

Development Fund for Iraq

**Report of Factual Findings
in connection with Export Sales**

For the period from 1 January 2004 to 28 June 2004

KPMG Bahrain

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This report contains 11 pages



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Report of Factual Findings
in connection with Export Sales

To the International Advisory and Monitoring Board of the
Development Fund for Iraq
To the Project and Contracting Office
(successor to the Coalition Provisional Authority)

We have performed the procedures enumerated in the attached Appendix, which were agreed with the International Advisory and Monitoring Board of the Development Fund for Iraq and the Coalition Provisional Authority, solely to assist you in evaluating the Development Fund for Iraq's compliance with United Nations Security Council Resolution (UNSCR) 1483 paragraph 20, for the period from 1 January 2004 to 28 June 2004. The Coalition Provisional Authority was responsible for the Development Fund for Iraq's compliance with UNSCR 1483.

This Agreed-Upon Procedures engagement was conducted in accordance with the International Standard on Related Services 4400: Engagements to Perform Agreed-upon Procedures Regarding Financial Information and with the International Organization of Supreme Audit Institutions (INTOSAI) Standards on Government Auditing.

The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described in the Appendix, either for the purpose for which this report has been requested or for any other purpose.

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1 Key internal controls over the capture of export sales

1.1 Procedure

We documented the key internal controls designed by the Coalition Provisional Authority (CPA) and the State Oil Marketing Organization (SOMO), the sales arm of the Iraqi Ministry of Oil, over the capture of revenue from export sales of petroleum, petroleum products and natural gas and the subsequent cash deposits in the Development Fund for Iraq (DFI).

1.2 Key internal controls

The CPA issued Order Number 36, Regulation of Oil Distribution on 3 October 2003 to supplement Iraqi law and to support the Iraqi authorities in the lawful distribution of oil into, out of and throughout Iraq. It was designed to assist in preventing theft and smuggling of natural resources, pending the outcome of a full review of Iraqi law, provisions and instructions.

The CPA Senior Advisor to the Iraqi Ministry of Oil (CPA Senior Advisor) maintained a spreadsheet tracking ship movements intended to ensure that for all lifted petroleum and petroleum products: ships were nominated and authorized; loaded in accordance with contractual provisions; invoiced; and the sale proceeds deposited at the Federal Reserve Bank of New York (FRBNY).

Although we were not given access to the Coalition's Naval Forces personnel or records, we were informed by the CPA Senior Advisor that the Coalition's Naval Forces monitored shipping in the Gulf and, where necessary, ensured that only authorized petroleum and petroleum products were lifted from Iraq.

We were informed by the CPA Senior Advisor that he performed reviews of oil production, as documented by the North and South Oil Companies, on a daily basis.

During August 2003, the CPA engaged international security companies and local tribes to guard the pipelines and installations against sabotage.

The CPA has approved a budget to replace, repair and calibrate the metering system on the pipeline network. To date, however, the equipment and services have not been contracted.

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- 1.2.7** Export sales of petroleum and petroleum products are required to be exclusively arranged and invoiced by SOMO, which is the sales arm of the Iraqi Ministry of Oil.

SOMO's policy is to accept payments only through irrevocable documentary letters of credit, thus ensuring that all exports will be paid for.

Cash receipts were to be deposited directly into the Oil Proceeds Receipts Account (OPRA), at the Federal Reserve Bank of New York.

For each shipment, SOMO is to perform a matching process with Bills of Lading, Certificates of Quantity and Quality, Ullage Reports, Export Cargo Manifests and Master Receipts against invoices raised, designed to ensure that all shipments are appropriately invoiced.

Currently, there are no export sales of natural gas, as there is no Iraqi infrastructure for the export of natural gas.

1.3 Findings

- 1.3.1** Key internal controls tested with our findings are noted in sections 3 and 4.

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2 Key internal controls over the bidding process

Procedure

We documented the key internal controls designed by the CPA and SOMO over the bidding on, and awarding of, export sales contracts.

2.2 Key internal controls

SOMO's policy is to sell Basra light oil through long-term contracts, primarily with well-known international oil companies. These contracts are subject to review on a regular basis by the contracting parties. For Basra light oil, while SOMO has a stated policy of only selling to end-users, certain reliable traders are also considered.

Contracts for Basra light oil are entered into based upon production plans and estimates of capacity received from the South Oil Company. The price of petroleum to be delivered under these contracts is SOMO's Official Selling Price (OSP) for the scheduled month of loading.

The OSP is required to be based on one of three international benchmarks, depending on the destination: WTI (second line) for North American destination; Brent dated for European destination; and, Oman/Dubai average for Eastern destination, as quoted in PLATTS daily publications.

