



in association with



Nigeria Extractive Industries Transparency Initiative (NEITI)

NEITI AUDITS 2005

SUMMARY OF RECOMMENDATIONS AND PROPOSED ACTIONS

Revised 2nd June 2009

Based on information contained in the reports and appendices dated September
to November 2008

Presented to the National Stakeholder Working Group

by
Hart Group
In association with
SS Afemikhe Consulting Ltd
SS Afemikhe & Co (Chartered Accountants)
CMA Ltd

The report and all appendices relating to the report are intended for the use of the National Stakeholder Working Group of the NEITI for the purpose of that initiative and are not to be relied upon by other parties.

Preface

The second independent Nigeria Extractive Industry Transparency Initiative audit was commissioned by the National Stakeholder Working Group and covered the period the year ended 31 December 2005. The audit was undertaken by Hart Group.

The audit scope was set out in Terms of Reference that specified a set of tasks and deliverables, grouped into Financial and Physical audits applicable to a defined set of entities of the oil and gas sector.

In accordance with the request of the NSWG, the audit was concluded based on information received up to 31st August 2008. The findings of the audits are set out in a report on the Physical and process audit dated September 2008 and a report on the Financial audit dated October 2008, addressing:

- Reconciliation of movements of hydrocarbon production and distribution
- Revenue flows in the oil and gas industries, reflecting payment streams made by Covered Entities to any Federation (Federal Government, State Government, or Local Government) entity.
- Calculations that underlie the calculation of payments, fees, taxes and royalties owing by private or public sector companies;
- Investment flows involving Government payments by way of Joint Venture investment, loan (including loan repayment), and equity investment transactions in Covered Entities; and
- Certain key processes by which the government manages the sector.

These reports are intended for the use of the National Stakeholder Working Group of the NEITI for the purpose of that initiative and are not to be relied upon by other parties.

Audit work was hindered by difficulties encountered in the identification of covered entities, primarily because of inadequate record keeping by DPR. Two companies have not cooperated with the audit. Delays by covered entities in returning requested data meant that the audit process was demanding and time consuming.

This summary specifies:

Part A: principal findings of the reconciliation of financial flows. The audit has produced a statement of financial flows that have been reconciled. Unreconciled items have been highlighted.

Part B: principal results of reconciliation of 2005 data.

Part C: the principal recommendations, based on matters that came to our attention in the course of the audit work done, which concerned 2005. More recent developments are mentioned to the extent we are aware of them.

Reference is made to the detailed reports for full background.

TABLE OF CONTENTS

Part A – financial Summary	3
Financial flows to the Federation.....	3
Federation financial investment in joint venture operations	3
Other financial flows from company covered entities.....	4
Company payments to Niger-Delta Development Commission	4
Part B – 2005 Audit reconciliations	5
Production.....	5
Terminal liftings.....	5
Refined Product importation and distribution.....	6
Reconciliations to Company audited financial statements.....	7
Company ownership	7
Summary data comparison	7
Payments not matched: Petroleum Profits Tax	8
Payments not matched: Royalty	9
Dividends and Debt servicing payments from NLNG	9
Payments to Niger-Delta Development Commission.....	10
PART C – Recommendations	11
Governance of the sector.....	11
Institutional linkage between technical and financial aspects.....	11
Government information systems	11
Government’s systems for financial management	12
Measurement systems for crude oil	12
Process of marketing Government Crude.....	13
Accounting for Government Sales of Crude Oil	14
Subsidy on refined product.....	15
Signature Bonus	15
Oil Transfers To The Federation	16
Monitoring inflows to the Federation Account.....	17
Role of the Department of Petroleum Resources.....	17
Royalty	18
Petroleum Profits Tax.....	19
Gas regulation	21
Gas Income shared with the Federation.....	21
Payments to Niger-Delta Development Commission.....	22
Management of refined product importation and distribution.....	23
Joint Development Zone	23

PART A – FINANCIAL SUMMARY

FINANCIAL FLOWS TO THE FEDERATION

The financial flows to the Federation reported by companies and, to the extent described in this report, confirmed by the Central Bank of Nigeria were as follows:

	<i>US\$ 000</i>	<i>NGN millions</i>
Sale of oil and gas net of allocation to Joint Venture cash calls	12,313,852	772,227
Other income		6,685
Taxation and other sector-specific flows from companies (CBN figure)	15,169,845	-
Company Income Tax	55,595	-
Non sector-specific flows from companies	374,756	11,313
Dividend from Nigeria LNG, interest and loan repayments	-	-
Total flow to the Federation	<u>27,914,048</u>	<u>790,225</u>
	<i>US\$ 000</i>	<i>NGN millions</i>
FINANCIAL FLOWS TO STATES	24,628	24,325

Some figures could not be confirmed between companies and the Central Bank of Nigeria. These are referred to in Part B of this Summary.

