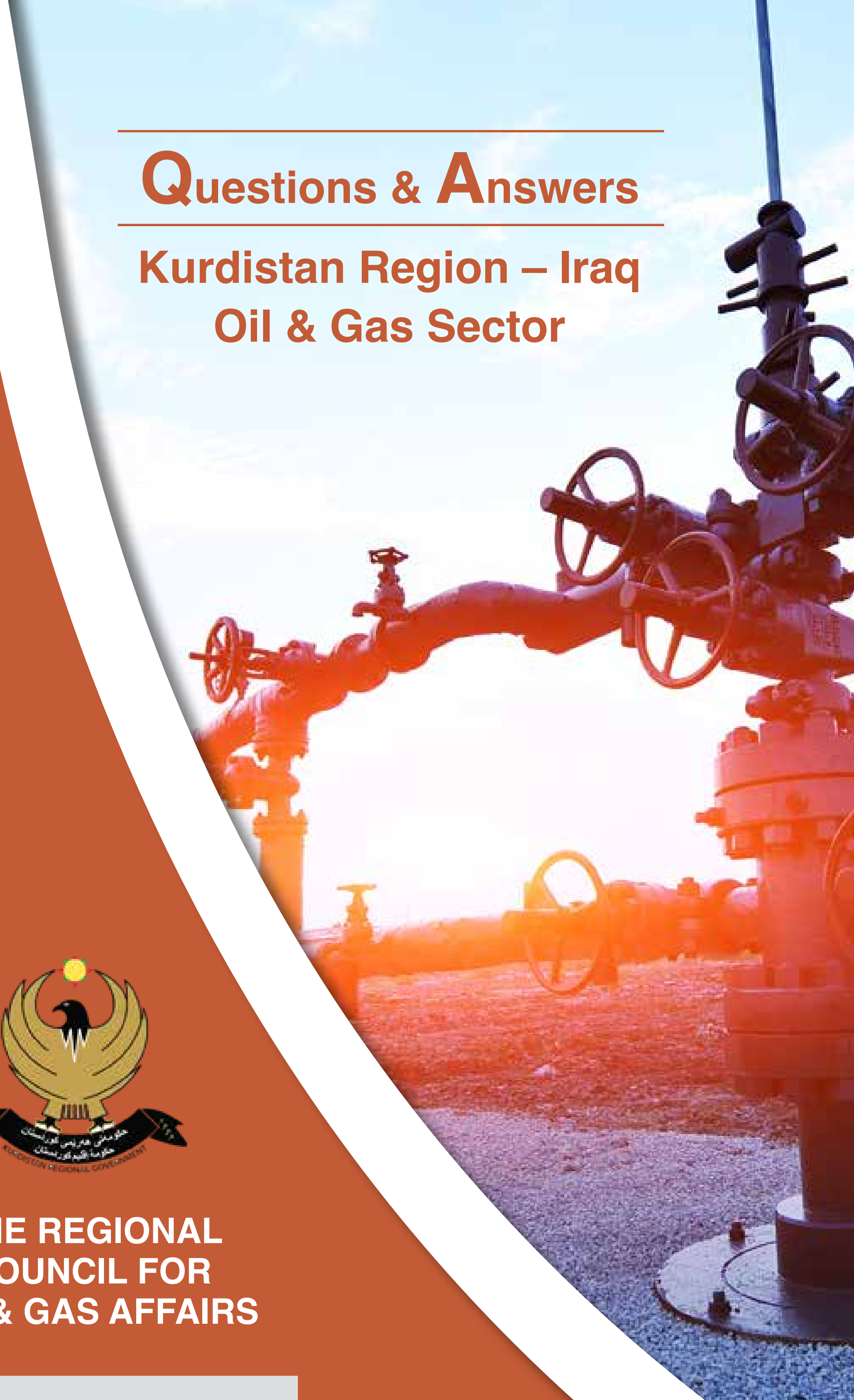


Questions & Answers

