Development Fund for Iraq

Report of Factual Findings in connection with Export Sales

For the period from 1 January 2005 to 30 June 2005

KPMG Iraq
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This report contains 15 pages

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Report of Factual Findings in connection with Export Sales

To the Government of Iraq
To the International Advisory and Monitoring Board of
the Development Fund for Iraq

We have performed the procedures enumerated in the attached Appendix A, which were agreed with the Government of Iraq and the International Advisory and Monitoring Board of the Development Fund for Iraq, solely to assist you in evaluating the Development Fund for Iraq's compliance with United Nations Security Council Resolution (UNSCR) 1483 paragraphs 20 and 21, for the period from 1 January 2005 to 30 June 2005. The Government of Iraq 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*.

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 Appendix A, either for the purpose for which this report has been requested or for any other purpose.

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(all amounts are in US dollars)

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1 Key internal controls over the recording of export sales

1.1 Procedure

We documented the key internal controls to be employed by the Ministry of Oil and the State Oil Marketing Organization (SOMO), the sales arm of the Ministry of Oil, over the recording of revenue from export sales of petroleum, petroleum products and natural gas, and subsequent cash deposits in the DFI.

Key internal controls

1.1.1 The former Coalition Provisional Authority (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.

1.1.2 The Ministry of Oil regularly visits SOMO and other state-owned oil companies to review management information regarding oil production, shipping and transportation, and distribution.

1.1.3 SOMO maintains a spreadsheet tracking ship movements to ensure that, for all lifted petroleum and petroleum products, ships were nominated and authorized, were loaded in accordance with contractual provisions; an invoice raised; and, the proceeds deposited in the Federal Reserve Bank of New York (FRBNY).

1.1.4 We were informed by a US Navy Commander that Coalition Naval Forces monitor large vessels in the Arabian Gulf and, where necessary, ensure that only authorized petroleum and petroleum products were lifted from Iraq.

1.1.5 The policy of the Government of Iraq is to engage international security companies and local tribes to guard the pipelines and installations against sabotage.

1.1.6 Export sales of petroleum and petroleum products are required to be exclusively arranged and invoiced by SOMO.

1.1.7 SOMO's policy for export sales of petroleum is to accept payments primarily through irrevocable documentary letters of credit (LCs), ensuring that full payment is received for all exports. A limited number of barter transactions for exports of petroleum are also entered into with the Government of Syria.

1.1.8 SOMO's policy for export sales of petroleum products is to sell primarily through cash advance payments and barter transactions, with a limited number of transactions paid through LCs.

1.1.9 Cash receipts for export sales of petroleum and petroleum products through LCs are to be deposited directly into the Oil Proceeds Receipts Account (OPRA) at the FRBNY.

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

Findings

Key internal controls tested together with our findings are noted in sections 3 and 4.

2 Key internal controls over the bidding process

2.1 Procedure

We documented the key internal controls to be employed by the Ministry of Oil and SOMO over the bidding on, and awarding of, export sales contracts.

Key internal controls

Basra light oil

2.1.1 SOMO's policy is to sell Basra light oil through medium-term contracts (six months), primarily to well-known international oil companies, with up to 5% of sales being made to reliable oil traders. All contracts are to be approved by the Minister of Oil.

2.1.2 Contracts for Basra light oil are to be entered into based on production plans and estimates of capacity received from the South Oil Company, a state-owned entity. The price of petroleum to be delivered under these contracts is required to be 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 month) for American destination; Brent dated for European destination; and Oman/Dubai average for Far East destination, as quoted in PLATTS daily publications.

The OSP, for European and American destinations, is required to be calculated using an average of PLATTS quotations, for five consecutive quotations starting on the 15th day from the date of the bill of lading.

The OSP, for Far East destination, is required to be calculated using a monthly average of PLATTS quotations, during the calendar month of loading.

The PLATTS averages, as calculated above, for the three destinations are then required to be entered into a price formula, which includes factors for quality differential from the benchmarks and transportation costs.

