

DEVELOPMENT FUND FOR IRAQ

Report of Factual Findings

In Connection With Oil Export Sales

For the Year Ended 31 December 2006



Private and confidential

2nd April 2007

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

REPORT OF FACTUAL FINDINGS - OIL EXPORT SALES

We have performed the procedures agreed with you and set out in Appendix A of the attached report with respect of export sales of petroleum and petroleum products of the Development Fund for Iraq. Our engagement was undertaken in accordance with International Standard on Related Services (ISRS) No. 4400, engagement to perform agreed-upon procedures regarding financial information. The procedures were performed solely to assist the International Advisory and Monitoring Board (IAMB) and the Government of Iraq in evaluating the Development Fund for Iraq's compliance with United Nations Security Council Resolution (UNSCR) 1483 paragraph 20 and 21, for the year ended 31 December 2006. The Government of Iraq is responsible for the Development Fund for Iraq's compliance with UNSCR 1483.

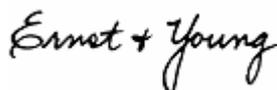
We have reported our findings in sections 1 to 4 in the attached report.

Because the procedures, which are detailed in Appendix A to this report, do not constitute 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.

Had we performed additional procedures or had we performed an audit or review made in accordance with International Standards on Auditing or International Standards on Review Engagements, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for the information of IAMB and the Government of Iraq and is not to be used for any other purpose or to be distributed to any other parties. We do not accept or assume responsibility for any other purpose or to any other person who may receive this agreed upon procedures report. This report relates only to the accounts and items specified in Appendix A of the attached report, and does not extend to any financial statements of the Development Fund for Iraq taken as a whole.

Yours faithfully
Ernst & Young



Baghdad, Iraq

1 KEY INTERNAL CONTROLS OVER THE RECORDING OF EXPORT SALES

1.1 PROCEDURE

We documented the key internal controls employed by the Ministry of Oil and the Oil Marketing Company (SOMO), the sales arm of the Ministry of Oil over the capture of revenue from export sales of petroleum and petroleum products and subsequent cash deposits in the Development Fund for Iraq (DFI).

KEY INTERNAL CONTROLS

- The former Coalition Provisional Authority (CPA) issued Order Number 36, Regulation of Oil Distribution, on October 3, 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 policy of the Government of Iraq is to engage international security companies and local tribes to guard the pipelines and installations against sabotage.
- There is segregation of duties between the extracting, refining and sales of petroleum and petroleum products functions, as each function is performed by a separate company related to the Iraqi Ministry of Oil.
- Export sales of petroleum and petroleum products are required to be exclusively arranged and invoiced by SOMO.
- SOMO maintains a spreadsheet to track vessels movements to ensure that, for all lifted petroleum, vessels were nominated and authorized, were loaded in accordance with contractual provisions; an invoice raised; and the Letter of Credit opened at the Central Bank of Iraq (CBI).
- 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 Syrian Government.
- For each shipment of petroleum, the customer opens a letter of credit, which should be accepted and confirmed by the CBI seven days prior to the scheduled shipping date. The customer should deposit the total amount of the invoice directly into the Oil Proceeds Receipts Account (OPRA) at the Federal Reserve Bank of New York (FRBNY) no later than thirty days from the date of the Bill of Lading.
- SOMO's policy for export sales of petroleum products is to sell primarily through cash advance payments, letters of credit and barter transactions.
- To ensure that all shipments are appropriately invoiced, SOMO performs a matching process of Bills of Lading, Certificates of Quantity and Quality, Ullage Reports, Export Cargo Manifests and Master Receipts against invoices raised for each shipment of export sales of petroleum.