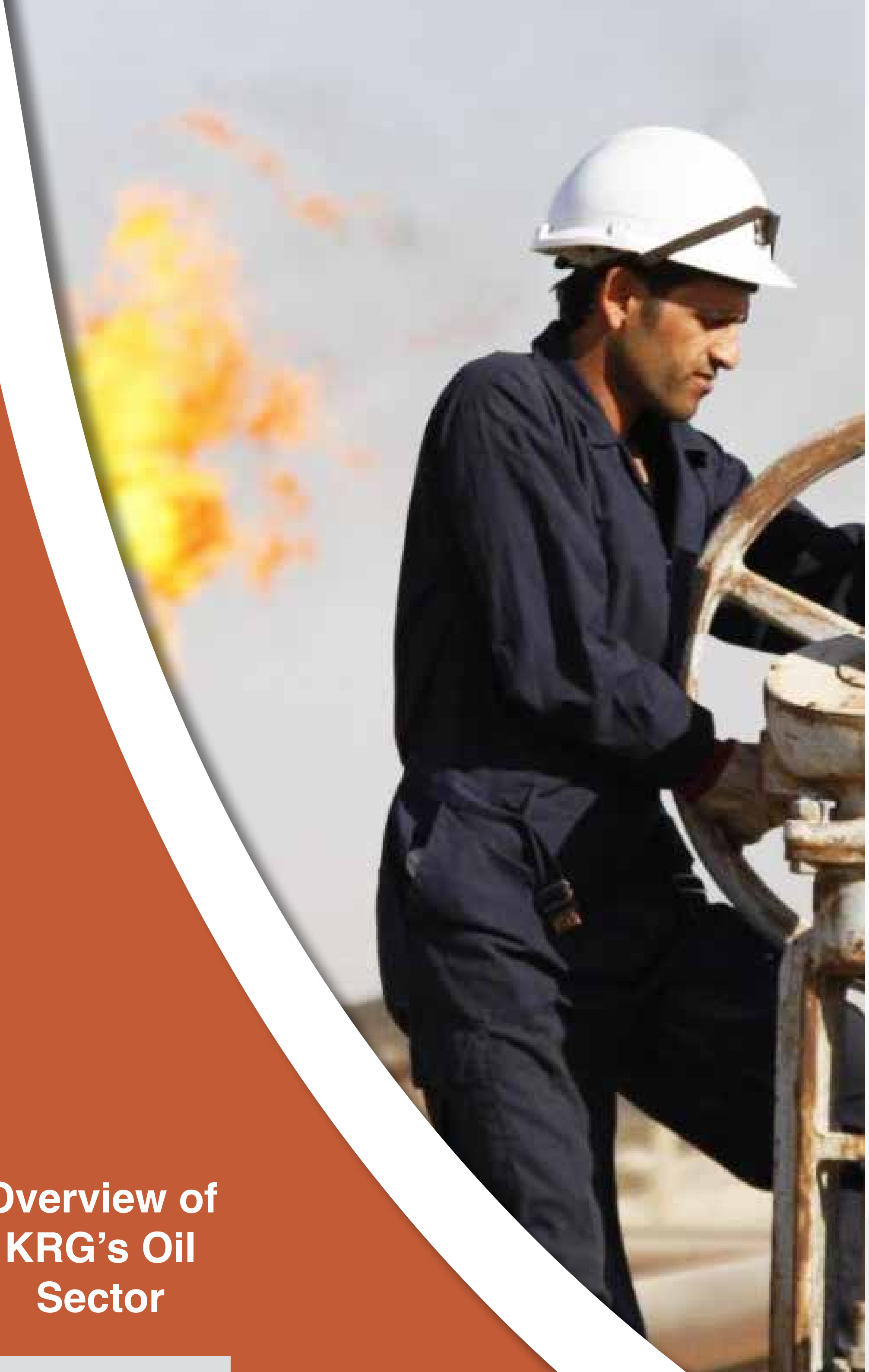
Kurdistan Region – Iraq
Oil & Gas Sector

