Appendix F

MAR. 06. 2001 (TUE) 15:00 GDP ASSOCIATES 212 832 5250 PAGE. 1

Sono OSP

GDP

ASSOCIATES, INC.

[redacted] • New York, NY 10022 [redacted]

FACSIMILE TRANSMISSION

To: Mr. David Chalmers, President, Bayoil Inc.

Fax #: [redacted]

From: Giandomenico Picco

RE:

Date: March 6, 2001

No. of pages (including this cover sheet): 10

PERSONAL

BAY04-01163

SECURITY COUNCIL COMMITTEE ESTABLISHED BY RESOLUTION 661 (1990) CONCERNING THE SITUATION BETWEEN IRAQ AND KUWAIT

S/AC.25/2001/OIL/COMM.07
20 February 2001
ORIGINAL: ENGLISH

Letter dated 20 February 2001 from the Overseers addressed to the Chairman of the Security Council Committee established by resolution 661 (1990) concerning the situation between Iraq and Kuwait

Reference S/AC.25/2001/OIL/1330/OC.12 20 February 2001

Sir,

The following report of the Oil Overseers was prepared pursuant to the request by the Chairman of the Security Council Committee established by resolution 661 concerning the situation between Iraq and Kuwait made at its informal meeting dated 13 February 2001, following the letter dated 6 February 2001 from the Chargé d'Affaires, A.I. of the Permanent Mission of the United States to the United Nations addressed to the Chairman (S/AC.24/2001/Comm.83 – attached). In this letter, *inter alia*, the Oil Overseers were requested to provide a clarification on "what their monitoring of the oil industry has indicated regarding payment of the surcharge; an explanation for Iraq's much lower than normal shipments of crude oil in January and December; the value of revenues lost to the Oil-for-Food program as a result of decreased oil exports; and whether or not there is room in the most recent pricing mechanism proposed by SOMO for imposition of a surcharge".

1. Background

The questions raised have to some extent been addressed in the Oil Overseers' letter dated 13 February 2001 addressed to the Chairman of the 661 Committee (S/AC.25/2001/OIL/Comm.06 - attached): Some of the analysis contained in that letter is repeated here.

In order to gain an understanding of the events that have taken place in the past few months it is important to be aware of the recent trends in the structure of contractual relationships between the different parties involved in Iraqi crude oil exports.

Amongst the phase IX contract holders there are very few companies that can be classified as end-users of crude oil. Many of the current contract holders seem to be intermediaries who are not known in the petroleum industry. They are very small in size and seem to have limited credit facilities. This means that, due to the large sums of money involved, they often cannot open letters of credit and/or charter ships on their own account. In most cases the end-users (i.e. refining companies) will not purchase from these companies because of the limited possibility for compensation in the event of non-performance. As a consequence of this, these contract holders have to sell their oil to the (bigger) trading companies, which subsequently on-sell the oil to the end-users.

Those trading companie... ormally have the (credit) facilities th... llow them to perform the activities that cannot be executed by the intermediaries. The relationship between the trading companies and the intermediaries appears to vary from being distant to an extremely close alliance.

The current structure, as described above, has gradually evolved from a situation in which SOMO, by and large, were: a) directly selling to end-users, then b) were selling via traders to end-users and now c), are selling via intermediaries to traders who on-sell to end-users.

This means that there are often at least two companies in the contractual chain between SOMO and the end-user, both of which naturally want to make a profit.

2. Pricing mechanisms proposed by SOMO and OSP setting

SOMO and the Oil Overseers agree from time to time on an Official Sales Price (OSP) that is fixed for a certain period. This period is normally a month but can be shorter depending on the volatility of the markets.

The Oil Overseers' objective is to set the OSP within a band which is determined by the following boundaries:

-The upper limit should be such that end-users (i.e. refiners) find the OSP levels attractive compared with alternative crudes. Due to volatility in the market this can only be evaluated over an extended period of time. (Say three to four months).

-The lower limit should be such that no structural trading profits exceeding some five cents per barrel can be made given the low risk nature of the task generally undertaken by the intermediaries.

The Oil Overseers are under the impression that SOMO's recent objective of the price setting is different in two aspects:

-SOMO seems to target a price (OSP) that allows at least $0.20 per barrel profit for traders/intermediaries.

-SOMO seems to prefer to see these profits to be realized on a cargo-by-cargo basis rather than over an extended period. This explains the frequent requests for a (downward) price revision as we have lately experienced. This short term view is also confirmed by SOMO granting contracts with a validity of only between six and eight weeks, rather than for the full six month period which was customary.

