AUDITOR GENERAL'S DEPARTMENT OF JAMAICA

A Review of Aspects of PCJ and a Comprehensive Audit of Petrojam Limited

Compendium Audit Report

December 2018

"A Better Country Through Effective Audit Scrutiny"

Foreword

The Petroleum Corporation of Jamaica (PCJ) is a statutory organization created by the Petroleum Act, with the exclusive right to explore and develop the petroleum resources of Jamaica. It is also the Government agency charged with the responsibility for facilitating the development of the country's energy resources in a manner that supports the overall strategy for national development in support of the National Energy Policy and Vision 2030 National Development Plan (NDP). PCJ's subsidiary Petrojam's primary function is to import and convert crude oil into various types of petroleum products for supply and use in the domestic market. Both PCJ and Petrojam's governance practices and financial operations are subjected to the Public Bodies Management & Accountability (PBMA) Act, GOJ Corporate Governance and Accountability Frameworks and applicable guidelines issued by the Ministry of Finance and the Public Service (MoFPS).

Stemming from public concerns regarding mismanagement at Petrojam, I commissioned a comprehensive audit using the performance, compliance and special audit methodologies, as well as financial statements assessment of Petrojam. I also reviewed specified areas of PCJ to assess whether its practices were consistent with the principles of good financial management and whether the practices accorded with GOJ Guidelines and good practices, to attain value for money. I also sought to assess whether PCJ provided robust oversight to Petrojam, based on its parent subsidiary relationship. This report is a compendium of the findings of the reviews of both entities.

The audit revealed a number of deficiencies, which have since been brought to the attention of the management of PCJ and Petrojam. I have proffered a number of recommendations for implementation aimed at strengthening the governance arrangements at both entities. However, I believe that these recommendations are of relevance to all public bodies and should be considered by the Office of the Cabinet and Ministry of Finance and the Public Service (MoFPS) for sector-wide implementation.

Thanks to the management and staff of Petrojam and PCJ for their co-operation and assistance during the audit.

Pamela Monroe Ellis, FCCA, FCA
Auditor General

Executive Summary

The Petroleum Corporation of Jamaica (PCJ) is the government entity mandated to manage the country's energy needs in a manner that supports the overall strategy for national development. The Corporation's mission is to undertake the development and promotion of Jamaica's energy resources in support of the National Energy Policy and Vision 2030, the National Development Plan. The PCJ is a partner in two joint venture companies, one of which is Petrojam Limited, 49 per cent of which is owned by PDVCaribe – a subsidiary of Petróleos de Venezuela (PDVSA). Petrojam's primary function is to import and convert crude oil into various types of petroleum products for supply and use in the domestic market, the productive and transportation sectors. Hence, Petrojam plays an important role in Jamaica's energy sector, which makes it necessary to ensure operational efficiency and economical management of resources for a viable and sustainable operation.

The audit was undertaken in response to public concerns about allegations of malpractice at Petrojam. A comprehensive audit was conducted using the performance audit, special investigation and financial statements analysis approach. The audit sought to assess whether the operational activities, governance and monitoring framework at both PCJ and Petrojam are consistent with the principles of good financial management and whether the procurement and contracts management practices accorded with GOJ Guidelines and good practices, to attain value for money.

The audit identified weaknesses in the governance and monitoring framework at both PCJ and Petrojam and deficiencies in Petrojam's procurement and contracts management practices and operational activities. These weaknesses and deficiencies, if left unresolved, will increase the risk of corrupt acts and further erode Petrojam's profitability, which has declined over the last three years. Our findings are summarized in this part of the report.

What we found

No action to cauterize cash flow leaks:

- Project cost overruns
- No value from consultancy arrangements
- Procurement practices undermined value for money objective.
- Questionable spending on donations and nonbusiness events

Weakening Financial Position:

- Minimal and declining net profits
- Inadequate cash to meet this obligation
- Reduced efficiency in the utilization of its assets to generate sales

Increased reliance on short and long-term loan financing:

- Working capital needs
- Capital expansion projects

1. **The Board of Directors was deficient in its oversight and monitoring of Petrojam's operations.** The inadequacy in the established oversight mechanism was demonstrated by the Board of Directors, and its sub-committees' failure to convene regular meetings, which impaired their ability to undertake strategic management and oversight responsibilities. The Accountability Framework, which complements Section 23 of the PBMA Act and Principle 15, Recommended Practice 2 of the GOJ Corporate Governance Framework, makes it a requirement for public bodies to submit minutes of board meetings and other specified reports to the portfolio Ministry. Petrojam's Board did not faithfully comply with these legally established reporting requirements to submit minutes of the Board meetings, annual, half-yearly and quarterly reports to the MSET. We found no evidence that MSET enforced the reporting requirements in ensuring that Petrojam faithfully complied with the reporting requirements and as such, the non-compliance would have curtailed its oversight responsibilities and reporting requirements to Parliament.