THE REGIONAL
COUNCIL FOR
OIL & GAS AFFAIRS

أسئلة وأجوبة

إقليم كوردستان - العراق
قطاع النفط والغاز

المجلس الإقليمي
لشؤون
النفط والغاز



Overview of KRG's Oil Sector

1. What is the Regional Council for the Oil & Gas Affairs (RCOGA)?

The Regional Council for the Oil & Gas Affairs was established based on the "Oil & Gas Law of the Kurdistan Region – Iraq" (Law No. 22 – 2007) and mandated with:

1. Formulating the general principles of petroleum policy, prospect planning and field development, and any modifications to those principles, in the Region
2. Approving petroleum contracts
3. Limiting production levels in the region consistent with the provisions of Article 112 of the Federal Constitution

The Council is made up of:

- The Prime Minister, as President of the Council
- The Deputy Prime Minister, as Deputy President of the Council
- The Minister of Natural Resources, as member of the Council
- The Minister of Finance and Economy, as member of the Council
- The Minister of Planning, as member of the Council

In effect, considering the importance of the oil sector in Kurdistan's economy, the Regional Council serves as the highest authority in regulating the sector and strategically supervises the works of the Ministry of National Resources (MNR), helping establish a system of checks and balances that encourages transparency and accountability.

Concretely, this means that all major decisions related to the sector need to be reviewed and approved by the Regional Council prior to taking effect, ensuring greater oversight and a more collegial and audited decision-making process.

2. How do the responsibilities of the Regional Council for the Oil & Gas Affairs (RCOGA) differ from those of the Ministry of Natural Resources?

The roles and responsibilities of both the Regional Council for the Oil & Gas Affairs and the Ministry of Natural Resources are clearly stipulated by law. While the Council is in charge of formulating the sector's policies and approving contracts, as per Article 5 of the law, the Ministry is responsible for the development of natural resources in the region as per Articles 6 to 9 of Chapter 4 of Kurdistan's Oil & Gas Law (Law No. 22 of 2007), which entered into force on August 9th, 2007.

The Ministry is the signatory to production-sharing agreements with companies willing to invest in the exploration of hydrocarbons and mineral resources in the Region. The Ministry is also the authority awarding licenses for transportation and storage infrastructure, hydrocarbons and minerals production operations as well as refining, petrochemicals and retail operations, subject to ratification by the RCOGA.

Said differently, the Council's role is to provide oversight, to set the overall policies of the sector, and to approve key contracts, while the Ministry's role is to execute and ensure the proper implementation of the established policies, to strengthen and develop the sector, and to sign all contracts and grant licenses.

3. On what legal grounds did the KRG base itself when it decided to export the Region's oil through its pipeline?

On May 22nd, 2014, and after the Federal Government had decided to cut the Kurdistan Region's share from the national budget, the Kurdistan Regional Government decided to directly export and sell the Region's oil as a necessary means to cover and pay public salaries and to provide for its constituents. Such a decision was made in line with Clause 2 of Article 6 of the Kurdistan Parliament's Law number 5 of 2013, and which determines the Region's financial share out of Iraq's national revenues, stating: The Kurdistan Regional Government is tasked with taking all the necessary measures that it deems appropriate, based on the herein law, to recover its financial dues, including by producing, exporting, and selling crude oil and gas to cover all expenses that the Federal Government is unwilling to cover, be it prior or subsequent to the herein law taking effect, while informing Parliament accordingly.

4. How many barrels of oil are sold by KRG every Month?

The number of barrels of oil sold by KRG every period differs and is contingent on a number of elements, ranging from production output, storage level, and domestic consumption demand, to levels of operational use in the field, refining and re-reprocessing losses, swaps, and sales contracts signed.

That said, a comprehensive review conducted by international auditing firm Deloitte denotes the barrels of oil exported during the reporting period (which is 6 months for the first report), either through the pipeline or by trucks. Please refer to Schedule-1 of the Deloitte report. Average numbers of barrels exported and consumed can be derived by dividing reported barrels by the number of days during the reporting period.