FEDERATION FINANCIAL INVESTMENT IN JOINT VENTURE OPERATIONS

The Federation invests in Joint Venture operations by means of cash contributions to the financing requirements of each Joint Venture.

The proceeds of oil and gas sales accruing to the Federation were reduced by \$4,065 million that was allocated for cash calls and transferred to NNPC. The reconciliation of the account maintained by NNPC has been checked.

The amount of cash calls paid in 2005 by NNPC totalled US\$ 3,469 million (including the Naira component). This amount was confirmed by the receiving companies. At 31st December 2005, NNPC held bank balances of US\$ 1,091 million for future cash call disbursements.

OTHER FINANCIAL FLOWS FROM COMPANY COVERED ENTITIES

Companies in the oil and gas sector, like other businesses, make payments of Value Added Tax, Education Tax and Withholding Tax to the Federation. They also pay 'Pay as You Earn' tax deductions and certain Withholding Tax to States that host their operations.

The amounts declared by the companies as having been paid in 2005 were:

	<u>Flows to states</u>		<u>Flows to the Federation</u>	
	US\$ 000	N'000	US\$ 000	N'000
Withholding tax	1,140	1,528,715	175,950	7,466,107
Pay as you Earn	23,488	22,796,704	132	48,093
Value Added Tax			82,405	227,190
Education Tax			116,269	3,572,042
	24,628	24,325,419	374,756	11,313,432

Note: US\$ figures include small amounts of Euro and Sterling.

These figures are not confirmed and appear to be incomplete, as several covered entities did not provide the requisite information. We were not requested to confirm these amounts.

COMPANY PAYMENTS TO NIGER-DELTA DEVELOPMENT COMMISSION

NDDC declared that they received US\$ 135 million and N 8.4 billion from companies in 2005.

The companies confirmed that they paid different figures, as set out on page 10.

PART B – 2005 Audit RECONCILIATIONS

PRODUCTION

Companies reported crude oil received into terminals in 2005 amounted to 917.7 million bbl, from the following operations:

Operator	Bbl millions
SPDC JV	337.6
MPNU JV	213.9
CNL JV	133.1
EPNL JV	75.7
NAOC JV	61.8
AENR	24.2
Addax	23.8
Continental	13.2
NAE	11.3
PanOcean JV	8.6
MoniPulo	5.8
NPDC	2.1
Express	1.6
SNEPCO	1.5
Cavendish	1.4
Amni	0.8
Conoil	0.7
Atlas	0.2
Dubri	0.2
NDPR	0.1
Total	917.7

Companies operating onshore did not provide information about gross field production. The audit could not therefore report on any losses occurring between wellhead and terminal.

DPR provided production data that differed from the data provided by the companies. In most instances, the company data appeared to be more consistent with other data we obtained.

There is a disagreement between Shell and Chevron about the amount of Chevron production piped to Bonny terminal during July – November 2005. The amount at issue is 0.5 million bbl. We could not resolve this due to the problem of attributing stocks (see Terminal Liftings below).

Production, exports and refinery liftings have been materially reconciled to the operational and company data provided. Production data provided by DPR however could not be fully reconciled.

TERMINAL LIFTINGS

Crude liftings amounted to 916 million bbl. The difference from Production relates mainly to changes in stock levels at terminals.

Terminal operators in some instances reported different lifted quantities from those reported to us by the company making the lifting.

NIGERIA EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE
2005 AUDITS: Summary of Recommendations and Proposed Actions

DPR confirmed total export volumes but had different information from lifters about the ownership of the cargoes.

The operators of terminals did not confirm the ownership of the terminal stocks, because the point at which stock ceases to be Joint Venture stock and becomes the sole ownership of each partner appears not to have been defined. Accordingly, although production and exports could be reconciled in total, stock ownership (including over-liftings) could not be allocated specifically to companies.

The quantities transferred to NNPC refineries and exported from five onshore and twelve offshore terminals were:

	bbbl Millions
Refinery Supply	72.1
Exports	843.9
Total	916.0

Crude lifted by NNPC was:

	bbbl Millions
Domestic crude, including refineries	159.9
Export	295.5
NNPC (re: Addax and Panocean)	1.0
	456.4

REFINED PRODUCT IMPORTATION AND DISTRIBUTION

NNPC PPMC imported 5.9 million tonnes of refined product. 43% of all imports were supplied by the traders Vitol and Trafigura.

<i>tonnes</i>	PMS	DPK	AGO
Opening Stock	712,120	370,330	265,005
Product Imports	5,384,587	517,292	-
Refinery Production	1,738,090	1,298,390	2,122,586
Product Sales	-7,010,563	-1,803,175	-2,179,728
(Losses)/Gains	-287,297	-150,610	13,818
Closing Stock	536,937	232,228	221,681

Losses in the distribution system amounted to 7% of imports with an estimated value of US\$ 239 million.

