstan's case on fraud, to the extent such case pertains to our views expressed herein.
9. The Republic of Kazakhstan's case on fraud against the Stati Parties is grounded on the alleged fraudulent extraction of funds through inflated costs, concealed by fraudulent financial reporting. During the period from at least 2007 to 2009, the Republic of Kazakhstan alleges that the Stati Parties materially falsified the financial statements of the three Stati companies operating in Kazakhstan: (1) Tristan Oil Ltd. ("**Tristan**"); (2) Kazpolmunay LLP ("**KPM**") and (3) Tolkyneftegaz LLP ("**TNG**") (jointly, the "**Financial Statements**"). The Stati Parties did this by undertaking a series of inflated related-party transactions that they concealed from their auditors and the outside world. The effect of these inflated related-party transactions was to significantly overstate the costs of the underlying companies and, in turn, allowing the Stati Parties to then directly benefit from the value of the overstated costs.
10. The Stati Parties also fraudulently obtained audit reports from KPMG opining that the Financial Statements of Tristan, KPM, and TNG presented fairly, in all material respects, the financial position of Tristan, KPM and TNG, when in fact they were materially misstated. The Stati Parties did this by mis-representing to KPMG, in particular, in connection with the 2007 to 2009 annual audits and/or the quarterly and six-monthly reviews of the Financial Statements of Tristan, KPM, and TNG. The Stati Parties failed to disclose the inflated transactions with related parties in these financial



statements and, indeed, provided written representations to KPMG that these inflated transactions were not with related parties. The reason for the identification and disclosure requirements in relation to related parties is that related party transactions carry a higher risk of fraud and misstatement, given the related ownership of the parties. In turn, where related parties are identified, a separate set of audit procedures would normally be undertaken to establish the 'arm's length' nature of the related party transactions.

11. The Stati Parties used the audited, yet false, Financial Statements to raise finance from investors (the "**Noteholders**"). The Republic of Kazakhstan alleges that, acting through Tristan, the Stati Parties entered into an Indenture pursuant to which two tranches of notes in the aggregate principal amount of USD 300 million and USD 120 million (together, the "**Tristan Notes**") were sold to the Noteholders on or about 20 December 2006 and 7 June 2007, respectively.
12. As noted above, after the Award was issued, facts came to light that began to reveal the Stati Parties' fraudulent scheme. Inter alia, in their Financial Statements and during the ECT Arbitration, the Stati Parties claimed to have invested USD 245 million in the construction of the LPG Plant. Evidence discovered after the Award shows that this amount was based on deliberate misrepresentations in relation to, and recording of, the real costs incurred by the Stati Parties. These misrepresentations were based on various schemes involving a purportedly independent, arms-length company, Perkwood Investments Ltd ("**Perkwood**").
13. In reality, Perkwood was not an independent arms-length company but a company controlled by Mr Stati and which had no employees nor premises and filed dormant company accounts.
14. Based on the evidence of the Stati Parties, the Tribunal relied on an indicative bid that the Stati Parties obtained from a potential purchaser (the "**Indicative Bid**").<sup>4</sup> It determined the bid value attributable to the LPG Plant "...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."<sup>5</sup>
15. The above LPG Plant historical costs of USD 193 million used in the Indicative Bid were based on:<sup>6</sup>

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<sup>4</sup> Which it considered to be "*the relatively best source of information for the valuation*", Award, paragraph 1747.

<sup>5</sup> KMG Indicative Bid, points d and f.

<sup>6</sup> 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.