5. Is extracted oil only exported or is it also consumed internally?

Oil extracted in Kurdistan is exported and used for internal consumption. The latter includes "domestic use" (Kerosene/Liquefied Petroleum Gas); "industrial use" (Fuel Oil/Naphtha); and power plants (Diesel).

In other words, oil produced in Kurdistan serves in part to power homes, businesses, factories, and cars, as well as to produce electricity, while a significant portion of it is sold internationally as a means of generating much-needed revenues for the Kurdistan Region, particularly to pay the salaries of civil servants following the Federal Government's decision to cut the Kurdistan Region's share from the national budget since February 2014.

6. How is the KRG oil exported?

Oil in KRG is exported via two different channels:

- The pipeline that goes into Turkey
- Trucks that carry the oil by land into Turkey

Once the oil reaches Turkey, it is then sold by the buyers to various clients around the world and shipped by sea.

7. What are "Swaps"?

Swaps are a form of trade in which a portion of the Government's share of oil is used for trading for products or product financing.

For example, to obtain sufficient diesel to supply the Region's power plants, the Government, at times, swaps crude oil with domestic traders who truck fuel to topping plants and provide diesel and other products in return.

The advantage of Swaps is that it allows the Government to save on liquidity, helping it pay salaries and cover other expenditures, whether related to healthcare, education, electricity, or a number of other priorities.

8. What are "Production-Sharing Contracts" (PSCs) and how do they function?

As per Chapter 10 of Kurdistan's Oil & Gas Law (Law No. 22 of 2007), ratified by Parliament on August 6th, 2007,, the Kurdistan Region follows the production-sharing contracts model to explore and develop its Oil & Gas sector, with the Law explicitly regulating the parameters of such contracts (Article 37 of the Law). The companies entering into these contracts share risks and rewards by incurring the cost of exploring oil and gas prospects which can only be recovered if reserves are found, and once a minimum of 5,000 barrels of oil are produced daily for a period of 12 months (otherwise operational costs are born solely by the IOC, with no liability on the KRG).

Upon commercial production of oil and gas, certain numbers of barrels are allocated toward the cost recovery (Cost Oil), while the remaining production is shared between the KRG and the IOC contractor. An illustrative example of KRG's production-sharing model can be found on MNR's website:

http://mnr.krg.org/index.php/en/the-ministry/contracts/new-psc.

9. How are oil revenues calculated?

Oil revenues represent sale proceeds from export sales adjusted for pipeline fee and terminal charges, payments made to oil producers pursuant to the provision of production-sharing contracts, and trucking cost to transport the crude oil from oil fields to pipeline unloading facility and to Turkey in the case of the Shaikhan oil field. Apart from export sales and IOC bonuses, oil revenues are derived from local sales and from the sale of refined products.

10. Why is the KRG oil sold at a lower price than that of the globally-set crude oil Brent price?

The price of oil is contingent on various elements that not only include the "supply and demand" equation and other geopolitical developments, but also the quality of the oil.

In fact, the quality of the oil produced varies significantly from one country/area to the other, with the two most important quality characteristics being density and sulfur content. Density ranges from light to heavy, while sulfur content is characterized as sweet or sour. Crude oils that are light and sweet (low sulfur content) are usually priced higher than heavy sour crude oils, due in part to the fact that their processing is easier.

In the case of KRG, a considerable portion of its oil is heavy and sour, which partly explains why it is sold at a discounted price. Competitiveness is another reason, whereby the disagreement with Baghdad and the limited exporting routes has meant that KRG had to render its oil exports more competitive in order to sell its output and generate critical funds for the Region.

11. Why is there a difference between the oil revenues stated by the Government and the total of exported barrels multiplied by the price per barrel?