The quality of data provided by PPMC is questionable: the audit indicated that measurement practices are not consistent or in accordance with international best practice. PPMC provided several successive sets of figures and appeared not to have a definitive position.

RECONCILIATIONS TO COMPANY AUDITED FINANCIAL STATEMENTS

Companies were requested to provide confirmations from their auditors that the data the companies provided for the purpose of this audit were consistent with their audited financial statements. Only Elf complied with this request.

Calculations prepared by Chevron and Mobil of their PPT and royalty liabilities could not be reconciled to company audited financial statements.

COMPANY OWNERSHIP

Companies were requested to confirm the identity of their beneficial owners.

Internationally owned companies provided this information. Most local companies declined to do so.

SUMMARY DATA COMPARISON

FINANCIAL FLOWS TO THE FEDERATION (US\$ ONLY)

	Reported by companies	Reported by CBN	Difference
	US\$ 000	US\$ 000	US\$ 000
Petroleum Profits Tax	10,638,047	10,629,247	8,800
Reserves Additional Bonus	-	-	-
Royalty	4,357,491	4,446,397	(88,906)
Gas Flare Penalty	18,605	28,909	(10,304)
	sub-total		
	15,014,143	15,104,553	(90,410)
Signature Bonus	90,025	-	90,025
	Total		
	15,104,168	15,104,553	(385)
<i>analysis:</i>			
IOC-owned companies	14,526,960	14,584,442	7,810
Other companies	577,208	585,403	(8,195)

The nature of the differences has been identified and is set out below. While some differences can now be explained, others require companies and CBN to meet to reconcile their data.

PAYMENTS NOT MATCHED: PETROLEUM PROFITS TAX

<i>Nature of difference</i>	<i>Amount (US\$ 000)</i>	<i>Companies affected</i>
Adjustment payment relating to 1999, omitted by company from its template	-7,350	Addax
Chevron templates did not include payments made by TOPCON or COCNL whereas CBN recognised all payments.	-6,517	Chevron
TOPCON items included by Chevron but omitted by CBN	5,825	Chevron
CBN recorded a higher receipt than the company made	-98,753	NAOC
Company included Reserves Additional Bonus, not reported by CBN	57,942	NAOC
CBN recorded a receipt where the company made no payment	-2,397	Panocean
CBN recorded a higher receipt (net) than the company made	-21,741	Phillips
CBN recorded a higher receipt (net) than the company made	-2,000	Continental
CBN on its templates attributed payments to the wrong company	-4,255	Conoil
Company payment could not be located on CBN template	61,200	Phillips
Company payment could not be located on CBN template	2,421	Conoil
Company payment could not be located on CBN template	20,725	Continental
Company payment could not be located on CBN template	3,326	Panocean
Company payment could not be located on CBN template	150	Brass Exploration
CBN misclassified withholding tax as PPT	-6	SPDC
Company did not submit templates, nor did CBN report any receipt. Although there is no difference, this cannot be construed as reconciled.		Cavendish, Express
CBN commission accounting	229	Chevron
Rounding differences on templates	1	
Total net difference	8,800	

PAYMENTS NOT MATCHED: ROYALTY

<i>Nature of difference</i>	<i>Amount (US\$ 000)</i>	<i>Companies affected</i>
Chevron templates did not include payments made by TOPCON or COCNL whereas CBN recognised all payments.	-4,895	Chevron
CBN recorded a higher receipt than the company made	-125	Amni
CBN recorded a higher receipt than the company made	-28,128	Elf
CBN recorded a higher receipt than the company made	-7,201	NAOC
CBN recorded a higher receipt (net) than the company made	-125,658	Conoil
CBN recorded a higher receipt (net) than the company made	-19,446	Moni Pulo
CBN recorded a higher receipt (net) than the company made	-3,851	Panocean
CBN recorded a higher receipt (net) than the company made	-99	SPDC
CBN recorded a higher receipt (net) than the company made	-2,208	Phillips
CBN recorded a higher receipt (net) than the company made	-357	Elf
CBN on its templates attributed payments to the wrong company	-66,557	Conoil
Company payments differed from those recorded by CBN	74,118	Continental
Company payment could not be located on CBN template	140	Dubri
Company payment could not be located on CBN template	5,407	Moni Pulo
Company payment could not be located on CBN template	90,147	NPDC
CBN receipts (net) lower than company payments	34	Elf (gas)
CBN misclassified gas royalty and gas flare penalty	-225	Phillips
Company did not submit templates, nor did CBN report any receipt. Although there is no difference, this cannot be construed as reconciled.		Cavendish Express
Rounding differences on templates	3	-
Total net difference	-88,906	

DIVIDENDS AND DEBT SERVICING PAYMENTS FROM NLNG

NLNG reported having paid US\$ 207 million in dividends, interest and loan repayments to NNPC but NNPC has not confirmed having received it.