OTHER CONTROLS NOTED

- For each scheduled shipment of export sales of petroleum, a Loading Card is opened by SOMO's shipping department to ensure that scheduled shipments do not commence until SOMO's finance department receives a copy of the opened letter of credit from the Central Bank of Iraq (CBI) and confirms that the contractual requirements relating to the letter of credit are met.
- The loading of each vessel is made by the North and South Oil Companies based on the approved loading schedules received from SOMO's shipping department.
- SOMO's shipping department checks the Bills of Lading, Certificates of Quantity and Quality, Ullage Reports, Export Cargo Manifests and Master Receipts, which are prepared by the oil production companies for each shipment, to the approved loading schedule.
- SOMO's shipping department then compares these documents with the approved loading schedule and documents the actual loaded quantities on the opened loading card.
- SOMO's finance department checks the loaded quantity reported in the Loading Card prepared by the shipping department and to the related supporting documents.
- SOMO's finance department then calculates the price of each shipment based on the monthly approved Official Selling Price (OSP) and documents this calculation in the Loading Card and the Access database.
- For each shipment of export sales of petroleum, SOMO's marketing department checks and approves the price used in the Loading Card.
- Based on the approved price in each Loading Card, SOMO's finance department prepares the sales invoices, which are approved by the Finance Manager before being issued to the customers.
- To ensure that all shipments are properly accounted for and invoiced on time, SOMO's finance department prepares a daily report of the shipments that have not been invoiced yet.

FINDINGS

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

2 KEY INTERNAL CONTROLS OVER THE BIDDING AND AWARDING PROCESSES

2.1 PROCEDURE

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

KEY INTERNAL CONTROLS

BASRA LIGHT OIL

- SOMO's policy is to sell Basra light oil through medium-term contracts (six months), primarily to well-known international oil companies, with a limited number sales being made to reliable oil traders. All contracts are to be approved by the Minister of Oil.
- 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: West Texas Intermediate (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.
- The OSP, including discounts for quality differential from the benchmarks and the 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 approves the monthly price differential and SOMO's General Manager approves the monthly transportation costs.

KIRKUK PETROLEUM

- Due to continuous disruption of production by sabotage of Kirkuk's pipelines, SOMO initiates a bidding process as and when sufficient quantities of petroleum have been accumulated in Iraqi storage tanks in Turkey.
- For Kirkuk petroleum, SOMO has a policy of selling exclusively to end-users. All bids results are to be approved by the Minister of Oil.
- SOMO's OSP for Kirkuk petroleum is required to be calculated using one of the following international benchmarks based on the destination:
 - The OSP, for European destination, is required to be calculated using an average of Brent Dated PLATTS quotations, for five consecutive quotations starting from the date of the bill of lading.
 - The OSP, for American destination, is required to be calculated using an average of WTI (first month) PLATTS quotations, for five consecutive quotations starting on the 15th day from the date of the bill of lading.
- During the year ended 31 December 2006, SOMO had five bid announcements for Kirkuk petroleum that were announced in local and international publications.
- The bid awarding process was based on the best offered prices and past performance, the customer being selected by a bidding committee and approved by SOMO's General Manager and the Minister of Oil.

PETROLEUM PRODUCTS

- SOMO's policy is to sell petroleum products through bidding process, with the bids usually being announced in local and international publications.
- SOMO's policy is to sell petroleum products through short term contracts (from one to three months). All contracts are to be approved by the Minister of Oil.
- As part of the segregation of duties control, separate opening and awarding committees were formed by SOMO's General Manager. The opening committee opens and documents the received offers, while the awarding committee reviews the bid documents and raises recommendations to SOMO's General Manager and the Minister of Oil.
- The awarding process was based on the buyers past performance and best offered prices and approved by SOMO's General Manager
- The price for each shipment is required to be calculated based on international benchmarks depending on the shipment terminal.

FINDINGS

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

3 RECONCILIATION OF EXPORT SALES LIST TO SOMO's SALES LEDGER AND AMOUNTS DEPOSITED INTO THE FRBNY

3.1 PROCEDURE

We obtained from SOMO a list of export sales of petroleum and petroleum products for the year ended 31 December 2006 and we agreed the total of the list to SOMO's sales ledger.