- An 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**”);<sup>7</sup> and
  - The financial information in the Information Memorandum was, in turn, derived from the Stati Parties’ financial statements as of 30 June 2008, and audited combined financial statements and unaudited interim financial statements for earlier periods.<sup>8</sup>
16. Both the Information Memorandum and the Stati Parties’ interim financial statements<sup>9</sup> referred to USD 193 million as representing TNG’s total capital investment in respect of the LPG Plant as of 30 June 2008.<sup>10</sup> 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).<sup>11</sup> As detailed later, the costs of the principal equipment supplied by Tractebel Gas Engineering GmbH (“TGE”) amounts to USD 35.1 million.
17. Following the date of the Award, we understand it has come to the attention of the Republic of Kazakhstan that the Stati Parties implemented a number of related-party transactions involving TNG, which resulted, *inter alia*, in the artificial inflation of the reported capital investments in respect of the LPG Plant.
18. In particular, we understand that a large proportion of the LPG Plant 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 and TNG dated 17 February 2006 (the “**Perkwood SPA**”).

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<sup>7</sup> 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”).*”

<sup>8</sup> 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.*”

<sup>9</sup> See analysis of the various financial statements further below.

<sup>10</sup> For example the Information Memorandum, page 10; Company Interim Statements of TNG, Note 15.

<sup>11</sup> Refer to, for example, the Award at paragraph 879.



19. We understand in its legal proceedings, the Republic of Kazakhstan has 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”<sup>12</sup>, including inter alia via the following arrangements<sup>13</sup>:

- **Management fee under the Perkwood SPA.** Charging of an unsubstantiated “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 unsubstantiated 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”<sup>14</sup> through Azalia LLC (“**Azalia**”) and Perkwood, both entities at all material times controlled by the Stati Parties.<sup>15</sup>
- Over-recognising capitalised interest in respect of the “costs” set out above.

#### **KPMG’s audit and review of the financial statements of the Stati Parties**

20. As set out above, the Information Memorandum on which the Indicative Bid was based, and in-turn the Award was also based, was derived from TNG’s combined interim financial statements as of 30 June 2008 (and the corresponding underlying accounting records). TNG’s combined interim financial statements at 30 June 2008 were reviewed by KPMG who issued the following opinion on these statements on 15 August 2008<sup>16</sup>:

*“Based on our review, nothing has come to our attention that causes us to believe that the combined interim financial statements do not present fairly, in all material respects, the combined interim financial position of the Companies as at June 30, 2008, and their combined interim financial performance for the three- and six-month periods ended June 30, 2008 and their combined interim cash flows for the six-month period then ended in*

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<sup>12</sup> Defendant’s Points of Claim in the English High Court, paragraph 10.

<sup>13</sup> We consider these in more detail further below.

<sup>14</sup> Expert opinion on transfer pricing aspects of intercompany transactions between Azalia, Perkwood and TNG, paragraphs 17 and 109.

<sup>15</sup> 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.

<sup>16</sup> TNG 30 June 2008 combined interim financial statements.



*accordance with International Financial Reporting Standard IAS 34 Interim Financial Reporting.”*

### **The KPMG Correspondence: Factual Overview**

21. As set out above, since the date of the August 2019 PwC Letter, we have been provided with certain correspondence between certain representatives of the Stati Parties and KPMG, who were the auditors to the Stati Parties, including TNG (we refer to this correspondence as the “**KPMG Correspondence**”). A copy of the KPMG Correspondence is included in **Exhibit 3** to this letter.
22. The first part of the correspondence took place in 2016 (the “**2016 Correspondence**”). We understand that the Republic of Kazakhstan learned of the existence of the 2016 KPMG Correspondence only recently, on 25 October 2019.
23. The second part of the KPMG Correspondence took place in 2019 (the “**2019 KPMG Correspondence**”) and partially included correspondence to / from counsel for the Republic of Kazakhstan. We understand that the Republic of Kazakhstan learned of the existence of the 2019 KPMG Correspondence addressed from KPMG to Stati only on 25 October 2019.
24. The 2016 KPMG Correspondence provides as follows:
  - (i) **15 February 2016** Letter from KPMG to Mr Stati: KPMG informs Mr Stati that it has become aware of facts which may have caused "*the audit reports to be amended, had such facts been known to us at the audit report date.*" The issues raised by KPMG included:
    - queries in relation to the substance of a USD 44 million management fee charged by Perkwood to TNG;
    - whether Perkwood was in fact a related party to TNG;
    - questioning why Perkwood had charged TNG for equipment for the LPG Plant at a level which was significantly different to the actual supplier costs for the equipment<sup>17</sup>; and
    - KPMG also noted that they had become aware that “*Perkwood was not an operating entity*” and that it had submitted “*dormant accounts*”<sup>18</sup>.