PAYMENTS TO NIGER-DELTA DEVELOPMENT COMMISSION

NDDC data differed from data provided by companies, as follows:

	Reported by companies US\$ 000	Reported by NDDC US\$ 000	Difference US\$ 000
Payments in US\$	<u>119,992</u>	<u>134,931</u>	<u>14,939</u>
	N'000	N'000	N'000
Payments in Naira	<u>8,160,882</u>	<u>8,355,938</u>	<u>195,056</u>

Additional work would be required to reconcile these differences.

PART C – RECOMMENDATIONS

GOVERNANCE OF THE SECTOR

There are gaps in the effective relationships between institutions involved in the sector: DPR, FIRS, CBN, AGF, NNPC (COMD, NAPIMS and PPMC). Revenue is at risk as a result as is discussed below.

INSTITUTIONAL LINKAGE BETWEEN TECHNICAL AND FINANCIAL ASPECTS

A feature of Government systems is that responsibility for engineering issues (physical production, volumes etc) is separated from the responsibility for financial management. Yet, the validity of the financial data is dependent on the technical data. This has led to unreconciled differences between the two. The institutions were not effectively sharing data. There is a basic need for government, the regulators and the industry to take a holistic view of the industry and to ensure good lines of communication and sharing of information between different parties in the industry, whether government bodies or private companies.

Action:

A thorough review of the institutional arrangements and relationships is required.

We note the OGIC report issued by Government aimed at restructuring sector governance; it should be confirmed whether the OGIC report fully addresses the matters raised by the audit.

Financial and physical data should be routinely reconciled. The responsibility for doing this should be allocated and the outcome should be reviewed by NEITI.

GOVERNMENT INFORMATION SYSTEMS

There is much reliance on decentralised, largely paper based systems. The use of suitable, secure IT systems to provide consistent data to various users and to analyse this data was limited or nonexistent for the period under review.

Action:

Undertake a review of Government information systems, including pending systems development programmes, to ensure that information is available to those who require it.

GOVERNMENT'S SYSTEMS FOR FINANCIAL MANAGEMENT

Financial information systems are not adequate for the purpose of controlling financial flows from the sector. Much greater use should be made of IT systems to improve controls, to eliminate inconsistencies and to improve transparency by making possible a wider sharing of data.

The Accountant General to the Federation (AGF) should exercise greater management and control. The flow of information currently consigns the Accountant General to a purely reactive role, where he is unable to exercise any effective control or authority. In particular, the following weaknesses in the OAGF systems should be addressed with utmost urgency

The monthly returns on crude oil sales, taxes and fees from NNPC, FIRS and DPR are not usually submitted to OAGF office on a timely or regular basis.

The OAGF office does not have access to a comprehensive database of all the Exploration and Production (E&P) upstream companies licensed to operate in the country.

The NNPC monthly returns on crude oil sales does not indicate the volume of crude, the applicable price, the exchange rate used and the method used for computing the proceeds.

There was no register maintained to record all the advices / monthly returns received from the NNPC, FIRS and DPR.

There is no standard system of documenting information relating to revenue arising from crude oil sales, taxes and fees as the system change when desk officers are redeployed to another office. There is an on-going effort to put in place new standardized system of recording revenue receipts by the Deputy Director which is awaiting management approval.

The OAGF has no control over the offshore accounts as it cannot deal directly with the Bankers. It relies on information supplied by CBN and NNPC.

Variances arising from internal revenue reconciliation prepared by the OAGF are not followed up.

Action:

The Accountant General should implement modern financial management systems and techniques, including predictive modelling, to allow him to manage financial flows from the sector.

The above will strengthen the OAGF's role as the Federation accounting office and ensure that the CBN is not be continually put in the position of having to provide the timely and reliable management information that is required for ordinary Government management of flows from the sector.

MEASUREMENT SYSTEMS FOR CRUDE OIL

The amount of oil produced (at the wellhead) is not reliably known. As discussed in the 1999-2004 audit, DPR has no system for measuring production, other than at through monitoring terminal receipts. Accordingly, DPR has no data from which possible product losses between the production point and the terminal can be estimated, measured or inferred.

Companies were requested to provide in-field measurement data for audit purposes. The templates received from companies did not include such data.

DPR should be strengthened to enable it to fulfil its strategic role in the industry.

Actions:

DPR should be mandated to work together with operators to develop standards and guidelines for the routine reporting of a gross liquids and hydrocarbons mass balance. A policy framework and implementation plan should be presented by DPR.

DPR should report to Government regularly on all hydrocarbon flows and holders of OMLs and OPLs and any transfers of working interests thereon.

Annual audited cost reports submitted by companies to NAPIMS should include the hydrocarbon mass balance. Auditors should report on its compilation.