FINDINGS

- We found that no export sales of natural gas took place in Iraq for the year ended 31 December 2006, due to the absence of infrastructure for the export of natural gas.
- We found that SOMO does not have accounting and financial reporting software to maintain the accounting records of the export sales; instead an internally developed Access database is being used.
- We found that SOMO does not properly prepare and document the reconciliation of its export sales records with the sales proceeds deposited into OPRA on a monthly basis.
- We found that the total export sales and barter transactions of petroleum and petroleum products for the year ended 31 December 2006 according to SOMO's records, were as follows:

	U.S. \$		
	Export Sales	Barter	Total
Petroleum	30,397,043,684	168,230,355	30,565,274,039
Petroleum Products	647,651,302	7,307,126	654,958,428
Total	31,044,694,986	175,537,481	31,220,232,467

- We found that the total amount of detailed export sales list of petroleum and petroleum products agreed to SOMO's sales subsidiary ledger as of 31 December 2006.
- We found that in the accounting records/trial balance of SOMO the exchange rate used for one U.S. Dollar as of 31 December 2006 was one Iraqi Dinnar (IQD), while the market rate was IQD 1331 : U.S. Dollar 1. However, SOMO's export sales subsidiary ledgers and list of sales are maintained in U.S. Dollars.
- We found that total petroleum export sales from Basra and Kirkuk terminals during the year ended 31 December 2006 according to SOMO's records, was as follows:

Terminal	Export Sales U.S. \$	Number of Barrels
Basra	29,731,962,683	535,761,699
Kirkuk	665,081,001	10,440,812
Total	30,397,043,684	546,202,511

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- We found that total export sales of petroleum products during the year ended 31 December 2006 according to SOMO's records, was as follows:

Terminal	Export Sales U.S. \$	Number of Tons
Khour Al-Zubair	567,174,088	1,984,839
Baiji	69,676,850	368,460
Dorreh	10,800,364	47,477
Total	647,651,302	2,400,776

3.2 PROCEDURE

We compared SOMO's list of export sales for the year ended 31 December 2006 to the amounts deposited into OPRA account held at the FRBNY.

FINDINGS

Petroleum

- We found that proceeds from export sales of petroleum during the year ended 31 December 2006 were made through letters of credit. All proceeds were collected within approximately 30 days from the date of Bill of Lading and in accordance with the letter of credit provisions.
- We reconciled the list of petroleum export sales for the year ended 31 December 2006 as stated in SOMO's records to the amounts deposited into OPRA at the FRBNY as follows:-

	<u>Note</u>	<u>U.S. \$</u>
List of petroleum export sales per SOMO's records		30,397,043,684
Add:		
December 2005 export sales collected during January 2006	I	1,499,735,920
Interest on delayed payments	II	369,611
Less:		
December 2006 export sales collected during January 2007	I	(2,068,606,201)
Deducted demurrage from export sales invoices	III	(16,017,454)
Seized amount by Court of Roma *	IV	<u>(10,886,400)</u>
Deposits at OPRA account per CBI's records		29,801,639,160
Deposit at OPRA not included in SOMO's records	V	<u>5,000,000</u>
Deposits at OPRA per FRBNY confirmation		<u>29,806,639,160</u>

- I. We found that proceeds from export sales of petroleum for 2006 were deposited into OPRA approximately 30 days after the lifting, in accordance with the terms of LCs. As a result, there is an amount of U.S. \$ 1,499,735,920 related to December 2005 export sales of petroleum deposited into OPRA during January 2006, and an amount of U.S. \$ 2,068,606,201 related to December 2006 export sales of petroleum deposited into OPRA during January 2007.
- II. This amount represents received interest for delayed bank transfers.
- III. This amount represents deducted demurrage from export sales invoices as a result of the buyers' vessels remaining in port beyond the number of days allowed for the purpose of loading as per contractual terms.
- IV. This amount was seized based on Court of Roma – Italy seizure order on 23 March 2006 as a result of a lawsuit against the Iraqi Ministry of Planning. The Government of Iraq is following up the collection of this amount and believes that the court order violates UNSCR 1483.

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V. This amount is recorded in the OPRA statement of accounts at the FRBNY, while it does not appear on SOMO's records. The amount was erroneously deposited on 10 October 2006 in the OPRA instead of the CBI account at the FRBNY. Later during 2007, the amount was transferred to the CBI account at the FRBNY.