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<sup>17</sup> KPMG Correspondence, letter dated 15 February 2016.

<sup>18</sup> KPMG Correspondence, letter dated 15 February 2016.



KPMG concluded the letter by stating: "*In case we receive no explanations or additional representations, we remain [sic] our rights to seek to prevent future reliance on our audit reports and in particular to withdraw our audit reports and to inform about such withdrawal all parties who are still, in our view, relying on these reports, included but not limited, [sic] Ministry of Justice of the Republic of Kazakhstan and the Svea Court of Appeals.*"

(ii) **26 February 2016** Letter from Mr Stati to KPMG: In this letter Mr Stati does not address any of the questions raised by KPMG and concludes by stating "*We expressly reserve the right to hold your firm accountable should you choose not to co-operate with us and/or proceed to withdraw your audit reports*".

(iii) **10 March 2016** Letter from KPMG to Mr Stati: KPMG reiterated its audit-related inquiries of its February 2016 letter.

25. Based on the 2016 KPMG Correspondence, the Stati Parties do not appear to have provided a response to this second letter sent by KPMG in 2016. We understand that the Republic of Kazakhstan is not aware of any further communications between the Stati Parties and KPMG, during the period from March 2016 to July 2019.

26. As can be seen from the 2016 KPMG Correspondence, KPMG was aware at the time that the Republic of Kazakhstan had initiated setting aside proceedings in the Svea Court of Appeals in Stockholm. In these proceedings the Republic of Kazakhstan submitted the then-available evidence of the fraud to the Svea Court of Appeals in Stockholm, consisting in essence in denouncing the same issues as raised by KPMG in its first letter of 15 February 2016. We understand that the Stati Parties have not disclosed the 2016 KPMG Correspondence to the Svea Court of Appeals in Stockholm or the Republic of Kazakhstan. An overview of the main developments before the Svea Court of Appeals in 2016 is set out in the Affidavit of the Swedish lead counsel for the Republic of Kazakhstan, Alexander Förster, attached as **Exhibit 4**.

27. The **2019 KPMG Correspondence** consists of the following:

(i) **5 July 2019** Letter from HSF to KPMG: HSF informed KPMG of new evidence that they had been provided with in the form of the sworn deposition of Mr Artur Lungu, (the former Vice-President of Tristan Oil Ltd. and Chief Financial Officer (CFO) of Ascom) from the US courts, who when asked about the relationship between TNG and Perkwood, we understand testified under oath that "*all of the transactions between TNG and*



*Perkwood should have therefore been disclosed as related party transactions*". Artur Lungu further explicitly stated under oath that the representation letters from the Stati Parties' management to KPMG were materially false. An affidavit of US counsel for the Republic of Kazakhstan summarizing the deposition of Artur Lungu is attached as **Exhibit 5**.

- (ii) **5 August 2019** Letter from KPMG to the Stati Parties: Following up on the sworn testimony of the Stati Parties' former CFO, KPMG requested additional information in relation to the transactions between TNG and Perkwood in order "*... to assess the potential impact on the financial statements of the Companies, and our audit report.*"

The Stati Parties apparently did not respond to this letter.

- (iii) **21 August 2019** Letter from KPMG to the Stati Parties: KPMG states that having received no response to their questions and having completed their own independent assessment, KPMG had concluded that the omissions in the annual and interim financial statements of TNG were "*material*" to the Financial Statements.<sup>19</sup> KPMG also noted that the additional information obtained by KPMG reflects "*that the management of [the Stati parties] made misrepresentations to KPMG Audit LLC*".<sup>20</sup>

KPMG concludes by stating:

*"We are therefore writing to inform you that you should immediately take all necessary steps to prevent any further, or future, reliance on the following audit reports issued by KPMG Audit LLC"*.