PROCESS OF MARKETING GOVERNMENT CRUDE

We updated the review of the process of marketing government crude that had been undertaken in the 1999-2004 audit. Principal recommendations are:

- (a) NNPC should review whether West Texas Intermediate (WTI) might give a better value basis than the European market benchmark Brent, given the preponderance of sales into the US refining areas.
- (b) NNPC charges only 0.03 \$/bbl (average for 2005) for the pricing option. This looks rather cheap compared with the benefits for the off taker certainly with the till very late allowed declaration moment for the option (5 working days before the loading takes place). NNPC should consider increasing the price for the option, more in line with the CFD derivatives market.
- (c) The methodology for deriving the Official Selling Price seems somewhat conservative, leading to prices that might be on the low side. NNPC however emphasizes that it is imperative to avoid any distressed cargo, through buyer no show.
- (d) Final decisions about setting NNPC's Official Selling Price take much time before the approved OSP price can be communicated to the off takers, leading to unnecessary uncertainties with existing and new off takers, at an implied cost to the Federation. Decisions should be expedited and published earlier.
- (e) Guidelines for off taker selection should not include a requirement from the off taker to invest in Nigerian projects. COMD has no means of checking whether the required performance has indeed taken place, nor any defined procedure for the eventuality that it appears it has not.
- (f) Where the guideline is applied, the sale contract should include appropriate clauses dealing with the project. Such a requirement will theoretically lead in the longer term to the Federation securing a lower price for its crude.
- (g) The COMD off-taker list is not well balanced. COMD should consider increasing the off taker list with final end user buyers/major oil companies at the expense of current large contract allocation to traders.

- (h) NNPC should review the use of Calson (Bermuda), its joint marketing company with Vitol. This marketing arrangement may present a conflict of interest between the Vitol and NNPC (on behalf of the Federation).
- (i) Volumetric measurements of gross and net loaded barrels should be reviewed in the light of observed round figures for Bills of Lading volumes. Out of the sample of 63 contract sales we reviewed, at least four were subject to uncertainty as to how the invoiced volume had been determined.

ACCOUNTING FOR GOVERNMENT SALES OF CRUDE OIL

ACCOUNTING SYSTEM IMPROVEMENTS

Export crude is marketed on behalf of the Federation by NNPC Crude Oil Marketing Division (COMD) and Domestic Crude is sold by the Federation to NNPC. The accounting system used by NNPC for equity crude is still largely not automated with consequent reconciliation and fund sweeping interface difficulties. Although the audit found that no funds were lost as a result of the above, it is important that the planned SAP Enterprise Resource Management should be accelerated in its implementation.

Action:

This transaction system manages the single most significant source of income to the Federation. The system should be urgently upgraded to best practice.

SALE OF TAX AND ROYALTY OIL

NNPC receives crude oil from Production Sharing operations which it sells in order to settle PPT and royalty liabilities. The method of accounting for the tax and royalty elements is unsophisticated and does not identify the relative proceeds separately from the sale of government equity crude.

Action:

Improved accounting procedures are required to improve the transparency of NNPC's handling of these components of the proceeds of crude sales.

OTHER PROCEDURAL RECOMMENDATIONS

Difficulties arose in tracing the proceeds of Naira-denominated income through NNPC to the Federation account. The audit did ultimately confirm that all relevant revenue had been duly accounted for. However, the efforts required to do this were immense. NNPC should improve its accounting procedure in order to put it in a position to demonstrate readily that it has properly accounted for all income.

The audit confirmed that NNPC owed the Federation 655 Billion Naira in respect of domestic crude and other sundry income. A part of this arose from only partial implementation of sweeping

mandates issued by NNPC. Thus payments to the Federation were in effect delayed beyond the authorised 3-month credit period to the extent of 332 billion Naira (subject to the Subsidy issue – see below).

Action:

NNPC accounting systems should be strengthened to enable the amounts owed to the federation to be readily determined on a day to day basis.

SUBSIDY ON REFINED PRODUCT

As at 31 December 2005 NNPC was claiming N351 billion product importation subsidy. This amount was supported by an independent accountant's report and had apparently been approved by the President. The amount has not, however, been disbursed to them to date. NNPC is currently notionally offsetting its arrears for payments of domestic crude against this claim. This is not a transparent position. It should be resolved promptly.

Action:

Government should pay NNPC approved product importation subsidy so that the domestic debt situation can be reduced.

SIGNATURE BONUS

RECEIPT OF SIGNATURE BONUS

We could not confirm all Signature Bonus payments in the year 2005 reported to us by DPR and the companies. The management of signature bonus in 2005 was not transparent.

The PTDF Act requires all Signature Bonus to be paid into the Petroleum Training Development Fund. The PTDF however refused to cooperate with the audit. We were therefore unable to obtain confirmations from PTDF that the Fund had received all bonuses that the companies and DPR reported.