- We further found that SOMO does not properly prepare and document the reconciliation of its records of export sales of petroleum with CBI's statement of account on a monthly basis.
- We reconciled the total quantity of export sales of petroleum as stated in SOMO's records with the total quantity per the lists received from the South and North Oil Companies for the year ended 31 December 2006 as follows:-

Port	Oil Production Figures / Barrels	SOMO Figures / Barrels	Difference
Basra	537,352,698	535,761,699	1,590,999
Kirkuk	10,440,812	10,440,812	-
Total	547,793,510	546,202,511	1,590,999

- As shown in the above table, there is a difference of 1,590,999 Barrels between SOMO's records and the South Oil Company. We requested but did not receive clarification from SOMO of the above reported difference.
- We further found that the quantities per the lists received from the Oil Production Companies have not been evidenced as having been reviewed by SOMO.
- We found that the proceeds from export sales of petroleum made through LCs is net of demurrage claims of U.S. \$ 16,017,454 deducted from export sales invoices during the year ended 31 December 2006 as follows:

Demurrage deducted during 2006:	U.S. \$
Deducted amount against 2006 export sales	15,633,089
Deducted amount against 2005 export sales	384,365
Total	16,017,454

- We further found that the proceeds from December 2006 export sales of petroleum made through LCs is net of demurrage claims of U.S. \$ 1,485,067 deducted from proceeds deposited into OPRA during January 2007.

Petroleum Products

- We found that SOMO's policy for export sales of petroleum products is to sell primarily through cash advance payments, except for a limited number of sales through letters of credit and barter transactions.
- We found that cash advances received for, and proceeds of, export sales of petroleum products during the year ended 31 December 2006 amounted to U.S. \$ 638,192,881 as recorded in SOMO's accounting records.

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- The export sales of petroleum products, excluding barter transactions, during the year ended 31 December 2006 according to SOMO's records were as follows:

	<u>U.S. \$</u>
Export sales of petroleum products	647,651,302
Total proceeds deposited into local banks	<u>638,192,881</u>
Difference	<u>9,458,421</u>

- As shown in the above table there is unreconciled difference of U.S. \$ 9,458,421 between the total sales and total collections during the year. We requested but did not receive a reconciliation or analysis of this difference.
- We found that the total proceeds of U.S. \$ 638,192,881 were not deposited into OPRA in accordance with UNSCR 1483, with the funds being deposited into SOMO banks accounts at the Trade Bank of Iraq and Al-Rafidain Bank Baghdad and Amman branches.
- We found that SOMO does not properly prepare monthly reconciliations for its banks accounts. The reconciliations have only been prepared at year-end, except for the account at Al-Rafidain Bank Amman Branch.
- We found that there are significant old and recent pending reconciling items in SOMO's bank reconciliations. The total reconciling items in the debit side amounted to U.S. \$ 2,942,065,802 and in the credit side amounted to U.S. \$ 1,626,209,450 as of 31 December 2006.
- We found that the Iraqi Ministry of Electricity engaged with KARTET KARADENIZ TOPTAN ELEKTRIC COMPANY (the "Turkish company") for exporting of petroleum products in exchange for electricity. According to the signed agreement dated 14 January 2004, between SOMO and the Turkish company, SOMO will charge U.S. \$ 27 per ton of export sales to the Turkish company and the remaining balance (the difference between the U.S. \$ 27 and the Official Selling Price) shall be charged to the Iraqi Ministry of Electricity.
- The following is a summary of the export sales of petroleum products to the Turkish company for the year ended 31 December 2006 according to SOMO's records, which are not reconciled with the Turkish company:

	<u>U.S. \$</u>
Charges to the Turkish company (fully paid during 2006)	5,350,741
Charges to the Iraqi Ministry of Electricity	<u>34,397,236</u>
Total export sales of petroleum products	<u>39,747,977</u>

- We found that the total amount due from the Iraqi Ministry of Electricity to SOMO as of 31 December 2006, as consequence to the agreement with the Turkish company, is U.S. \$ 34,397,236. The Ministry of Electricity did not pay the amount due to SOMO until the end of 2006. Also, there is no confirmation or statement of account from the Ministry of Electricity.