We understand that the Stati Parties did not disclose this letter in the then ongoing court proceedings and, as noted above, that the Republic of Kazakhstan learned of it only on 25 October 2019.

- (iv) **Correspondence between 6 September and 3 October 2019:** We understand that the Republic of Kazakhstan only learned on 25 October 2019 of further correspondence between the Stati Parties and KPMG:

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<sup>19</sup> KPMG Correspondence, letter dated 21 August 2019.

<sup>20</sup> KPMG Correspondence, letter dated 21 August 2019.



- Letter from **Mr Stati to KPMG of 6 September 2019** requesting KPMG to withdraw their letter invalidating the audits;
- Letter from **KPMG to Mr Stati of 20 September 2019** noting again that there had been no response and that to date their “*questions raised remain conspicuously unaddressed*” in the most recent correspondence received back from the Stati Parties.<sup>21</sup> KPMG noted that the identification of Perkwood as a related party is “*in conflict with multiple representation letters signed inter alia by Mr. Stati*”.<sup>22</sup> As a consequence, KPMG confirms for the second time that the audit reports must not be relied upon:

*"In the absence of any evidence to the contrary – which to date Mr. Stati has failed to provide – there is no justification for a change in KPMG's position."*

- Letter **Mr Stati to KPMG of 25 September 2019** alleging that Mr Stati had not had sufficient time to answer the questions of KPMG.
- Letter **KPMG to Mr Stati of 3 October 2019** where KPMG further took note of the “*shifting explanations for the failure to provide a response*” which they found to be “*without basis*”.<sup>23</sup> KPMG confirms for the third time that there is no basis for KPMG to change its position in view of the repeated failure of Mr Stati to provide any explanation despite having had ample time:

*"...we have not received a substantive response to the allegations we reported to you in our 5 August Letter (indeed, we note that you have made no effort at all to deny these)."*

- (v) Letter from **KPMG to HSF on 21 August 2019**: On the same day on which KPMG requests the Stati Parties to ensure that no further and future reliance is placed on the audit reports, KPMG also informs HSF about this demand to the Stati Parties. We understand that until 25 October 2019 this is the only letter of the 2016 and 2019 KPMG Correspondence that was known to the Republic of Kazakhstan and their counsel.

We set out below our comments on the information contained in the KPMG Correspondence.

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<sup>21</sup> KPMG Correspondence, letter dated 20 September 2019.

<sup>22</sup> KPMG Correspondence, letter dated 20 September 2019.

<sup>23</sup> KPMG Correspondence, letter dated 3 October 2019.



## **Findings from the KPMG Correspondence**

### ***No further or future reliance on audit reports***

28. The issues raised by KPMG in the 2016 and 2019 KPMG Correspondence with the Stati Parties relate to serious and material allegations of misstatement.
29. The absence of a substantive response from the Stati Parties to the issues raised by KPMG is concerning and entirely undermines the reliability of the Financial Statements and related information.
30. Further, the fact that KPMG itself apparently was unable to answer the questions raised to the Stati Parties from the information it possessed suggests an inaccuracy and / or incompleteness in the relevant information provided previously by the Stati Parties to KPMG.
31. The decision by KPMG in 2019 to take steps to prevent any further, or future, reliance on the audit opinions that had previously been issued by KPMG in respect of TNG et al. is a highly unusual and serious issue. The actions taken by KPMG do not only go to specific transactions, for example in relation to those between Perkwood and TNG, but represent in effect a complete 'withdrawal' by KPMG of its audit opinions over all of the financial information of the Financial Statements. This includes but is not limited to KPMG's report on the TNG financial statements to 30 June 2008 that formed the basis of the costs and EBITDA figures that fed into the calculation of the Awarded Amount. As set out in the KPMG Correspondence, it further extends as well to a wider range of 26 sets of financial statements prepared by the Stati Parties for which KPMG had previously issued audit reports.
32. We note that, in their letter of 21 August 2019 to Mr Stati, KPMG also request that Mr Stati "*should immediately take all necessary steps to prevent any further, or future, reliance*" on the 2007 to 2009 audit reports and opinions in respect of Mr Stati's Kazakh companies. We understand that the Financial Statements to which these audit reports refer have been relied upon by the Stati Parties in the ECT Arbitration, their witnesses, their experts, and their counsel, as well as the Arbitral Tribunal, and they continue to be part of the court records in the court proceedings following the Award.