CBN did not provide any data on Signature bonus payments.

CBN maintained the PTDF Reserve Account in Naira whereas the payments were made by the paying companies in USD bank drafts.

Action:

PTDF should be required to cooperate with the audit and should make available all relevant bank statements.

All signature bonus payments should be made by one clear method to an offshore account designated for that purpose. For example, payment could be made by transfer into an offshore US\$ account with notification to DPR and the Office of the Accountant General of the Federation similar to the system used for other oil and gas flows such as Royalty and

PPT. The current multiplicity of payment methods to different bank accounts is not transparent and does not serve accountability.

We note that an independent report was commissioned into the PTFD. Accordingly, while the issue remains unresolved for NEITI audit purposes, the need for further work in this area should be assessed in the light of the findings of other reports.

We have been informed by the Accountant General that improved procedures have been established for payments occurring in 2008. It remains necessary however to address the uncertainties relating to previous years.

TIMING OF PAYMENT OF SIGNATURE BONUS

The payment plan prescribed in the guidelines to bidders in the 2005 bid round required successful bidders to make payment after the execution of the PSC agreement with NNPC. On the other hand, the guidelines do not define the time frame within which the agreement must be concluded for the payments to take effect.

To manage the receipt of signature bonus, DPR requires information from NNPC NAPIMS in relation to the achievement of certain development milestones. No such channel of communication existed.

OIL TRANSFERS TO THE FEDERATION

Under Production Sharing Contracts, Carry and Unitisation agreements, “in kind” transactions are used to settle Petroleum Profits Tax and Royalty liabilities in lieu of financial payments. The sharing of profits is also effected by allocation of oil production. In 2005, these transactions were relatively new because up to that point most production had been from Joint Ventures; in 2005, PSC production became much more significant. The value of in-kind transactions in 2005 was US\$ 648 million. The accounting methodologies for in-kind transactions were under-developed and were not adequately managed by NNPC. It should be noted that NNPC became aware of this issue and has informed us that the systems have subsequently been strengthened.

The financial provisions made by the respective PSCs could not be completely reconciled to the allocated crude volumes or matched against the proceeds realized by NNPC COMD for PPT and Royalty. NNPC did not keep suitable records of its entitlements, liftings and respective sales proceeds. The method of settling liabilities in this way appeared not to have been thoroughly thought-through. NNPC did not account separately for the portion of oil sold in settlement of tax and royalty liabilities. Consequently, although there is no loss to the Federation, FIRS and DPR are being put in a position of being required to issue receipts for payments they never see and cannot verify.

There is no separate accounting for any holding gain or loss that NNPC might suffer as a consequence of being changes in the oil price between the month of an entitlement being allocated to NNPC and the month in which NNPC actually lifts it. If NNPC is unable to (or choosing not to) lift crude entitlements from PSCs, such gains or losses should be identified and accounted for. NNPC would then have a conflict of interest in deciding whether to nominate a particular cargo (which might have an inherent gain or loss) as export crude or domestic crude.

NNPC confirmed that separate FIRS and DPR accounts were opened in 2007 for the collection of tax oil and royalty oil proceeds respectively. These proceeds are therefore now regularly reconciled with FIRS and DPR. Furthermore, NNPC is now fully responsible for the determination of PSC PPT and Royalty and now routinely reconcile the sales proceeds to the related liability provisions.

Action

NNPC's conflict of interest should be eliminated by establishing clear rules on accounting.

Rules on the order in which cargoes are applied should be developed.

Benefits in Kind are of more and more significance because more and more PSCs and Carry Agreement are coming on stream. All concerned- companies, FIRS, DPR, and NNPC should improve their records to be able to cope with the reconciliation, validation and reporting that this intricate flows deserve.

It is recommended that a comprehensive system documentation of NNPC records and reconciliation of volume and value of PSC and Carry transactions should be carried out in the 2006 audit. Appropriate templates should be designed and applied in the collection of the relevant benefit in kind data from NNPC and the other party to the agreements.

MONITORING INFLOWS TO THE FEDERATION ACCOUNT

The Revenue Mobilisation Allocation and Fiscal Commission has the senior role in the monitoring of revenues. However, its practical activity as regards income has been limited, in effect, to participation in the FAAC.

Action:

In the light of the difficulties encountered in the course of the audit in determining definitive financial values, the Commission should make use of the audit findings and check whether the correct 2005 figures were used for FAAC purposes.

ROLE OF THE DEPARTMENT OF PETROLEUM RESOURCES

Government should position itself to manage hydrocarbon development on a wider front than presently. DPR does not have a comprehensive database of those who hold OML and OPL in the sector with the consequence that complete information on all the stakeholders in the sector cannot be readily obtained. Furthermore, the inter-relationship of physical and financial aspects is not being covered. In the short term this means that Government makes no direct correlation between physical production and the financial flows (taxation, equity crude) that are derived from production.