The difference between the value of crude oil sold as stated by the Government and the cash received by the Government from oil is due to the fact that there are other cost and revenue centers that need to be accounted for in computing the net amount received by the Kurdistan Regional Government from oil, including pipeline fees and terminal charges, payments made to oil producers according to existing PSC contracts, as well as trucking transportation costs.

(Please refer to question 9 for more details on how oil revenues are calculated).

12. How are oil revenues spent?

Revenues generated by oil are spent according to the annual budget set by the Kurdistan Regional Government, in a way to address the priorities and needs of constituents.

Low oil prices coupled with a large public sector has meant that oil revenues in recent years have entirely been used to pay the salaries of more than 1.2 million civil servants, Peshmerga fighters, retirees, social care recipients, and families of martyrs. The Government's plan is to restructure and optimize the public sector, enhance non-oil revenues and allow them to finance salaries, and invest a considerable part of oil revenues in diversifying the economy and in reinforcing revenue-generating sectors such as agriculture, industry, and tourism.

Oil resources are finite and oil prices are volatile. Therefore only through efforts to reduce our financial reliance on oil could we truly achieve our goal of a sustainable Kurdistan.

13. How are International Oil Companies operating in Kurdistan benefiting the local economy?

International Oil Companies (IOC) operating in Kurdistan greatly benefit the local economy on a number of levels, including:

- **Oil Production:** IOCs are instrumental in helping explore and extract oil, whereby their technological know-how and expertise, global experience, and economies of scale and financial resources allow them to produce the oil at competitive prices and without forcing the Government to directly spend massive amounts on the tools and infrastructure needed to do so.
- **Jobs:** IOCs employ more than 4,500 employees in Kurdistan according to the latest audited figures, 63% of whom (or more than 2,800) are locals. Local employees not only include skilled workers, but also high-ranked Executives, Senior Managers, and Functional Managers, among others. Moreover, as the Region's production capacity grows, the workforce is also expanding. The Production Operations Training Board forecasts the production force alone to increase by 200 new positions for every 100,000 barrels per day of capacity added.
- **Transfer of Knowledge:** IOCs play an essential part in transferring know-how and expertise onto local stakeholders, helping develop the Oil & Gas industry in Kurdistan and allowing the Region to build its own capacities.
- **Investments:** IOCs invest considerable amounts in the Region, whether in building and operating the Oil & Gas infrastructure, in sourcing and procuring products and services locally, or in housing and covering many of the expenses of their thousands of employees. Such an ecosystem, in turn, greatly benefits the local economy, helping stimulate economic activity and create jobs across.
- **Taxes and CSR Payments:** In addition to certain direct and indirect taxes, IOCs pay a 10% royalty and various Corporate Social Responsibility (CSR) payments to the Government. The CSR payments are largely used for the welfare and development of the local communities in which oil is extracted. An illustrative example of CSR payments can be found on MNR's website:

http://mnr.krg.org/index.php/en/the-ministry/contracts/new-psc

Review of KRG's Oil Production, Export, Consumption and Revenue

14. Are figures related to the oil sector reviewed and validated by an independent and credible entity?

For years, figures related to the oil sector were regularly compiled, computed, and communicated by the KRG's Ministry of Natural Resources. However, to further validate such figures, the Regional Council for the Oil & Gas Affairs commissioned international auditing firms Deloitte and EY to independently carry out a review of key aspects of the sector, starting with figures related to KRG's oil production, export, consumption, and revenue, for the period extending from January 1st 2017, to June 30th, 2017.

The objective of bringing on board a company such as Deloitte was to ensure that all published figures are thoroughly checked and validated by an independent and credible entity void of any conflict of interest, and with the know-how, expertise, and reputation that can inspire trust among all stakeholders, be they local or international.

15. Who is Deloitte and why was it chosen to carry out the review?

Deloitte Touche Tohmatsu Limited, commonly known as Deloitte, is one of the "big four" accounting firms and the largest professional services network in the world by revenue and number of professionals. With more than 244,400 professionals at member firms delivering services in audit, tax, consulting, financial advisory, risk advisory, and related services in more than 150 countries and territories, Deloitte is recognized around the world as a benchmark and an authority in its field.