### ***The actions taken by KPMG are significant and extremely rare***

33. The effective 'withdrawal' of an audit opinion is a last resort by an auditor and only arises in rare circumstances, including for example when management can provide no explanation for repeated,



material false statements by management to the auditor and/or when management can provide no explanation for material misstatements in the accounts and resulting financial statements.

34. The correspondence in 2019 between KPMG and the Stati Parties is also very unusual in that management did not engage with its auditors to respond to allegations that (i) financial data is materially misstated; and (ii) that representations provided previously by management have been found to be wrong.
35. To put the actions of KPMG in context, we have consulted with our own audit standards team at PricewaterhouseCoopers LLP. They have informed us that in the UK, there has only been one occasion that they can recall over the past fifteen years, a period during which PricewaterhouseCoopers LLP has issued tens of thousands of audit opinions, when PricewaterhouseCoopers LLP has had to take similar actions to 'withdraw' a previously issued audit opinion.
36. As KPMG informs the Stati Parties in its letter of 10 March 2016, KPMG's "*professional obligation is to protect the quality of our audit work to our client and to the parties using our audit report.*" We understand that the Financial Statements to which these audit reports refer have been used by the Stati Parties in the ECT Arbitration, their witnesses, experts, and counsel, as well as the Arbitral Tribunal, and they are also part of the court records in the court proceedings following the Award.

#### ***Impact on Financial Statements***

37. Without rationale or justification for the transactions between TNG and Perkwood, there appears to be no basis for the level of funds transferred from TNG to Perkwood and in essence, they appear to simply represent a means for shifting funds from TNG (which we understand were originally provided by various third-party investors) to Perkwood and, thus, to an entity controlled by the Stati Parties. The KPMG Correspondence also shows that the costs recorded in respect of the LPG Plant, including those capitalised, would appear to be materially misstated.
38. The above, coupled with the withdrawal by KPMG of its audit opinions, renders the Financial Statements to be entirely unreliable.

#### ***Non-reliance extends to entire credibility***

39. From the perspective of a user of the Financial Statements, the ultimate request by KPMG that the Stati Parties undertake steps to cease any further, or future, reliance on KPMG's audit reports issued is also a very serious issue. The actions of KPMG, and the KPMG Correspondence, show that KPMG had



reached the conclusion that the Financial Statements and supporting documents / records of TNG were materially misstated. Further, the KPMG Correspondence records that misleading representations had been provided by management of the Stati Parties to KPMG. Such misleading representations demonstrate the lack of credibility of management and further increase the skepticism with which any information provided by them would be / should be viewed.

40. In short, the actions taken by KPMG and their subsequent actions would entirely remove confidence in the reliability of Tristan's, TNG's and KPM's overall financial information and anything derived therefrom or based thereon (including, but not limited to, any written and oral testimony in the ECT Arbitration, expert opinions and statements from counsel based on such financial information<sup>24</sup>).