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- According to the signed agreement between SOMO and the Turkish company, the maximum quantity that can be exported to the Turkish company at U.S. \$ 27 per ton is 30,000 ton per month, and any additional quantities should be totally charged to the Turkish company. However, during April 2006, SOMO exported 51,387 ton to the Turkish company and charged them only U.S. \$ 27 per ton and the difference was charged to Ministry of Electricity.
- From SOMO point of view, the arrangement with the Turkish company is not considered barter transactions as SOMO receives part of the value of the sales from the Turkish company and the remaining is charged to the Iraqi Ministry of Electricity.
- We found that SOMO does not obtain from the Turkish company a certificate of discharge on a monthly basis to confirm the received quantity as stated in the signed agreement.
- Also we found that SOMO signed an agreement with Jordan Petroleum Refinery Company on 23 October 2006 for exporting a minimum of 30,000 barrel of petroleum per day. We understood that, due to the security situation in Iraq, no exports of petroleum to the Jordanian Company were carried out during 2006. According to the signed agreement, the exported price shall be calculated using a monthly average of PLATTS quotation for Brent during the calendar month of loading less a discount of U.S. \$ 18 per barrel.

Barter Transactions

- We found that on 5 January 2006 SOMO renewed the barter agreement with the Syrian Government for the exports of petroleum and petroleum products. Barter transactions were mainly in the form of exporting petroleum in exchange for electricity and petroleum products, and exporting fuel oil in exchange for petroleum products.
- We found that, as barter transactions are non-cash transactions, no cash was deposited into OPRA or the DFI's account and Compensation Fund.
- We reconciled the total barter transactions with the Syrian Government for the year ended 31 December 2006 from SOMO's records as follows:

	<u>U.S. \$</u>
Due from Syrian Government as of 1 st January 2006	18,325,999
Adjustments related to prior period	*(258,698)
Imports:	
Petroleum products	(101,279,959)
Exports:	
Crude oil	168,230,355
Fuel oil	7,307,126
Due from the Syrian Government as of 31 December 2006	** 92,324,823

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* This amount is related to differences arising from the measurement of quantities of barter transactions during 2005 and have been approved during 2006 by a committee appointed by the Ministry of Oil.

** This amount represents the due amount from the Syrian Government as of 31 December 2006 according to SOMO's records; however, this amount is neither confirmed by, nor reconciled with the Syrian Government.

- According to the signed agreement between SOMO and the Syrian Government, the two parties should meet on a monthly basis to settle the outstanding amount due to each party. However, such meetings were not held on a monthly basis and no final reconciliation has been prepared for 2006.
- Also according to the signed agreement, when the amount due from the Syrian Government exceeds U.S. \$ 10 million for more than three months, a cash payment covering 75% of the due amount should be transferred to the other party. However, during the period, the amount due from the Syrian Government exceeded U.S. \$ 10 million for more than three months and no cash transfer was received during 2006.
- We found that the price of petroleum export sales of the barter agreement with the Syrian Government is determined based on Syrian petroleum prices, less a discount for overhead costs stated at U.S. \$1.25 per barrel, as obtained on monthly basis from the Syrian Oil Marketing Office. Syrian petroleum prices is determined using the arithmetic average of the means of high and low spot assessment of Brent Dated quotations as published in the PLATTS crude oil Marketwire for the scheduled calendar month of loading.
- We did not perform any procedures on the imports from the Syrian Government as this is not part of our scope of work.
- The following is a summary of the monthly barter exports to the Syrian Government during the year ended 31 December 2006 according to SOMO's records:

	U.S. \$		
	Petroleum	Petroleum Products	Total
January	-	-	-
February	-	1,244,393	1,244,393
March	-	128,291	128,291
April	8,490,419	173,740	8,664,159
May	20,716,477	-	20,716,477
June	21,838,195	-	21,838,195
July	25,397,342	-	25,397,342
August	23,921,676	1,206,880	25,128,556
September	16,082,253	3,875,426	19,957,679
October	17,278,656	678,396	17,957,052
November	17,512,528	-	17,512,528
December	16,992,809	-	16,992,809
	168,230,355	7,307,126	175,537,481