It is important to bear in mind that the attractiveness of all crudes may fluctuate substantially due to changing market conditions. The OSP for a certain period can only reflect one set of market assumptions for that (future) period. This means that, even in the case of the OSP being set at exactly the "right" level, the markets will during that period sometimes value the crude higher than the OSP or sometimes lower than the OSP. For a freely tradable crude like Iraq's this can lead to prices in the market which are either above (premia) or below (discounts) the OSP. These premia or discount represent normal oil industry commercial practice.

If the current mode of exports continues, some 100 million barrels will be exported and the estimated revenue generated during Phase IX would be around Euro 3.9 billion ($ 3.5 billion). If export levels returns to more or less normal, then the revenue generated is estimated at around Euro 6.3 billion ($ 5.7 billion).

6. Summary and Conclusions

a) Iraqi crude oil, on a fob basis, has been consistently offered to end-users at substantial premia over the OSP's. Under certain market conditions these premia (but not necessarily surcharges to Iraq) could be economically justified and could have been paid by some end-users. Others have refused to purchase oil because of concerns related to the possibility of part of the premia being used for surcharges to be paid to Iraq outside of the United Nations Iraq account.

b) In cases where no substantial premia could be acquired deals have fallen apart, nominations have been cancelled and the oil was not exported. This also explains (at least partly) why Iraqi crude oil, on a fob basis, has not traded at small premia, or even discounts during the past few months.

c) At the same time some traders who have been involved in delivering Iraqi crude into the Gulf of Mexico might have incurred losses. This is due to taking an exposure to the US market for delivered oil, which has recently deteriorated substantially.

d) Due to the short term profit perspective of SOMO's direct customers it is almost impossible to set an OSP that guarantees them a realistic profit level on a cargo by cargo basis. The Oil Overseers have repeatedly resisted giving in to an OSP setting that leaves a substantial "profit cushion" in case the markets deteriorate. This has lead to some friction between SOMO and the Oil Overseers.

The Oil Overseers appreciate the confidence in their work and the support they receive from the Committee.

Accept, Sir, the assurances of our highest consideration.

The Overseers

Morten Buur-Jensen

Alexandre Kramar

This needs to be considered when addressing the specific question o. whether the OSP recommended by the Overseers allows room for surcharges. Certainly, the intention in setting the OSP is to mitigate the possibility of excessive premia being paid. However, the natural fluctuation of the market will mean that regardless of how the OSP is set, under some market conditions there could be room for surcharges.

3. Payment of surcharges

It would appear that since December, end-users can consistently only buy Iraqi crude oil at a premium of 20 - 50 cents per barrel over the OSP on a free on board (fob) basis.

To what extent, if any, these premia are being used to pay illegal surcharges to Iraq is unknown to the Oil Overseers. When directly asked by the Oil Overseers about surcharges the State Oil Marketing Organization (SOMO) categorically denied the allegations.

However, direct contacts with traders and end-users in the oil industry confirm in broad terms what has been written in the professional press on this matter.

4. Lower than normal shipments of Iraqi crude oil in January and December

The Oil Overseers are of the opinion that export levels seem to have been negatively affected under those conditions in which, for legal or commercial reasons, end-users are not prepared to pay a substantial premium.

5. The value of revenue lost to the Oil-for-Food programme

During the month of December 2000 Iraq exported approximately 18 million barrels of crude oil, which is some 50 million barrels less than would have been expected. Assuming an average price of $20 per barrel, the reduced export level reflects a loss in revenues of about $1 billion for December.

During January 2001, Iraq has exported some 31 million barrels of oil. This export level was considerably lower than had been expected and, at an assumed export level of 2.2 million barrels a day and an oil price of $20.80 per barrel, this represents a loss of income of some $775 million for January.

Since the beginning of phase IX to 16 February 2001 about 65 million barrels of Iraqi crude oil were exported, including 51 million barrels from Mina-al-Bakr (78%) and 14 million barrels from Ceyhan (22%). The value of this export is estimated at Euro 1,481 million ($ 1,346 million at the current rate of exchange).

Normally Iraqi crude oil exports per month are some 26-28 million barrels ex Ceyhan and 38-45 million barrels ex Mina-al-Bakr. On the assumption that the average level of Iraqi crude oil export per month is (conservatively) 65 million barrels, then at least 100 million barrels of export volume has been forgone up to 16 February. In terms of money, some Euro 2.4 billion ($ 2.2 billion.) in revenue has been lost.

