Development Fund for Iraq

Report of Factual Findings
in connection with Export Sales

For the period from 29 June 2004 to 31 December 2004

KPMG Bahrain
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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 29 June 2004 to 31 December 2004. 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* 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 Appendix A, either for the purpose for which this report has been requested or for any other purpose.

Development Fund for Iraq
Report of Factual Findings
in connection with Export Sales
For the period from 29 June 2004 to 31 December 2004
(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 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 Government of Iraq continued the policy of engaging international security companies and local tribes to guard the pipelines and installations against sabotage.

1.1.6 A budget to replace, repair and calibrate the metering system on the pipeline network has been approved by the Ministry of Oil. As at the date of this report, we were informed by the Ministry of Oil that a tender for this metering system is ongoing.

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

1.1.8 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 were also entered into with the Government of Syria.

1.1.9 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.

1.1.10 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.

1.1.11 For each shipment, SOMO is to perform a matching process among 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

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. For Basra light oil, SOMO has a policy of selling primarily to end-users, 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 line) for North 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 North American destinations, is required to be calculated using an average of PLATTS quotations, for five consecutive days 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 Discounts for quality differential from the benchmarks and transportation costs are 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 discounts.

Kirkuk

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

2.1.5 For the period from 1 September 2004 to 31 December 2004, SOMO changed its Kirkuk 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. There were no sales of Kirkuk petroleum for the period from 29 June 2004 to 31 August 2004, due to pipeline sabotage.

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

2.1.6 SOMO's OSP for Kirkuk 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 days 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 29 June 2004 to 31 December 2004, 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 29 June 2004 to 31 December 2004.

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, which also includes nominated vessels.

3.1.4 We found that during the period from 29 June 2004 to 31 December 2004, SOMO held contracts with 30 customers for export sales of petroleum (see 4.1.2).

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 29 June 2004 to 31 December 2004, were as follows:

	Petroleum	Petroleum Products	Total
LCs	$ 9,444,220,019	$ 820,080	$ 9,445,040,099
Cash received	-	77,724,019	77,724,019
Barter transactions	60,567,275	74,161,423	134,728,698
	$ 9,504,787,294	$ 152,705,522	$ 9,657,492,816

The amount of export sales of petroleum made through LCs includes interest receipts of $44,368 for delayed bank transfers, and is net of demurrage claims paid of $4,919,376.

(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 and petroleum products for the period from 29 June 2004 to 31 December 2004, 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:

29 June 2004 to 31 December 2004	$ 8,118,513,333
Subsequent to 31 December 2004	1,326,526,766
	$ 9,445,040,099

3.2.2 We found LCs amounting to $1,581,328 issued in early 2004 for exports sales of fuel oil, to the Far East market, are still outstanding as at the date of this report. We were informed by the CBI that documentation required under the LC terms was issued to the correspondent bank subsequent to the LCs deadline. Payment has been refused by the correspondent bank and the customer. SOMO is pursuing these funds.

Cash

3.2.3 We found that cash advances received for, and proceeds of, export sales of petroleum products during the period from 29 June 2004 to 31 December 2004 amounted to $77,724,019 (from inception (22 May 2003) to 31 December 2004: $97,762,019), were not deposited into the OPRA account, nor the DFI or the Compensation Fund, in accordance with UNSCR 1483. These funds were deposited in two Iraqi bank accounts and one Jordanian bank account controlled by SOMO.

During the period from 29 June 2004 to 31 December 2004, SOMO transferred $24,178,478 (from inception to 31 December 2004: $24,178,478) to the Ministry of Oil. The balance of the SOMO bank accounts as at 31 December 2004 is $73,583,542 (28 June 2004: $20,038,000), including prior period transactions.

Barter transactions

3.2.4 We found that SOMO engages in barter transactions for exports of petroleum and petroleum products. These barter transactions consist mainly of exports of residual 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)

3.2.5 The value and volume of these barter transactions for the period from 29 June 2004 to 31 December 2004, as recorded by SOMO, were as follows:

	Petroleum	**Petroleum Products**	**Total**
June (2 days)	$ -	$ 1,530,539	$ 1,530,539
July	3,752,480	18,870,442	22,622,922
August	12,927,992	26,271,013	39,199,005
September	12,392,100	19,433,261	31,825,361
October	14,758,982	3,314,018	18,073,000
November	9,477,494	2,161,282	11,638,776
December	7,258,227	2,580,868	9,839,095
	$ 60,567,275	$ 74,161,423	$ 134,728,698
Volume	Barrels: 2,125,681	Tons: 759,281	

The value of the barter transactions for the period from inception to 31 December 2004, was $461,208,631.

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

3.2.6 During the period from 29 June 2004 to 31 December 2004, the Ministry of Finance authorized a funding allocation of $1,150,000,000 to SOMO for the import of light petroleum products, commencing during August 2004. Accordingly, the volume of barter transactions decreased substantially, except for the aforementioned barter of crude oil with the Government of Syria.

3.2.7 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, but exports of crude oil to Syria continued. Regular reconciliations between crude oil and fuel oil exported and electricity and light petroleum products imported are performed by SOMO. The balance as at 28 February 2005 of $18,736,092, as calculated by SOMO, had not yet been confirmed to SOMO by the Government of Syria as at the date of this report. SOMO has requested this amount be paid to the DFI account at the FRBNY rather than through an exchange of products.

Unreconciled and unauthorized Exports from Iraq

3.2.8 We obtained from the Ministry of Oil a reconciliation of the quantity of fuel oil produced, consumed locally, injected into the pipeline and wells, and exported. We found that this reconciliation contained unreconciled quantities of 618,203 tons for the period from 29 June 2004 to 31 December 2004. Without an adequate explanation for the unreconciled quantities, the implication is that fuel oil produced was greater than that consumed locally, injected into the pipeline and wells, and exported by 618,203 tons.