Internal Controls

- We found that there is no fully operational metering system and due to the 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.
- We found that there is no reconciliation prepared between the total quantity of petroleum extracted from producing wells with the total quantity of petroleum exported and delivered to local refineries and other local users.
- We found that there is no fully operational metering system at the local refineries, and it is not possible to determine the volume of petroleum delivered to the local refineries.
- Due to weaknesses in the internal control systems, we could not extend our procedures sufficiently to determine such volume.

4 TESTING EXPORT SALES OF PETROLUUM AND PETROLUUM PRODUCTS

For all export sales of petroleum and a selected sample of petroleum products covering 76% of total value of exported petroleum products, we performed the following:

4.1 PROCEDURE

We determined whether internal control procedures, noted in section 2 of this report, for the bidding on and awarding of contracts to which the sale related were followed.

FINDINGS

- We found that SOMO does not have formal documented policies and procedures for contract bidding and awarding of export sales approved by the Government of Iraq.
- During the year ended 31 December 2006, we found that SOMO did not initiate contract bidding procedures for export sales of petroleum, except for Kirkuk's export sales.
- We found that the minutes of meetings of petroleum and petroleum products awarding committee were not fully and formally documented.
- We found that a list of contracts awarded was signed by SOMO's General Manager and approved by the Minister of Oil.
- We found that SOMO used past performance and international reputation of the existing customers as the main criteria for awarding process. However, there were no performance analysis and due diligence performed to ensure the competence of the selected companies.
- According to SOMO standard export sales of petroleum contracts, the shipment destination is predetermined in the contract and any change in the destination shall be subject to SOMO prior approval.
- We found that there were 13 petroleum export sales contracts in which the customers had free shipment destination. In such cases, the OSPs billed to the customers were calculated based on the shipments destinations selected by the customers.

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- For the year ended 31 December 2006, we found that SOMO has signed contracts for export sales of petroleum for Basra and Kirkuk with the following customers:

Company Location	Company Name
North and South America	Exxon Mobil Sales and Supply Corp.
	Chevron Texaco Products Company
	Koch Supply & Trading Company LP
	ConocoPhillips International Inc.
	North Atlantic Refining (Bermuda) LTD
	Petrobras Int'l Finance Company
	Valero Marketing & Supply Co.

Europe	BP Oil International
	Shell Int'l Trading and Shipping Company
	Total International Limited
	Repsol YPF Trading Y Transporte, S.A.
	Eni S.P.A. Refining and Marketing Division
	Taurus Petroleum Limited
	Petrogal S.A Lisbon
	Compania Espanola de Petroleos
	Turkish Petroleum Refineries Corp
	ERG Raffinerie Medditerranean

Far East	Petro Diamond Company
	China Int'l United Petroleum & Chemicals
	China National United Oil Corporation
	Reliance Industries
	Chinese Petroleum Corporation
	SK Corporation
	Sinochem Int'l Oil (London) Co.
	Hindustan Petroleum Corporation
	Indian Oil Corporation
	Thai Petrochemical Industry Public Company

- We found that export sales of Basra petroleum were made through medium-term contracts to international end users and oil traders and export sales of Kirkuk petroleum were sold to international end users only.

4.2 PROCEDURE

We observed wither the contracts and sales invoices were signed and approved by an authorized person in accordance with SOMO policies and procedures, and approved by the Minister of Oil.