DPR should be strengthened to enable it to fulfil its strategic role in the industry.

Actions:

DPR should receive technical assistance to establish and maintain a database of license holders and license areas.

DPR should report to Government regularly on transfers of working interests by holders of OMLs and OPLs.

DPR should report to Government regularly on all hydrocarbon flows.

DPR should develop, consult with the sector and issue regulations for the computation of royalty.

Consultation should be undertaken between NSWG, DPR, NAPIMS and the operating companies on practical steps to achieve this.

ROYALTY

DEFINITION OF STANDARDS

The industry has no consistent practice regarding the point at which production is measured for royalty purposes. The law is unclear. DPR has not promulgated a standard interpretation.

Action:

Undertake a consultation process with operators to define a workable and clear basis on which production volumes and API for royalty purposes are to be determined.

VERIFICATION OF COMPANY ROYALTY CALCULATIONS

DPR has not rigorously verified royalty computations prepared by companies and the key related variables in computation - volume and API seem to be interpreted and applied subjectively by the companies.

Audit review of Royalty calculations indicated an estimated US\$ 243 million under-assessment of royalty, arising from the use of inappropriate pricing.

Action:

Establish a system for verifying royalty volumes, API and applicable royalty rates to reconciled physical data.

PETROLEUM PROFITS TAX

Companies self-assess their PPT liabilities. These assessments have tended to be accepted by FIRS without due validation. FIRS was not proactive in assessing and collecting the PPT liabilities of the companies. The regime in 2005 amounted to unregulated self-assessment.

The audit review highlighted many areas of difference between PPT computations and audited financial statements. Differences relate both to matters of principle and reconciliation of figures.

The companies in many cases disagree with the findings of the review. Having regard to the amounts of money at stake, FIRS should follow up the issues with the companies. It is important to the stability of the sector investment environment that tax law should be clear and its application predictable.

Action:

FIRS should prepare and issue a policy statement addressing the Issues of principle, including the interpretation of legislation, and should engage with companies to clarify how the legislation should be applied.

AGREEMENT OF COMPANY PPT RETURNS TO AUDITED FINANCIAL STATEMENTS

Two companies (Chevron Nigeria Limited and Mobil Producing Nigeria Unlimited) do not have JV AFS in Dollars but in Naira whereas the PPT return is filed in Dollars. The Naira JV audited financial statements, when expressed in US Dollars, do not reconcile to gross JV costs in the templates submitted for audit, nor to the JV approved performance for the year under review.

In recent years, additional sums have been approved as 'performance' long after the year end, complicating this reconciliation. The companies could not support their PPT returns with a meaningful reconciliation to audited financial statements.

Action:

FIRS, with NEITI should carry out a detailed investigation into this issue with a view of establishing how Mobil Producing Nig. Unlimited have compiled their PPT returns cost in the past and what steps should be taken to improve the situation in future.

PPT FISCAL VALUE/REVENUE

In the determination of the PPT Fiscal Value all the Joint Venture companies failed to apply correctly the Memorandum of Understanding (2000) as regards the use of Realizable Price (RP) to derive their PPT Fiscal Value. They did not elect PPT Fiscal Value on basis of higher of sale proceeds and Official Selling Price (OSP) as per section 2.4 of the 2000 MOU.

- Companies that are not covered by the MOU also used RP instead the OSP provisions set out in the PPTA.
- Misapplication of the MOU revealed significant differences which the FIRS should investigate with a view of issuing additional assessments.

- The oil producers have requested a meeting with DPR and NEITI to discuss these issues.

The fiscal value difference, for the 10 companies examined in the audit, amounted to US\$ 374 million, with consequent PPT impact of \$310 million.

Action:

FIRS, with NEITI should carry out a detailed investigation into this issue.

CAPITAL EXPENDITURE

Two companies, Shell PDC and Mobil PNU claimed capital allowances on capital construction in progress. They argue that Para 15 of the Second Schedule to the PPT Act allows for the claiming of capital allowances from the moment the expenditure is incurred, rather than when the asset is first put to use.

By accelerating their claims for capital allowances, these companies have significantly reduced their calculations of their PPT liabilities.

The amount of Fixed Assets under construction was US\$ 1,216 million.

Action:

This issue requires urgent clarification by FIRS and if necessary a legal interpretation.

CARRY AGREEMENTS

NNPC enters into Carry Agreements with some of its Joint Venture Partners where the respective JV Partner funds the full cost of executing the development of a field or a Production Improvement Project (PIP). The Carry Party has a right to recover such cost together with interest, through Capital allowances and Investment Tax Allowances and sometimes by additional production entitlement. Arising from this review, it appears that there might be significant amounts of PPT underassessment.

Action:

We recommend that NEITI, FIRS and NNPC should establish a working committee to address these issues.