The decision of the Council of Ministers on February, 3rd, 2016 (No. 73) to commission an international auditing firm to review the Region's Oil & Gas sector and to disclose its findings, therefore, stems from the Government's commitment to transparency, its desire to reinforce public trust in the sector, and its efforts to reform and optimize its public finances. This, on top of it being a requirement according to Clause 6 of Article 15 of the Kurdistan Oil and Gas Law No. 22 of 2007, and which requires the Region's oil and gas revenues to be audited and made available for public viewing, all while having the Oil & Gas Revenue Fund carry out its responsibilities consistent with principles and criteria of the Extractive Industries Transparency Initiative (EITI).
According to section 4.9 of EITI Standards 2016:

- It is a requirement that payments and revenues are reconciled by a credible, Independent Administrator, applying international auditing standards, and with publication of the administrator's opinion regarding that reconciliation including discrepancies, should any be identified.
- The reconciliation of company payments and government revenues must be undertaken by an Independent Administrator applying international professional standards.

Moreover, Article 7 of the Oil & Gas Revenue Fund Law No.2 of 2015 stipulates that all data related to the accounts and activities of the Fund should be reviewed and audited using accredited international auditing firms, and that regular reports summarizing the findings of these firms should be publicized in accordance with the principles of transparency and financial disclosure as per international best practices.

The selection of Deloitte to carry out the review, meanwhile, was also made based on a diligent procurement and tendering process and pursuant to the Decision of the Council of Ministers Number 73 of 03/02/2016, whereby the "big four" international audit firms (Deloitte; PwC; EY; KPMG) were called upon to submit their technical and financial proposals, and which were consequently carefully reviewed and assessed, according to the international standards of the World Bank, in order to shortlist the chosen firm based on clear criteria and key performance indicators.

16. How was the 2017 review of KRG's oil data conducted by Deloitte? What procedures were put in place to ensure that the review process was conducted independently?

Deloitte's review of the KRG's oil data for the first half of 2017 comprised obtaining direct confirmations from all relevant stakeholders regarding the crude oil export, consumption and revenue data contained in Schedule 1 of the Report. Where required, Deloitte also obtained further supporting documentation and held meetings with the various stakeholders to verify the oil data.

Deloitte corresponded directly with the various stakeholders to obtain and verify the information contained in Schedule 1, rather than directing all its requests through the RCOGA or the MNR. This helped ensure that all data could be independently verified.

17. What are the main findings of the Deloitte review process?

The Deloitte review focused on KRG's oil export, consumption, and revenue, with the first report covering the period from January 1st, 2017 to June 30th, 2017 (first half of 2017). The validated numbers based on the Deloitte review are provided in Schedule 1 of the report, which mainly covers the following areas:

Oil Export and Consumption

- Piped export of crude oil (bbls)
- Trucked export of crude oil (bbls)
- Crude oil delivered to refineries under refinery contract (bbls)
- Crude oil allocated to oil producers (bbls)
- Local sales and swaps (bbls)

Pipeline Export Sales Analyses

- Net oil lifted by the buyers (bbls)
- Gross value of crude oil sold (USD)
- Average price per barrel achieved ($/bbl)

Trucking Export Sale Analyses

- Net oil lifted by the buyers (bbls)
- Gross value of crude oil sold (USD)
- Average price per barrel achieved ($/bbl)

Financial Flows

- Change in buyer account balances excluding new advance payments (USD)
- Interest and other charges from the buyers (USD)
- Payments made to oil producers on behalf of the KRG (USD)
- Payments made to third parties on behalf of the KRG (USD)
- Payments made to Kirkuk Governorate for oil lifted from Kirkuk (petrodollar payment) (USD)
- Payments made to the Ministry of Finance for oil security costs (USD)
- Payments to Dana Gas (USD)
- Net cash balance received by the KRG for current period sales (USD)
- New advance payments made by buyers against future sales (USD)

It should be noted that currently Deloitte did not report on the KRG's oil production data, pending the completion of a historical oil production reconciliation for 2014, 2015 and 2016.