FINDINGS

- We found that SOMO does not have formal documented policies and procedures for the preparation, review and approval of sales invoices.
- We found that SOMO does not have a formal documented delegation of authority or approved list of authorized signatories.
- We found that the Minister of Oil rejected the proposed quantity for petroleum export sales contract number M/06/03. Later, SOMO sent a letter to the Minister of Oil asking to reconsider the proposed quantity; nevertheless the proposed quantity was approved by the Minister of Oil consultant, and we did not receive proper and documented delegation of authority from the Minister of Oil for such actions.
- We found that the Minister of Oil approved only 50% of the proposed quantity for petroleum export sales contract number M/06/26. Latter, SOMO sent a letter to the Minister of Oil asking to reconsider the proposed quantity; nevertheless the proposed quantity was approved by the Minister of Oil consultant. We did not receive a documented delegation of authority from the Minister of Oil for this approval.
- We found that sales invoices were signed by the Finance Manager, except for 80 sales invoices of petroleum and 56 sales invoice of petroleum product which were signed by other members of SOMO's senior management. We requested but were not provided with documented delegation of authority.
- We found that the finance department generates invoices using an internally developed Access database but serial numbers are entered manually.
- We found that for export sales of petroleum contracts number M/06/34 and M/06/13, the contracts were not signed by the buyers. The total export sales for each contract during the contract period were U.S. \$ 1,280,753,440 and U.S. \$ 311,215,026 respectively.
- We found that for certain contracts there was a delay on signing the export sales contract by the buyers for the first half of 2006, such as contract numbers M/06/18 and M/06/06, which were signed on April 4, 2006 and March 1, 2006 respectively, while the shipments commenced during February 2006.

4.3 PROCEDURE

We compared 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.

FINDINGS

- We found that for all recorded petroleum export sales and the tested sample of the recorded petroleum products, quantities and prices in the issued invoices agreed to Sales Contracts, Bills of Lading, Certificates of Quantity and Quality, Ullage reports, Export Cargo Manifests and Masters Receipts, except for the certain deviations as presented in this section.
- We found that SOMO does not obtain from its customers a certificate of discharge for each shipment to ensure the customers compliance with SOMO's contractual provisions.
- We found that there is no third party confirmation for receipt of shipments to ensure that all shipments are discharged to the intended destination in accordance with SOMO's contractual provisions.
- We found that petroleum export sales contracts state that SOMO has the right to receive verification of quantity and quality for each shipment from its customers but no such verification was obtained by SOMO.
- We found that Loading Cards, certificates of quantity and quality, Ullage reports and export cargo manifests do not have serial numbers and bills of lading are not pre-numbered.
- We found that SOMO does not have formally approved and documented procedures for demurrage claims.
- We found that demurrage payments are calculated by SOMO's marketing department, reviewed by SOMO's internal auditor and approved by the General Manager.
- We found that SOMO does not deduct demurrage claims from petroleum sales invoices until the customer provides written acceptance of SOMO's calculation.
- We found that the exported quantity per Export Cargo Manifest relating to invoice number B/2006/258 with total amount of U.S. \$ 113,158,362 does not match the exported quantity per sales invoice, as there was 194 Barrels difference. This resulted in the issued sales invoice being understated by U.S. \$ 10,967. We have requested but not received clarification from SOMO for this difference.

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- We found that two export sales invoices hold the same number B/2006/204 issued for two different buyers, with the first being issued on 29 June 2006 for the amount of U.S. \$ 60,554,515; and the other being issued on 30 July 2006 for the amount of U.S. \$ 124,144,667. We have been advised by SOMO's finance department that this was due to human error since the invoice number is entered manually.

4.4 PROCEDURE

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

FINDINGS

- We found that the OSP for petroleum, 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.
- 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, except for the following:
 - ✘ SOMO's finance department obtained the Minister of Oil approval to issue 7 export sales invoices of petroleum during December 2006 based on provisional prices, instead of actual prices, in order to avoid delay in issuing the invoices and collection of the invoices amount. Consequently, during 2007 the finance department has issued debit and credit notes to adjust the difference between the actual and provisional prices amounting to U.S. \$ 4,883,751 (net) for the benefit of SOMO.
 - ✘ For petroleum products, we found the following differences between the billed prices per SOMO's sales invoices and our recalculation of the prices based on PLATTS quotations:

Invoice Number	U.S. \$		
	Billed price	Calculated price	Difference
F/06/128	3,879,589	3,886,797	7,208
F/06/139	3,393,294	3,397,136	3,842
F/06/126	2,428,687	2,433,199	4,512
F/06/127	946,238	947,996	1,758
F/06/225	1,977,687	1,982,446	4,759
F/06/009	2,709,166	2,715,686	6,520
F/06/012	3,669,282	4,609,207	939,925

- We requested but did not receive any clarification of the above differences.
- Based on our sample tested, we found that the pricing policy for the export sales of petroleum products included a discount on the PLATTS quotations to encourage customers to collect the fuel oil within Iraq and to ensure that production of refined oil is not interrupted.