2.1.3 The OSP, including discounts for quality differential from the benchmarks and transportation costs, is required to be published on a monthly basis for all customers, by the 10th day of the month preceding the month of loading. The Minister of Oil is to approve all OSPs.

Kirkuk petroleum

2.1.4 For the period from post-hostilities to 28 June 2004, Kirkuk petroleum was sold through a bidding process.

2.1.5 On 1 September 2004, SOMO changed its Kirkuk petroleum policy and entered into short-term contracts for all Kirkuk petroleum, based on production plans and estimates of capacity from the North Oil Company, a state-owned company.

2.1.6 For Kirkuk petroleum, SOMO has a policy of selling exclusively to end-users. All contracts are to be approved by the Minister of Oil.

2.1.7 SOMO's OSP for Kirkuk petroleum is required to be calculated using similar methods to those used to calculate the OSP for Basra light oil, with the following exception:

The OSP for European destination is required to be calculated using an average of PLATTS quotations, for five consecutive quotations starting from the date of the bill of lading.

Findings

Key internal controls tested together with our findings are noted in section 4.1.

(all amounts are in US dollars)

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

3.1 Procedure

We obtained from SOMO a list of export sales of petroleum (crude oil), petroleum products (mainly fuel oil) and natural gas for the period from 1 January 2005 to 30 June 2005, and compared this total to the SOMO sales ledger.

Findings

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

3.1.2 We found that SOMO's sales ledger reconciled to SOMO's list of export sales of petroleum and petroleum products for the period from 1 January 2005 to 30 June 2005.

3.1.3 We obtained a list of nominated vessels from a US Navy Commander detailing all vessels monitored by the Coalition Naval Forces in the Arabian Gulf. We agreed each vessel to the SOMO list of export sales of petroleum.

3.1.4 We found that during the period from 1 January 2005 to 30 June 2005, SOMO held contracts with 28 customers for export sales of petroleum (see 4.1.4).

3.1.5 We found that export sales of petroleum and petroleum products were made through LCs, cash and barter transactions, as recorded in SOMO's accounting records for the period from 1 January 2005 to 30 June 2005, were as follows:

	Petroleum	Petroleum Products	Total
LCs	$ 10,382,510,546	$ -	$ 10,382,510,546
Cash	-	79,716,221	79,716,221
Barter	63,152,138	36,743,995	99,896,133
	$ 10,445,662,684	$ 116,460,216	$ 10,562,122,900

The amount of export sales of petroleum made through LCs includes interest receipts of $45,474 for delayed bank transfers, and is net of paid demurrage claims of $12,952,430 incurred during the period from 1 January 2005 to 30 June 2005.

(all amounts are in US dollars)

3.2 Procedure

We compared the list of export sales to amounts deposited into the OPRA account, held on behalf of the CBI at the FRBNY.

Findings

LCs

3.2.1 We found proceeds from export sales of petroleum for the period from 1 January 2005 to 30 June 2005, were deposited into the OPRA account approximately 30 days after lifting, in accordance with the terms of the LCs, as follows:

Deposited in OPRA for the period:

1 January 2005 to 30 June 2005	$ 8,368,115,959
Subsequent to 30 June 2005	2,014,394,587
	$ 10,382,510,546

Cash

3.2.2 We found that net cash advances received for, and proceeds of, export sales of petroleum and petroleum products during the period from 1 January 2005 to 30 June 2005 amounted to $79,716,221 (from inception (22 May 2003) to 30 June 2005: $177,478,240), were not deposited into the OPRA account, nor the DFI or the Compensation Fund, in accordance with UNSCR 1483. These funds were deposited in SOMO bank accounts at two Iraqi banks and a Jordanian branch of an Iraqi bank.

During the period from 1 January 2005 to 30 June 2005, SOMO transferred $58,354,519 (from inception to 30 June 2005: $82,532,997) to the Ministry of Oil. The balance of the three SOMO bank accounts as at 30 June 2005 was $94,945,243.