***The Stati Parties concealed that Perkwood was a Related Party***

41. The KPMG Correspondence confirms KPMG's position that the Stati Parties falsified their related party disclosures to KPMG, thus creating the false impression on the part of KPMG and any other users of the Financial Statements that Perkwood was an independent third party when in reality it was a company controlled by Mr Stati.
42. This is also confirmed in the Prima Facie Fraud Judgement stating that "*...there is no reference in the financial statements of TNG to Perkwood being a related party. This gives rise to the strongest suggestion that even the auditors of TNG did not know, with one consequence being that audit or review scrutiny of related-party dealings was avoided.*"<sup>25</sup>

***Money laundering***

43. Aside from the seriousness of the events that form the basis of KPMG's actions, which undermine the reliability of TNG's overall financial data and the credibility of management, the issues raised by KPMG also raise a number of potential 'red-flags' in relation to broader money laundering issues. Potential red-flags in relation to money laundering typically include the following items<sup>26</sup>:

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<sup>24</sup> We understand that this is as confirmed by Justice Knowles: "*Before the Tribunal, the Claimants claimed to have invested more than US\$ 245 million in the development and construction of the LPG Plant. This was the evidence of the first Claimant himself and of Mr. Lungu called by the Claimants, each by witness statement and in oral evidence before the Tribunal. It carried through into expert reports and into statements from arbitration counsel.*" No. 16

<sup>25</sup> Judgement of Mr Justice Knowles CBE in the High Court of Justice dated 6 June 2017, Case No CL-2014-000070, para. 71.

<sup>26</sup> <https://flagitup.campaign.gov.uk/>



**Transactions:** Are transactions unusual because of their size, frequency or the manner of their execution, in relation to the client’s known business type?

**Structures:** Do activities involve complex or illogical business structures that make it unclear who is conducting a transaction or purchase?

**Assets:** Does it appear that a client’s assets are inconsistent with their known legitimate income?

**Resources:** Are a client’s funds made up of a disproportionate amount of private funding, bearer’s cheques or cash, in relation to their socioeconomic profile?

**Identity:** Has a client taken steps to hide their identity, or is the beneficial owner difficult to identify?

**Behaviour:** Is the client unusually anxious to complete a transaction or are they unable to justify why they need completion to be undertaken quickly?

**Political Status:** Is the client engaged in unusual private business given that they hold a prominent public title or function? Or do they have ties to an individual of this nature?

**Documents:** Are information or documents being withheld by the client or their representative, or do they appear to be falsified?

**Geographical Area:** Is the collateral provided, such as property, located in a high-risk country, or are the client or parties to the transaction native to or resident in a high-risk country?

**Choice of Professional:** Have you, or other professionals involved been instructed at a distance, asked to act outside of your usual speciality, or offered an unusually high fee?

44. The fact that Perkwood was a dormant company, yet ultimately, as we understand, purported to charge TNG in excess of USD 130 million, would certainly raise a red flag in terms of both the size of these transactions and the illogical transaction structure. Similarly, the fact that the Stati Parties apparently mis-represented to KPMG the status of Perkwood as a related party, and did not go on to address the queries raised by KPMG, raises red flag factors around both “identity” and “behaviour”. Ultimately, the questions raised by KPMG around the transactions between TNG and Perkwood bring into doubt the rationale for the transactions and also raise a number of serious money laundering red flags.



***Amounts already received by the Stati Parties***

45. To the extent that the Awarded Amount was meant to compensate the Stati Parties for alleged losses suffered in respect of their alleged investment in Kazakhstan, including in respect of the LPG Plant, and to the extent that the Stati Parties had already potentially drawn a constructive dividend by shifting funds from TNG through inflated value transactions with Perkwood, this inflated cost would reflect a double-counting of the alleged investment, to the benefit of the Stati Parties.