18. Why is the Deloitte review so important?

The Deloitte review is particularly important since it will provide, for the first time, official data related to the Region's oil production, export, consumption, and revenue, validated by an independent, international firm, allowing to transparently provide citizens with monitored, unambiguous, and clearly-presented figures related to the Region's largest source of revenue.

Yet transparency is simply a means to an end, in that the Government seeks to entrench a culture of accountability where constituents are called on to hold their Government accountable for the ways in which it manages public finances, helping establish a new social contract in which citizens have both rights and responsibilities.

19. How will citizens of Kurdistan benefit from the review process and its outcome?

The review process will directly benefit the citizens of Kurdistan by allowing them to be fully informed about the Government's oil revenues, helping them hold their elected officials accountable as to ways in which such revenues are disbursed or invested, in line with the principles of democratic governance that Kurdistan aspires to uphold.

More so, the review process will allow citizens, who sometimes mistrust or are wary of their Government, to feel safe knowing that an independent, international professional services firm has reviewed and validated the figures, especially that the review is bound to send a positive signal to international investors, encouraging them to invest in the country's oil and gas sector, and creating jobs and spurring economic growth along the way.

The Deloitte review will also help set a precedent and a benchmark in the Region on the importance and need for proper auditing and verification, on top of exposing a large number of civil servants to the latest in international auditing and verification techniques, building their capacity and allowing them to transfer that know-how to others across the public and private sectors in KRG.

20. Will a similar independent review be carried out in subsequent periods, or is the review a one-off initiative?

The Deloitte review is certainly not a one-off initiative, whereby official and independently-verified figures related to the Oil & Gas sector will be regularly published, starting with the outcome of the review conducted by Deloitte for the third quarter of 2017, and which will be published once completed, separately or along with the 4th quarter. As mentioned, the first report from Deloitte covers a 6 months period, however, in the future, the RCOGA may consider shortening the reporting period to a monthly or quarterly frequency, depending on what will be more efficient.

Moreover, Deloitte has been commissioned with reviewing and validating all figures related to past years, covering 2014, 2015, and 2016.

21. What role did the Ministry of Natural Resources (MNR) have in this project?

The review of the Oil & Gas sector in Kurdistan was commissioned by the Regional Council for the Oil & Gas Affairs, and which is the only authority in charge of dealing with the auditing firms. As such, the Ministry of Natural Resources did not and does not have any direct relationship with the auditing firms in this context, with the former treated independently as an important stakeholder.

The Regional Council for the Oil & Gas Affairs encompasses multiple political parties and figures in Kurdistan, and therefore represents the interests of all constituents in the Region. The reports submitted by the auditing firms will be diligently reviewed by the Council and treated with the utmost attention, helping close any process gaps in a swift, professional, and transparent way.

22. Will IOC Bonuses received by the KRG be audited?

As per Clause 30 of Article 1 of the Kurdistan Oil & Gas Law, the KRG can generate revenue from petroleum sales, royalty, signature and production bonuses related to petroleum contracts with foreign and local companies.

IOC Bonus Evaluation and Reporting has been awarded to International Auditing firm EY. The review will verify PSC Bonuses received by the Government, Government bonus entitlement, and spending of such bonuses. EY will report on the flow of revenue including observations regarding the use of the funds received. The relevant stakeholders have been contacted by EY and information request letters have been sent to begin the review. The company is expected to submit its report to the RCOGA in the near future, after which it will be made public.