Barter transactions

3.2.3 We found that SOMO engages in barter transactions for exports of petroleum and petroleum products. These barter transactions consist mainly of exports of fuel oil in exchange for light petroleum products, and the export of crude oil in exchange for electricity and light petroleum products from the Government of Syria.

(all amounts are in US dollars)

3.2.4 The value and volume of these barter transactions for the period from 1 January 2005 to 30 June 2005, as recorded by SOMO, were as follows:

	Petroleum	**Petroleum Products**	**Total**
January	$ 9,200,180	$ 4,006,971	$ 13,207,151
February	9,613,430	914,845	10,528,275
March	14,071,683	9,396,927	23,468,610
April	13,097,141	7,885,030	20,982,171
May	5,948,461	10,806,981	16,755,442
June	11,221,243	3,733,241	14,954,484
	$ 63,152,138	$ 36,743,995	$ 99,896,133
Volume	Barrels: 1,870,406	Tons: 235,441	

Total value of barter transactions for the period from inception to 30 June 2005 was $561,104,764.

As these were non-cash transactions, no proceeds were deposited in the OPRA account, nor the DFI or the Compensation Fund.

3.2.5 Since September 2003, SOMO engaged in barter transactions for electricity and light petroleum products with the Government of Syria. The import of electricity ceased on 1 September 2004 and resumed in June 2005. The balance due to the Government of Syria, as calculated by SOMO, was $4,893,949 at 30 June 2005. The balance has not yet been confirmed by the Government of Syria at the date of this report.

(all amounts are in US dollars)

Exports of fuel oil from Iraq

3.2.6 We noted that export sales of fuel oil, as recorded by SOMO, decreased by 420,734 tons, from 1,091,702 tons for the period from 29 June 2004 to 31 December 2004 to 670,968 tons for the period from 1 January 2005 to 30 June 2005, or decreased by 972,369 tons when compared to the period from 1 January 2004 to 28 June 2004.

Period	**Cash**	**Barter**	**Total**
22 May 2003 - 31 December 2003	$ -	$ 94,602,158	$ 94,602,158
1 January 2004 - 28 June 2004	9,943,362	137,693,562	147,636,924
29 June 2004 - 31 December 2004	48,400,537	74,158,210	122,558,747
1 January 2005 - 30 June 2005	88,739,895	36,743,995	125,483,890
	$ 147,083,794	$ 343,197,925	$ 490,281,719
	Tons	*Tons*	*Tons*
22 May 2003 - 31 December 2003	-	1,086,280	1,086,280
1 January 2004 - 28 June 2004	94,139	1,549,198	1,643,337
29 June 2004 - 31 December 2004	332,458	759,244	1,091,702
1 January 2005 - 30 June 2005	435,527	235,441	670,968
	862,124	3,630,163	4,492,287

The estimated sales value of the decrease in export sales is approximately $79,000,000 when compared with the period from 29 June 2004 to 31 December 2004, or $182,000,000 when compared with the period from 1 January 2004 to 28 June 2004. The estimated sales value of the decrease was calculated using an average price per ton for fuel oil export sales for the current period.

We requested but were not provided with access to complete accounting and shipping records for fuel oil at the Ministry of Oil.

Internal control systems

3.2.7 In the absence of a fully operational metering system and continued sabotage of the pipelines, it is not possible to determine the volume of all exports of petroleum and petroleum products, for which proceeds are to be deposited in the OPRA account.

Due to weaknesses in the internal control systems, we could not extend our procedures sufficiently to quantify such amounts.

(all amounts are in US dollars)

4 Testing over the export sales of petroleum and petroleum products

For all export sales of petroleum and for a sample of export sales of petroleum products covering 51% (by value), we performed the following procedures:

4.1 Procedure

We determined whether the key internal controls, noted in section 2, for the bidding on, and awarding of, contracts to which the sale related were applied.

Findings

4.1.1 There were no sales of Kirkuk petroleum for the period from 1 January 2005 to 13 June 2005. We were informed by SOMO that this was due to pipeline sabotage. Sales resumed on 14 June 2005.