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- We found that the price for export sales of petroleum products is calculated as follows:
 - Iraqi southern boarders (Khour Al-Zubair terminal): five quotations around the date of the bill of lading, using FOB Arab Gulf HSFO 180 CST quotation, less a discount of U.S. \$ 18 per ton for the period from 1st January 2006 to 12 December 2006 and U.S. \$ 15 until the end of the year.
 - Iraqi southern boarders (Baiji and Dorreh terminals): monthly Average of PLATTS quotations for the month of loading using FOB Arab Gulf HSFO 180 CST quotation, less a discount of U.S. \$80 per ton for Baiji and U.S. \$90 per ton for Dorreh for the period from 1st January 2006 to 15 September 2006 and U.S. \$ 80 until the end of the year.
 - Iraqi western boarders (Baiji and Dorreh terminals): monthly average of PLATTS quotations for the month of loading using FOB Med Italy 3.5% fuel oil quotations, less a discount of U.S. \$ 90 per ton for the period from 1st January 2006 to 15 September 2006 and U.S. \$ 80 until the end of the year.
 - Iraqi northern boarders (Baiji terminal): monthly average of PLATTS quotations for the month of loading using FOB Med Italy 3.5% fuel oil quotations, less a discount of U.S. \$ 90 per ton.
 - Iraqi eastern boarders (Baiji and Dorreh terminals): monthly Average of PLATTS quotations for the month of loading using FOB Arab Gulf HSFO 180 CST quotation, less a discount of U.S. \$ 110 per ton for Dorreh and U.S. \$120 per ton for Baiji.
- We found that the OSP calculation formula and the Freight Escalation formula are not formally documented and approved, and also there are no documented procedures to be followed by SOMO in the calculation of the monthly OSP for each destination.
- We requested but were not provided with documentation approving the API escalation computation formula for Basra and Kirkuk petroleum.
- We found that SOMO does not have a formally documented policy for pricing delayed shipments after the original scheduled month of loading.
- We found that for the first half of 2006, no minutes of meetings of the OSP committee were maintained.
- During the year ended 31 December 2006, SOMO had two shipments to South Africa with total invoices of U.S. \$ 118,625,844 and we found that the OSP used for these shipments was month of loaded approved OSP for Europe destination except for Freight Escalation, which was calculated based on 50% of Europe destination approved freight escalation. We found that this formula was approved by SOMO's General Manager.
- We further found that the OSP calculation formula and Freight Escalation formula for South Africa shipments are not formally documented and approved by the Minister of Oil.

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- We found that the Freight Escalation for South Africa shipments was reduced during 2006 compared with last year from 75% to 50% of Europe destination approved Freight Escalation. We requested but did not receive justification for such a change.

SCOPE OF WORK

According to the agreed upon scope of work set out in our engagement letter dated 12 August 2006, the procedures to be performed in connection with export sales of petroleum and petroleum products for the year ended 31 December 2006 are as follows:

1. Document the key internal controls designed by the Government of Iraq and Oil Marketing Company (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 Government of Iraq and SOMO, over the bidding on, and awarding of, export sales contracts.
3. Obtain from SOMO a list of export sales and:
 - 3.1 Agree the total of export sales list to SOMO's sales ledger.
 - 3.2 Agree the list of export sales to the amounts deposited into the FRBNY.
4. For all export sales of petroleum and a selected sample of petroleum products perform the following:
 - 4.1 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.
 - 4.2 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 Government of Iraq.
 - 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 OSP, by reference to PLATTS publications, for each lift and compare to the price per the invoice, and report any deviations noted.