23. What other audits is the RCOGA planning on conducting?

Apart from the currently on-going projects of independently verifying production and oil revenues and IOC contract bonuses, the RCOGA is planning to implement a comprehensive audit plan of the Oil & Gas sector, and which will include:

1. Gap analyses of various processes in the Oil & Gas sector and an implementation action plan for the RCOGA
2. Audit of costs and expenditures incurred by IOCs
3. Production and entitlements audits of individual fields
4. Audit of local sales and swaps
5. Audit of refinery products sales

24. Will Kurdish personnel conduct such reviews and audits of the Oil & Gas sector in the future, or will we continue to only rely on foreign entities such as Deloitte for such tasks?

As part of the contractual agreements with international auditors, including Deloitte, the RCOGA made sure to include the need to have teams from the Kurdistan Region Board of Supreme Audit (KRG–BSA) be involved in various upcoming audit and review projects, so as to enhance their skills in the Oil & Gas industry and get them familiar and trained with the modern audit tools and best practices.

Such exposure and on-the-ground experience will allow Kurdish audit personnel to carry the torch in more actively and professionally auditing Oil & Gas and other sectors across Government.

That said, relying on international auditing firms is a common practice adopted by most countries around the world, including the most developed ones that possess well developed and competent state audit functions.

The KRG-BSA is governed by Law No 2 of 2008, which established the institution and sets out its powers, responsibilities and the framework within which it works. Supreme audit institutions are the lead public sector audit organizations and among the key players in the public governance system. By ensuring that money is well spent, these audit institutions can contribute to national development and the fight to reduce poverty. The KRG-BSA provides overall guidance for maintaining a system of internal controls and conducts the external audits after the implementation of the budget.

25. Where can the Deloitte report be accessed and read?

The Deloitte report, available in English, Kurdish, and Arabic, can be accessed and read on the website of the Kurdistan Regional Government:

http://cabinet.gov.krd/

The Future for KRG's Oil Sector

26. What are the Government's future plans for the Oil & Gas sector? What does it intend to do to strengthen its capabilities and optimize its output?

The Government is committed to the continuous development of the Region's Oil & Gas sector, in a way to optimize its returns and to ensure that it operates in full transparency and at par with international best practices.

For this, and in addition to the audit and review process, the Government plans on carrying out a series of other reforms in the sector, and which includes reorganizing and empowering the following institutions:

- Establishing a Board for the Oil & Gas Revenue Fund, as per Article 4 of the Oil & Gas Revenue Fund Law No.2 of 2015, in order to oversee and audit the full Oil & Gas revenues generated in the Region and to ensure that they are transferred to the accounts of the Ministry of Finance and Economy, in line with the principles of transparency and financial disclosure.
- Enacting the Draft Law related to the Kurdistan Oil Marketing Organization (KOMO), and which has been ratified by the Council of Ministers and sent to Parliament to enact as a law, allowing the organization to carry out its mandate of selling and marketing the Region's oil instead of the Ministry of Natural Resources.
- Establishing the Kurdistan Exploration and Production Company (KEPCO), which will be in charge of exploration and production in partnership or in competition with other companies, and in lieu of the Ministry of Natural Resources.

Such reforms will ensure greater governance of the sector, all while dividing and allocating responsibilities according to particular functions/specialties and areas of expertise.

27. What is the Government doing to minimize the Region's economic and financial dependence on oil?

The Government of the Kurdistan Region is conscious about the dangers of overly relying on oil as its main source of revenue, which is why it is currently exhaustively reviewing and implementing a series of reforms across underserved revenue streams, including taxation, customs, and other Government-provided services.

The Government is similarly rolling out a cross-sectorial reform agenda that will see it reform and develop a wide range of sectors, including banking and finance, energy and electricity, water and waste management, healthcare, and education.

Moreover, the Government's economic diversification plan will see it invest some of its oil revenues to strengthen other sectors, such as agriculture, industry, and tourism, and for which Kurdistan has a notable competitive edge.

Beyond maximizing non-oil revenues, the Government also intends on optimizing its spending and cutting on inefficiencies, be it by strategically dealing with the inflated public sector, reducing corruption through the Biometrics registration and other initiatives, or minimizing bureaucracy and red tape by streamlining Government services and leveraging electronic tools.