4.1.2 We found that all export sales of petroleum and petroleum products were made through short-term or medium-term contracts. However, as from 1 July 2005, export sales of Kirkuk petroleum resumed through a bidding process.

4.1.3 We found that during the period from 1 January 2005 to 30 June 2005, 253,790,394 barrels of Basra petroleum and 1,608,304 barrels of Kirkuk petroleum were sold through exports.

4.1.4 We found that export sales of Basra petroleum were made through medium-term contracts to international end-users and oil traders and that export sales of Kirkuk petroleum were sold through short-term contracts to international end-users only. SOMO's customers for Basra and Kirkuk petroleum for the period from 1 January 2005 to 30 June 2005 were as follows:

BP Oil International	Petro Diamond Company
China Int'l United Petroleum & Chemicals	Petrobras Int'l Finance Company
China National United Oil Corporation	Petrogal S.A Lisbon
Compania Espanola de Petroleos	Reliance Industries
Chevron Texaco	Repsol YPF Trading and Transporte
Chinese Petroleum Corporation	SK Corporation
Conoco Philips (U.K)	Shell Int'l Trading and Shipping Company
Eni S.P.A. Refining and Marketing Division	Sinochem Int'l Oil (London) Co.
Exxon Mobil Sales and Supply Corp.	Syrian Oil Marketing Organization
Hindustan Petroleum Corporation	Taurus Petroleum
Indian Oil Corporation	Total International
Koch Supply & Trading LP	Thai Petrochemical Industry Public Company
Marathon Ashland Supply	Turkish Petroleum Refineries Corp
North Atlantic Refining (Bermuda)	Valero Marketing & Supply Co.

4.1.5 We found that Basra and Kirkuk petroleum were sold based on PLATTS pricing in accordance with SOMO's OSP for the scheduled month of loading.

4.1.6 We found that the OSP for the petroleum bartered with the Government of Syria was calculated using a monthly average of Brent dated as quoted in PLATTS daily publications during the calendar month of loading, less discounts for overhead costs, quality differential and transportation costs.

The discount for overhead costs was $1.25 per barrel for the period from 1 January 2005 to 30 June 2005. The discount for quality differential between Syrian heavy crude oil and Brent dated, and transportation costs to European destination, as communicated by the Government of Syria to its customers, was $16 per barrel in January and February 2005; $14.5 in March 2005; $14.3 in April 2005; $13.3 in May 2005 and $12 in June 2005.

We were informed by SOMO that petroleum bartered with the Government of Syria originates from the oil field Ain Zala, which contains heavy crude oil similar to Syrian oil fields.

4.2 Procedure

We observed whether the contract and sales invoice were signed and approved by an authorized person in accordance with SOMO policies and procedures. We additionally observed that contracts were approved by the Minister of Oil.

Findings

4.2.1 SOMO does not have a formal, written delegation of authority or a list of signatories. We found that all contracts and sales invoices were signed and authorized by a member of SOMO's senior management. We also noted that all contracts were approved by the Minister of Oil or, in exceptional cases, by his Deputy.

4.3 Procedure

We 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.

Findings

4.3.1 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 required documentation.

4.3.2 We noted that SOMO General Terms and Conditions state that demurrage claims should be compensated. We found that the demurrage claims were deducted against proceeds from subsequent export sales.

Final settlement of demurrage claims against SOMO relating to export sales of crude oil during the period from post-hostilities to 30 September 2004, was set at 75% of the amount incurred, as calculated by SOMO. As from 1 October 2004, demurrage claims were settled at 100% of the amount incurred, as calculated by SOMO.

Demurrage claims, as calculated by SOMO, relating to export sales of crude oil for the period from inception to 30 June 2005 amounted to $25,919,240. Demurrage claims of $16,462,191 were deducted against proceeds received during the period from 1 January 2005 to 30 June 2005 and, as at 30 June 2005, $9,289,432 remains to be deducted.