OTHER AREAS

Our review indicated potentially significant PPT under assessments in relation to:

- operating expenses- (Opex): amounts claimed in PPT self assessments exceeded amounts shown in audited financial statements by US\$ 250 million.
- intangible drilling and development costs- (IDDC): amounts claimed for PPT purposes exceeded audited financial statements by US\$ 64 million and further amounts of US\$ 304 million require investigation.

- investment tax allowance: possible overclaims amount to US\$ 86 million.
 - a) capital allowance on non-associated gas: US\$ 122 million requires policy clarification.
 - b) review of gas flare penalty:

In several areas, the legislation is unclear as to how the liabilities and allowances should be computed. A comprehensive list of these matters is included in the report and should be taken up by FIRS. Legal opinion will in several cases be required in order to resolve the matters definitively.

Actions:

FIRS should follow up the apparent discrepancies in the PPT computations, raising revised assessments as applicable. Companies should be required to justify the figures they use in their self assessments.

FIRS CAPACITY BUILDING

FIRS requires significant capacity building. Assistance is required to strengthen its capacity to deal with technical oil industry accounting issues. FIRS also needs better collaboration with DPR to ensure that PPT computations are consistent with production data. FIRS internal financial systems should be upgraded.

Action:

The FIRS chairperson, following FEC approval in December 2006, had already initiated steps in these directions after the 1999-2004 audit but little progress has been made thereon.

GAS REGULATION

In 2005, there was no effective regulation of gas. Company declarations of gas produced, flared and sold were not susceptible to corroboration. Gas purchasers had no independent means of measuring the quantities of gas they received.

Action:

Subject to the OGIC review, the regulation of gas should be clarified.

Standardised methodologies for measurement of gas flared should be promulgated.

GAS INCOME SHARED WITH THE FEDERATION

The Federation is entitled to a share of the proceeds of gas sales, in accordance with the contracts governing each development.

NNPC NAPIMS is responsible to supervise / control whether the Federation is receiving its due share of income from gas sales. NAPIMS did not respond to audit requests for data on this Federation entitlement. It appears that the interest of the Federation was not being effectively protected.

A multiplicity of methods are used for paying the Federation share of gas proceeds. Some are Accounted for by JV operators, some paid directly by gas purchasers to NNPC, some shared in terms of equity profit share of operations. The arrangements should be reviewed and a single method agreed that everybody understands and is readily verifiable.

Action

NNPC should design a system that suitably controls gas income to the Federation.

PAYMENTS TO NIGER-DELTA DEVELOPMENT COMMISSION

UNRECONCILED TRANSACTIONS

Some payments notified to us by companies as having been made to NDDC, and supported by usual transaction documentation, were not included on the reports NDDC provided to us.

Action

Accounting controls within NDDC should be audited and the destination of the payments ascertained.

DETERMINATION OF AMOUNTS REQUIRED TO BE PAID TO NDDC

The amounts calculated by the companies as due to NDDC for 2005 differed from our calculations.

The calculation method is set out in section 14.2(b) of the NDDC Act 2000 which requires relevant companies to pay 3% of total annual budget to NDDC.

Whereas the companies are of the opinion that this is a reference to the annual budget prepared at the beginning of the year, it should be noted that, in the oil and gas sector, this terminology usually refers to the total actual expenditure approved by the parties after the end of a financial year. We therefore consider the Law intends that obligations to NDDC should be based on actual expenditure for the year (annual approved budget closure).

Action

The NSWG should liaise with NDDC and if necessary obtain legal opinion to get an authoritative interpretation as is necessary so that past payments can be adjusted and future payments accurately calculated.

It should be noted that the amount of this levy is of great significance to relevant companies, as it not based on profit but on gross expenditure. It is therefore in effect a surcharge on all capital and operating expenditure.

MANAGEMENT OF REFINED PRODUCT IMPORTATION AND DISTRIBUTION

The system of measuring and recording refined product receipts and pipeline movements requires upgrading.

The measurement methods used by PPMC and DPR are not in accordance with best practice. They are not consistently applied and cannot be relied upon.

The systems for recording the movement of refined product through the PPMC pipeline system are outdated, paper-based and subject to error. The management and monitoring strategy requires revision and upgrading.

A substantial value of product was lost in 2005. PPMC has not offered an analysis of the losses, in terms of pipeline vandalism, theft, leaks, evaporation etc.

Action:

NNPC has agreed with the foregoing comments and wishes to proceed to upgrade the system.

JOINT DEVELOPMENT ZONE

The Joint Development Authority did not cooperate with the audit.

Questions have been raised as to the probity and transparency of the 2005 licensing round. We reviewed the available evidence. We were not able, however, to access the JDA itself to review documentation concerning the award of licenses.

The NEITI audit for 2006 should confirm that Nigeria receives its attributable share of signature bonuses from the Joint Development Zone.