Consistent with these unreconciled quantities, we noted that export sales of fuel oil, as recorded by SOMO, decreased by 561,596 tons, from 1,643,336 tons for the period from 1 January 2004 to 28 June 2004, to 1,081,740 tons for the period from 29 June 2004 to 31 December 2004. Furthermore, the recorded export sales of fuel oil from 1 October 2004 to 28 February 2005 have decreased from an average of 282,000 tons per month, for the period from 1 January 2004 to 30 September 2004, to less than 57,000 tons per month.

The estimated sale value of the unreconciled quantities is approximately $69,000,000, when calculated using an average price per ton for fuel oil export sales for the current period.

We were not provided with a satisfactory explanation for either the unreconciled quantities or sales decrease of fuel oil.

3.2.9 The former CPA believed that an unknown quantity of petroleum and petroleum products was smuggled from Iraq, bypassing the authorized processes of marketing, sales and cash collection. Despite internal controls put in place by the Ministry of Oil, SOMO and the former CPA, the Government of Iraq believes that in the absence of a fully operational metering system, 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.

It was not practicable for us to 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 62% (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 We found that a bidding process was not used for the sale of petroleum and petroleum products.

4.1.2 We found that export sales of Basra petroleum were sold 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 29 June 2004 to 31 December 2004 were as follows:

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

Export sales for API Oil and Bay Oil related to quantities allocated during the period from 1 January 2004 to 28 June 2004, which were lifted in early July 2004 due to security constraints surrounding the transfer of authority to the Government of Iraq. API Oil and Bay Oil were not granted petroleum allocations during the current period.

4.1.3 We found that during the period from 29 June 2004 to 31 December 2004, 260,016,218 barrels of Basra petroleum and 20,516,318 barrels of Kirkuk petroleum were sold.

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

4.1.5 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 two discounts for quality differential, and transportation and overhead costs.

This discount changed from $6 per barrel for the period from inception to 31 July 2004, to $1.25 per barrel for overhead costs, plus a further discount for quality differential between Syrian heavy crude oil and Brent dated, and transportation costs to European destination ($12 in August, $12.5 in September, $14 in October, and $17 in November and December 2004), as communicated by the Government of Syria to its customers, for the period from 1 August 2004 to 31 December 2004.

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 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 a member of SOMO's senior management. We 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 We found one case where the value of an invoice had been incorrectly calculated based on provisional documentation resulting in a customer being under-charged by $400,191. As a result of our finding, SOMO has subsequently issued an invoice to the customer and proceeds have been deposited in the OPRA account.

4.3.2 For all other 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 requisite documentation.

4.3.3 We noted that SOMO General Terms and Conditions state that demurrage claims should be compensated, in line with common industry practice. Historically, SOMO has responded to demurrage claims on a limited basis. However, as a reaction to customer pressure, an oversupply of medium/heavy sour petroleum, a strong market for light petroleum products and increasing prices for petroleum and petroleum products during the period from 29 June 2004 to 31 December 2004, SOMO had commenced paying demurrage claims.

Final settlement of demurrage claims against SOMO has been set at 75% of the amount incurred, as calculated by SOMO, during the period from post-hostilities to 30 September 2004.

SOMO has calculated demurrage claims amounting to $10,730,842, which are to be deducted against subsequent invoices for export sales. Of these claims, $167,617 has been deducted against proceeds received in 2004, $4,751,759 has been deducted from proceeds received in 2005 for export sales of 2004, and $5,811,466 is to be deduced against future export sales.

SOMO informed its customers that as of 1 October 2004, it intends to carry out a prompt evaluation of demurrage claims received. Additional demurrage claims were received, and are currently being evaluated by SOMO.

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 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. Lifting from Khor al Amaya Oil Terminal is subject to technical limitations, and cargos are limited to 1,000,000 barrels per vessel due to draught constraints. However, as from 1 April 2005, SOMO ceased this practice, as the Khor al Amaya Terminal was declared 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.

We also found that discounts for fuel oil were published on a monthly basis for all customers lifting their quantities by truck, as 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 for barter and cash transactions. These discounts were $25 per ton FOB Khor Al Zubair terminal and varied from $65 to $88 per ton FOT Iraqi refineries.

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

Iraqi northern 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 to $88 per ton FOT Baiji, Dora and Kasak.

Iraqi southern border: monthly average of PLATTS quotations for the month of lifting or 5 day around the bill of lading, using FOB Arab Gulf HSFO 180 CST quotation, less a discount of $25 per ton FOB Khor Al Zubair terminal, or $65 per ton FOT Baiji 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 Baiji.

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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 29 June 2004 to 31 December 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 29 June 2004 to 31 December 2004, with our audit report issued thereon on 6 April 2005. We expressed a qualified audit opinion on the completeness of cash receipts, as also noted in our findings in section 3.2.3. 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 3.2.8 and 3.2.9. 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.

Manama, Kingdom of Bahrain
6 April 2005

KPMG

Development Fund for Iraq
Agreed-Upon Procedures
in connection with Export Sales
For the period from 29 June 2004 to 31 December 2004

Appendix A

In accordance with the engagement letter issued on 13 December 2004, 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 Government of Iraq and SOMO, over the capture 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 Government of Iraq and SOMO, over the bidding on, and awarding of, export sales contracts.

3. Obtain from SOMO:

    3.1 A list of export sales, and agree the list of export sales to SOMO's sales ledger;

    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;

    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;

    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.