SECURITY COUNCIL COMMITTEE ESTABLISHED BY RESOLUTION 661 (1990) CONCERNING THE SITUATION BETWEEN IRAQ AND KUWAIT

S/AC.25/2001/OIL/COMM.06
13 February 2001
ORIGINAL: ENGLISH

Letter dated 13 February 2001 from the Overseers addressed to the Chairman of the Security Council Committee established by resolution 661 (1990) concerning the situation between Iraq and Kuwait

Reference: S/AC.25/2001/OIL/1330/OC.10 13 February 2001

Sir,

With reference to the attached communication dated 13 February 2001 from the State Oil Marketing Organization (SOMO) of Iraq, submitting for the approval of the Security Council Committee established by resolution 661 (1990) concerning the situation between Iraq and Kuwait the revised pricing mechanisms for loadings of crude oil during 13-28 February 2001 in accordance with paragraphs 5 and 6 of the Procedures to be employed by the Committee in the discharge of its responsibilities as required by paragraph 12 of Security Council resolution 986 (1995), the Overseers have the following assessment:

On 6 February the Committee endorsed the revised prices (OSP's) for February loading crude oil that is destined for the European and US markets. Since then the attractiveness of Iraqi crude oil in these markets has deteriorated further.

Notwithstanding this deterioration, end-users have been confronted with fob offers of Iraqi crude oil which reflect in general a substantial premium over OSP's: say between 20 and 70 cents a barrel. In an essentially risk-free environment these premia should be considered as excessive. Although many end-users have shied away from paying high premia for legal reasons, there have been temporary market conditions under which these could be justified economically. There have also been moments however, at which the economics should have dictated a smaller premium or even a discount, as could be expected at this moment. However, no such reduced premia or discounts have occurred for some months.

Export levels seem to have been negatively affected under those conditions in which, for legal or commercial reasons, end-users were not prepared to pay a substantial premium.

The current situation can be summarized as follows:

- By far the largest part of Iraqi crude oil is nowadays sold via middlemen and traders rather than directly to end-users (refiners). The former have a very short term profit perspective and often look at this issue on a cargo-by-cargo basis.

- The markets have moved in such a way that the OSP's for Europe and the US are currently too high to allow any sales to end-users to take place without the middlemen/traders accepting negative or zero premia.
- In absence of end-users paying premia of at least around 20-25 cents per barrel the oil is apparently not exported.

In the context of the foregoing, the Oil Overseers would like to make the following observations:

- The need for price revisions more than once a month is mostly a direct consequence of the nature of the contractual structures between SOMO and the end-users.
- SOMO's contract holders' requests for excessive premia in combination with the erratic nature of the exports has been damaging for the income into the UN-Iraq account.
- The Oil Overseers recommendation is motivated by their objective of maximizing oil exports and income into the UN Iraq account within the contractual structure as has been chosen by SOMO.
- This contractual structure asks for market responsive pricing and, as the Oil Overseers do not allow a substantial built-in "profit cushion", price revisions may occur more often if markets are volatile.
- The Oil Overseers are concerned that, under the current arrangement, price revisions can only go in one direction (i.e. downwards) since there is no mechanism, apart from SOMO's request, to increase prices.

Notwithstanding the observations above, given the current situation, the Oil Overseers would like to recommend to the Committee the proposed SOMO adjustments of the pricing mechanisms for US and European destinations for loadings during 13-28 February.

Accept, Sir, the assurances of our highest consideration.

The Overseers

Alexandre Kramar | Morten Buur Jensen | Michel Tellings

MAR. 06. 2001 (TUE) 15:05 ODP ASSOCIATES [redacted] PAGE. 9

جمهورية العراق
وزارة النفط
هيئة التسويق
سومو

REPUBLIC OF IRAQ
MINISTRY OF OIL
STATE OIL MARKETING
S.O.M.O

HK, MT, MA

Ref P/2491
Date 1 2/2/2001

TO: H.E. OLE PETER KOLBY
CHAIRMAN
SECURITY COUNCIL COMMITTEE
ESTABLISHED BY RESOLUTION 661 (1990)
FAX: 212 963 1300

CC: THE UN OVERSEERS
FAX: 001212 963 1025 NEW YORK

FROM: SOMO - BAGHDAD - IRAQ
FAX : 00964-1-8853926

DEAR SIR,

F.O.FAX P/(88) DATED 1/2/2001.
DUE TO THE RECENT CHANGES IN THE OIL MARKETS, AND IN ACCORDANCE WITH
PARAGRAPH (6) OF THE PROCEDURES ADOPTED BY YOUR COMMITTEE DURING ITS
MEETING NO.142 ON 8/8/1996, STATE OIL MARKETING ORGANIZATION (SOMO) HEREBY
SUBMITS ITS REVISED PRICING MECHANISMS FOR LOADING DURING FEBRUARY (1-28 2001) AS FOLLOWS:

1. FOR THE EUROPEAN MARKET
   - KIRKUK EX-CEYHAN = BRENT DATED – U.S.DLRS. 3.80/BBL. 3.80
   - BASRAH LIGHT EX-ALBAKR = BRENT DATED – U.S.DLRS 4.75/BBL. 4.75

2. FOR THE U.S. MARKET
   - BASRAH LIGHT EX AL BAKR = WTI (SECOND MONTH) – U.S.DLRS 9.20/BBL 9.20
   - KIRKUK EX CEYHAN = WTI (FIRST MONTH) – U.S.DLRS 8.35/BBL 8.35

3. SHOULD THE CURRENT DIFFERENTIALS BETWEEN SOUR AND SWEET CRUDES CHANGE, SOMO SHALL CONSIDER REVISING ABOVE PRICING MECHANISMS ACCORDINGLY.

API ESCALATION/DE-ESCALATION AND OTHER TERMS AND CONDITIONS REMAIN THE SAME.

YOUR CONSIDERATION AND EXPEDITE APPROVAL OF THE ABOVE-MENTIONED PRICE MECHANISMS IS HIGHLY APPRECIATED.

PLEASE ACCEPT MY HIGHEST REGARDS.

SADDAM
SADDAM Z. HASSAN
EXECUTIVE DIRECTOR GENERAL
S. O. M. O.

P. O. Box : 5118 Baghdad - IRAQ

BAY04-01170

SECURITY COUNCIL COMMITTEE ESTABLISHED
RESOLUTION 661 (1990) CONCERNING THE
SITUATION BETWEEN IRAQ AND KUWAIT

S/AC.25/2001/COMM.83
7 February 2001
ORIGINAL: ENGLISH

LETTER DATED 6 FEBRUARY 2001 FROM THE CHARGE D'AFFAIRES A.I. OF THE PERMANENT MISSION OF THE UNITED STATES TO THE UNITED NATIONS ADDRESSED TO THE CHAIRMAN

The United States Mission to the United Nations presents its compliments to the Chairman of the Security Council Committee established pursuant to Resolution 661 (1990) concerning the situation between Iraq and Kuwait and would like to take this opportunity to share our concerns about the oil pricing mechanism. The United States has consistently supported the oil overseers' assessments regarding Iraqi oil prices. We recognize that it has been particularly difficult for the overseers to carry out their responsibilities over the last several weeks, and we are appreciative of their efforts and professionalism.

Our support for the overseers' assessments has been based on the assumption that a fair market value price offers the most effective protection against an oil purchaser being in the financial position to pay any unauthorized surcharge or kickback to the seller. We are very troubled, therefore, by continuing reports in the business press and communications we have received from companies that SOMO is demanding, and some oil buyers are paying, a surcharge of 10-50 cents a barrel, to be paid directly to Iraq. Although this is clearly a contravention of UNSC resolutions, as well as written instructions provided to all buyers by the overseers with the agreement of the 661 Committee on December 15, 2000, some reports indicate that many buyers are not still not aware of these facts or are simply ignoring them. A February 2 report from Reuters is typical, and it outlines a very sophisticated surcharge mechanism that has been changed in reaction to market:

> "Iraq has meanwhile eased its oil surcharge demand considerably from an initial 50 cents per barrel over the official selling price, but the Iraqi government is by no means backing down from its policy. Indeed, industry sources said Iraq has softened its cash request in a bid to reflect market conditions. "Retroactive to December 1, lifters to Europe must pay 25 cents a barrel and lifters to the U.S. must pay 30 cents a barrel," said an official in the Iraqi capital. "Some customers have paid the 40 cents and they will be reimbursed the difference."

BAY04-01171

MAR. 06. 2001 (TUE) 15:06 GDP ASSOCIATES [redacted] PAGE. 10

It is important that the overseers not recommend to the Committee a pricing mechanism that leaves room for a surcharge. We request that the oil overseers prepare a written report to the Committee on this issue to include: what their monitoring of the oil industry has indicated regarding payment of the surcharge, an explanation for Iraq's much lower than normal shipments of crude in January and December, the value of revenues lost to the Oil-for-Food program as a result of decreased oil exports and whether or not there is room in the most recent pricing mechanism proposed by SOMO for imposition of a surcharge. We further request that when the report is completed, the overseers give a presentation on their findings and observations to the Committee in a formal meeting.

While we do not object to the pricing mechanism proposed in your note of 1 February, we hope that the overseers report and presentation will provide the Committee with a basis for improved evaluations of future pricing mechanisms and consideration of actions to address problems.

Finally, we request that this note be circulated to members of the Committee.

Accept, Sir, the assurances of my highest consideration.

Sincerely,

James B. Cunningham
Chargé d'Affaires, a.i.

BAY04-01172