The OSP's monthly price is required to be calculated using an average of PLATTS quotations, for the selected destination, for a certain number of days following the lifting of the petroleum. This average is then required to be entered into a price formula, which includes factors for quality differential from the benchmarks and transportation cost.

This is a method employed by other major oil producers in the region.

2.2.3 Kirkuk petroleum is currently sold through a tender process, as transportation by pipeline was disrupted by sabotage.

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- 2.2.4** A Tender Committee is required to be formed with 12 members from various divisions of SOMO. Bids received by facsimile are to be placed in separate envelopes and forwarded to the Tender Committee, who are to open the bids at an appointed time and ensure that all qualifying bids meet the stated criteria. Any bids received via means other than facsimile are to be excluded from selection. During 2004, SOMO updated its policies to accept bids submitted by email.

The Tender Committee is required to recommend the successful bidders, based on a range of criteria, including price and the reliability, reputation and geographical positioning of the purchaser. For Kirkuk petroleum, while SOMO has a stated policy of only selling to end-users, certain reliable traders are also considered.

The Committee's recommendation is required to be sent to the Iraqi Minister of Oil for final approval. Approval by the Minister may be verbal or in writing. Subsequent to approval, contracts are required to be signed with the successful bidders.

We were informed by the CPA Senior Advisor that he reviewed and concurred with the business practices utilized by SOMO. He also informed us that he performed reviews of contracts signed and tenders awarded.

2.3 Findings

Our findings are noted in sections 4.2.1 and 4.2.2.

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3 Agreement of export sales to SOMO sales ledger and to FRBNY

3.1 Procedures

We obtained from SOMO a list of export sales of petroleum (crude oil) and petroleum products (mainly residual fuel oil) for the period from 1 January 2004 to 28 June 2004, and compared this total to the SOMO sales ledger.

Thereafter, we compared the list of export sales to amounts deposited into the OPRA account, held on behalf of the Central Bank of Iraq at the FRBNY.

3.2 Findings

Export sales of petroleum and petroleum products are required to be arranged and invoiced exclusively by SOMO, the sales arm of the Iraqi Ministry of Oil.

3.2.2 As there is no Iraqi infrastructure for the export of natural gas, there were no export sales of natural gas from Iraq.

We found that, for the period from 1 January 2004 to 28 June 2004, export sales of petroleum and petroleum products were undertaken through cash and barter transactions.

Export sales of petroleum made through cash transactions, as recorded by SOMO in its accounting records for the period from 1 January 2004 to 28 June 2004, amounted to \$8,085,192,743. See section 3.2.8 for barter transactions.

Export sales of petroleum products made through cash transactions, as recorded by SOMO in its accounting records for the period from 1 January 2004 to 28 June 2004, amounted to \$686,549. See section 3.2.8 for barter transactions.

Proceeds from export sales of petroleum and petroleum products are required to be paid directly into the OPRA account, through irrevocable documentary letters of credit, with proceeds received approximately 30 days after the petroleum or the petroleum products have been lifted.

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We found that proceeds from export sales of petroleum and petroleum products for the period from 1 January 2004 to 28 June 2004 were deposited in the OPRA account as follows:

Period deposited in OPRA

1 January 2004 to 28 June 2004	\$ 6,884,062,972
Post-28 June 2004	<u>1,201,816,320</u>
	<u>\$ 8,085,879,292</u>

Cash advances received for and proceeds of export sales of petroleum and petroleum products during the period from 1 January 2004 to 28 June 2004 amounting to \$20,038,000 were deposited in an Iraqi bank account controlled by the State Oil Marketing Organization, the sales arm of the Iraqi Ministry of Oil. This amount was not deposited in the OPRA account, or the DFI and the Compensation Fund in accordance with United Nations Security Council Resolution 1483.

SOMO also engages in barter transactions for exports of petroleum and petroleum products. Barter transactions consist mainly of exports of residual fuel oil for light fuel products and the export of crude oil for electricity from Syria. The exports of residual fuel oil and crude oil, and the imports of light fuel products are recorded in the accounting records at SOMO.

We found that the value of these barter transactions, as recorded by SOMO, for the period from 1 January 2004 to 28 June 2004 was \$209,881,292. As these were non-cash transactions, no proceeds were deposited in the OPRA account, or the DFI and the Compensation Fund.

The CPA believed that an unknown quantity of petroleum and petroleum products was illegally exported from Iraq (smuggling), by-passing the authorized processes of marketing, sales and cash collection. Despite the key internal controls put in place by the CPA and SOMO, as noted in section 1.2 above, the CPA also believed that internal control systems over the Iraqi oil industry were insufficient to ensure that all petroleum and petroleum products were accounted for in the absence of a metering system. The CPA was unable to reliably estimate the amounts of petroleum and petroleum products that were illegally exported for the period from 1 January 2004 to 28 June 2004.

It was not practicable to extend our procedures sufficiently to quantify such amounts.