4.4 Procedure

We recalculated the OSP, by reference to PLATTS publications, for each lift and compared to the price per the invoice.

Findings

4.4.1 We found that the OSP, including discounts for quality differential from the benchmarks and transportation costs, for petroleum were distributed to customers on a monthly basis, by the 10th day of the month preceding the month of loading.

4.4.2 For all export sales of petroleum and for our sample of export sales of petroleum products, we found that the price per the invoice agreed to the OSP when recalculated using PLATTS quotations.

4.4.3 We found that a discount of $0.10 per barrel of petroleum was granted to customers who lifted from Khor Al-Amaya Oil Terminal. However, as from 1 April 2005, SOMO ceased this practice, as the Khor Al-Amaya Terminal was declared officially fully operational.

4.4.4 Based on our sample tested, we found that the pricing policy for the export sales of petroleum products was as follows:

We found that for export sales of fuel oil, a substantial discount is offered on the PLATTS quotations to entice purchasers to collect the fuel oil within Iraq and to ensure that the production of refined oil products is not interrupted.

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We also found that discounts for fuel oil were published on a monthly basis for all customers, and approved by the Minister of Oil. Discounts were based on several factors, including security constraints in Iraq, quality of the fuel oil, forms of transportation and distances, and overhead costs for barter and cash transactions.

Furthermore, we found that OSPs for export sales of fuel oil through vessels and trucks were calculated as follows:

- Iraqi southern border: monthly average of PLATTS quotations for the month of lifting or five quotations around the bill of lading, using FOB Arab Gulf HSFO 180 CST quotation, less a discount of $18 to $25 per ton FOB Khor Al-Zubair terminal, or $50 per ton FOT Bayji and Dora.

- Iraqi western border: monthly average of PLATTS quotations for the month of lifting using FOB Med Italy 3.5% sulfur fuel oil quotation, less a discount of $65 per ton FOT Bayji.

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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 2005 to 30 June 2005. 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 2005 to 30 June 2005, with our audit report issued thereon on 29 September 2005. We expressed a qualified audit opinion on the completeness of cash receipts, as also noted in our findings in section 3.2.2. We further expressed a qualified audit opinion on the completeness of export sales of petroleum and petroleum products, as also noted in our findings in sections 3.2.6 and 3.2.7. Furthermore, we expressed a qualified audit opinion on the completeness and accuracy of contractual commitments.

This report is intended solely for the information and use of the Government of Iraq and the International Advisory and Monitoring Board of the Development Fund for Iraq, 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.

Baghdad, Iraq
29 September 2005

KPMG

Development Fund for Iraq
Agreed-Upon Procedures
in connection with Export Sales
For the period from 1 January 2005 to 30 June 2005

Appendix A

In accordance with the engagement letter issued on 16 July 2005, the procedures to be applied to the export sales of petroleum and petroleum products are as follows:

1. Document the key internal controls, employed by the Ministry of Oil and SOMO, over the recording of revenue from the export sales of petroleum and petroleum products (export sales) extracted from the ground, and subsequent cash deposits in the DFI.

2. Document the key internal controls, employed by the Ministry of Oil and SOMO, over the bidding on, and awarding of, export sales contracts.

3. Obtain from SOMO:

   3.1 A list of export sales for the period from 1 January 2005 to 30 June 2005, and agree the list of export sales to SOMO's sales ledger; and

   3.2 Agree the list of export sales to the amounts deposited in FRBNY.

4. For all recorded or known contracts of export sales of crude oil and for a selected sample of export sales of petroleum products (scope: to be determined at a future stage):

   4.1 Determine whether the internal control procedures, noted in point 2 above, for the bidding on and awarding of the contracts to which the sale related were followed;

   4.2 Observe that contracts and sales invoices were signed and approved by an authorized person in accordance with SOMO's policies and procedures, and approved by the Minister of Oil or his Deputies;

   4.3 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; and

   4.4 Recalculate the Official Selling Price, by reference to the PLATTS publications, for each lift and compare the price to the invoice, and report any deviations noted.