***No explanation from the Stati Parties***

46. The KPMG Correspondence shows that the Stati Parties at no point in time, and despite repeated requests from KPMG, provided any explanation for the issues raised by KPMG. KPMG states so explicitly in three different letters to the Stati Parties.
47. KPMG having to raise these issues with Mr Stati in the first place would presumably reflect the fact that KPMG itself was unable to identify a basis or explanation for the issues based on their knowledge, information and documentation obtained as the Stati Parties' auditors over the years of their auditing.
48. The Stati Parties failed to provide explanations to KPMG even though the issues raised by KPMG as of early 2016 (and thus before the start of the proceedings for the enforcement of the Award) were and are, as we understand, the main subject of numerous court proceedings in seven jurisdictions.
49. The failure of the Stati Parties to provide KPMG with explanations caused KPMG to take the extraordinary step of withdrawing their audit reports.
50. We understand that the Stati Parties sought to raise various positions in certain court proceedings in defence against the fraud allegations. We set out below an overview of these positions, as well as how these positions compare to the findings from the KPMG Correspondence set out above as well as our understanding of the Republic of Kazakhstan's response to these positions.



**Position 1:** The Stati Parties never concealed that Perkwood was a related party

This position contrasts to the following:

- We understand that Mr. Lungu confirmed under oath that the Stati Parties knowingly and repeatedly misrepresented to KPMG for the express purpose of concealing that Perkwood was a related party.
- KPMG confirms explicitly in the KPMG Correspondence that the Stati Parties presented Perkwood as a non-related company, concluding arms' length contracts and that it was not revealed to KPMG that Perkwood was a Stati Party.
- KPMG had notified Mr Stati in 2016 that the Stati Parties' statements to the Svea Court of Appeal were in contradiction with the statements made to KPMG.
- We understand that the Stati Parties belatedly admitted that Perkwood was related after the Republic of Kazakhstan submitted the Powers of Attorney from Perkwood to Anatolie and Gabriel Stati.

**Position 2:** Perkwood is an operating company and provided legitimate services

This position contrasts to the following:

- KPMG confirmed that Perkwood is a dormant company.
- The Stati Parties do not provide this explanation to KPMG within the KPMG Correspondence.
- In any event the activities of a company are reflected in contracts, invoices, correspondence. We understand that no supporting documents were presented by the Stati Parties.
- We understand that no witnesses or experts were presented by the Stati Parties to address this allegation.
- We understand that the only employees listed in the Perkwood Agreement are employees of the actual supplier, TGE.

**Position 3:** The TGE / Perkwood scheme is a legitimate transfer pricing mechanism

This position contrasts to the following:

- A transfer pricing mechanism takes place between related parties. The Stati Parties concealed from KPMG and others that Perkwood was a related party and instead presented Perkwood to KPMG as an independent third party (and hence this was not presented to KPMG at the time as a transfer pricing mechanism).



- There does not appear to have been a basis for the inflated costs charged by Perkwood to TGE and so this would not represent a legitimate transfer pricing mechanism. This is further enforced by the absence of employees etc. of Perkwood which would also raise concerns as to how Perkwood could have added sufficient value to have justified the level(s) of alleged transfer pricing.

**Position 4:** The tripling of the LPG Plant costs is caused by transport, storage and insurance

This position contrasts to the following:

- We understand that the Stati Parties do not provide supporting documents.
- It does not appear plausible that for a plant for which we understand the principal equipment actually only cost approximately USD 35 million, there would be legitimate costs of transport, insurance and storage amount to almost triple the equipment price.

**Position 5:** USD 31 million in costs for the LPG Plant relate to spare parts

This position contrasts to the following:

- It does not appear plausible that a plant for which we understand the principal equipment actually only cost approximately USD 35.1million would require spare parts of almost the same value.
- We understand that no plausible supporting documents were submitted by the Stati Parties.

**Position 6:** The increase in costs for the LPG Plant was caused by foreign exchange differences

This position contrasts to the following:

- We understand that no supporting documents were submitted by the Stati Parties in support of this allegation.
- It does not appear plausible that the tripling of the LPG Plant costs can be the result of foreign exchange differences.

51. We note that the nature of the alleged positions adopted by the Stati Parties changed over time. None of these alleged positions answer the questions raised by KPMG in the KPMG Correspondence.



Your faithfully,

A handwritten signature in black ink, appearing to read "Tim Allen", with a long, sweeping underline that extends to the left.

Tim Allen

Partner, PricewaterhouseCoopers LLP