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4 Detailed testing over the export sales of petroleum and petroleum products

4.1 Procedures

For all export sales of petroleum, including all barter transactions for petroleum, and for a sample of export sales of petroleum products covering 60% (by value), we performed the following procedures:

Determined whether the key internal controls, noted in section 2.2 above, for the bidding on, and awarding of contracts to which the sale related were followed;

Observed whether the contract and sales invoice were signed and approved by an authorized person in accordance with SOMO policies and procedures, and approved by the CPA;

Compared the quantity and price per the invoice to the Sales Contract, Bill of Lading, Certificate of Quantity and Quality, Ullage Report, Export Cargo Manifest and Masters Receipt; and

- 4.1.4** Recalculated the OSP, by reference to PLATTS publications, for each lift and compared to the price per the invoice.

4.2 Findings

- 4.2.1** We found that the key internal controls, noted in section 2.2 above, for the bidding on, and awarding of contracts to which the sale related were followed.

We noted that during the period from 1 January 2004 to 28 June 2004, 17,976,482 barrels of Kirkuk petroleum were sold through three tenders, to well known end-users.

Although SOMO does not have a formal, written delegation of authority or a list of signatories for certain documents, we found that all contracts and sales invoices were signed and authorized by one of eight members of SOMO's senior management. We noted that all contracts were approved by the Iraqi Minister of Oil, or in exceptional cases by his Deputy.

We were informed by the CPA Senior Advisor that he undertook a review of sales invoices issued and contracts signed. These reviews were not documented.

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- 4.2.3** For all export sales of petroleum and for our sample of export sales of petroleum products, we found that the quantity and price per the invoice agreed to the other documents included in section 4.1.3 above.
- 4.2.4** For all export sales of petroleum and for our sample of export sales of petroleum products, we found that the price per invoice agreed to the Official Selling Price recalculated using PLATTS publications.

We also found that for export sales of residual fuel oil, a substantial discount is offered on the PLATTS prices, to entice purchasers to collect the residual fuel oil within Iraq and to ensure that the production of refined oil products is not interrupted. Additionally, we found that prices and discounts were published for monthly periods for all customers. These were dependent upon a mixture of security issues, forms of transportation and distances, and an assessment of the quality of the product. It was additionally noted that the Minister of Oil approved all prices and discounts.

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Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements, we do not express any assurance on Export Sales for the period from 1 January 2004 to 28 June 2004. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

We have performed an examination of the statement of cash receipts and payments of the Development Fund for Iraq for the period from 1 January 2004 to 28 June 2004, with our audit report issued thereon on 30 September 2004. We expressed a qualified audit opinion on the completeness of cash receipts, as also noted in our findings in section 3.2.7 above. We expressed a qualified audit opinion on the completeness of export sales of petroleum and petroleum products, as also noted in our findings in section 3.2.9 above.

This report is intended solely for the information and use of the International Advisory and Monitoring Board of the Development Fund for Iraq and the Project and Contracting Office, and is not intended to be, and should not be, used by, or relied upon by, anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited. We do not accept or assume responsibility for any other purpose or to any other person to whom this statement is shown or into whose hands it may come save where expressly agreed by our consent in writing.

Manama, Kingdom of Bahrain
30 September 2004

KPMG

**Development Fund for Iraq
Agreed-Upon Procedures
in connection with Export Sales
For the period from 1 January 2004 to 28 June 2004**

Appendix

To assist the IAMB and the CPA in determining whether the export sales of petroleum, petroleum products and natural gas from Iraq are made consistent with prevailing international market best practices, you have requested us to perform the following procedures for the period from 1 January 2004 to 28 June 2004:

1. Document the key internal controls, designed by the CPA and SOMO, the sales arm of the Iraqi Ministry of Oil, over the capture of revenue from export sales of petroleum, petroleum products and natural gas (export sales) extracted from the ground, and subsequent cash deposits in the DFI.
2. Document the key internal controls, designed by the CPA and SOMO, over the bidding on, and awarding of, export sales contracts.
3. Obtain from SOMO a list of export sales, and agree the total to SOMO's sales ledger and to the amounts deposited in the FRBNY.
4. For all export sales of petroleum and a selected sample of petroleum products:
 - Determine whether internal control procedures, noted in point 2 above, for the bidding on and awarding of contracts to which the sale related were followed,
 - Observe that contracts and sales invoices were signed and approved by an authorized person in accordance with SOMO policies and procedures, and approved by the CPA,
 - Agree the quantities and prices as per invoice to the Sales Contracts, Bills of Lading, Certificates of Quantity and Quality, Ullage Reports, Export Cargo Manifests and Masters Receipts,
 - Recalculate the OSP, by reference to PLATTS publications, for each lift and compare to the price per the invoice, and report any deviations noted.