2. **GoJ's Corporate Governance framework states that the Board is the primary authority collectively responsible for making decisions.** Whereas, a Board may delegate responsibilities, such as oversight over financial, audit and other critical areas, to its chairman or subcommittees to approve decisions, the decision is subject to authorisation and/or ratification by the full Board. This approach is consistent with good governance; however, we identified inconsistencies in the application of the delegated function. For example, PCJ's Board approved the Sponsorship Policy, wherein the General Manager and Chairman were granted authority to approve sponsorship awards of up to $100,000 and over $100,000 respectively. From a sample of 36 sponsorship awards valuing $39.7 million, over the period 2015-16 to 2017-18, we observed that 18 valuing $22.9 million were approved by the Board. As a result of the delegated function, the Chairman approved 12 sponsorships valuing $15.2 million; however, 10 of these sponsorships valuing $11.6 million were not subjected to ratification by the Board. This approach was inconsistent with good governance, given the value of the sponsorships and the Board's accountability for the outcome of any delegated function and enabled an over extension of the authority of the Chairman.

3. **This was demonstrated by PCJ's management failure to evaluate potential sponsorship awardees, in breach of its Sponsorship Policy, which requires its Information and Corporate Affairs (ICA) Department to evaluate every sponsorship request against PCJ's sponsorship objectives, criteria and risk assessment[1].** However, of the 36 sponsorships, 25 totalling $30.5 million were not evaluated in keeping with the policy. Whereas we observed that the majority of the sponsorships were made to government entities, clubs and societies, for sponsorship approvals granted unilaterally and without the required due diligence PCJ risked sponsoring activities not supported by its policy. In addition, *whereas PCJ's Board consistently submitted board minutes to MSET,* we found no evidence that MSET was active in monitoring and overseeing PCJ's operations.

[1] Meet one or more of the PCJ's sponsorship objectives, fulfil one or more of the PCJ's sponsorship criteria and successfully pass the risk assessment.

4. **Inadequate oversight and monitoring led to systemic breakdown in resource management practices at PCJ and Petrojam resulting in material financial losses.** In executing due diligence to inform its Refinery Upgrade Project (RUP), we found no evidence that Petrojam benefitted from $17.4 million paid for consultancy services to conduct feasibility research and analysis as the deliverables were not achieved (**Case Study 1** and **Case Study 2)**. We examined four projects amounting to $1.5 billion and noted cost overrun totaling $615.7 million on New Petroleum Testing Laboratory Main Docking Facility and the F-2 Furnace Replacement. For the other project, North Perimeter Fence Replacement, Petrojam made a bad business decision by awarding a contract which was $67 million more than an initial estimate for which it could not determine that the additional value was received. This brought total financial exposure on the four contracts to $682.7 million.

	A	B	C	D	E	E-A	E-B
Projects	**Initial Estimates $'000**	**Contract Cost $'000**	**Total Approved Variations $'000**	**Total Variations Paid $'000**	**Total Spent to date $'000**	**Total in excess of Initial Estimates $'000**	**Total paid in excess of Original Contract Sum $'000**
New Petroleum Testing Laboratory	402,310	409,149	132,149	131,009	536,902	134,592	127,753
North Perimeter Fence Replacement	29,771	96,761	-	-	96,761	66,990	-
Main Docking Facility	N/P	783,636	580,588	449,967	1,233,603	N/D	449,967
F-2 Furnace Replacement	138,450	245,495	37,963	37,963	283,458	145,008	37,963
Total	**-**	**1,535,041**	**750,699**	**618,939**	**2,150,724**	**-**	**615,683**

Note: N/P – Not provided; N/D – Not determined

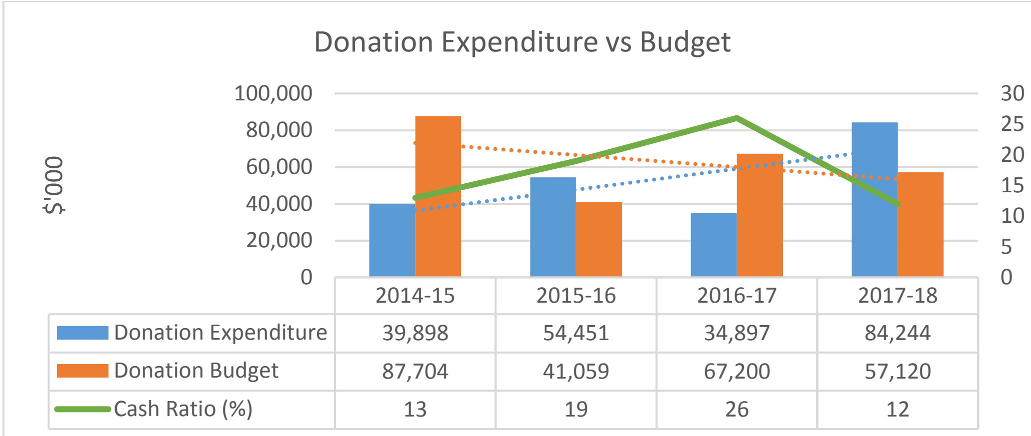
We found breaches of GoJ's Procurement Guidelines in the selection and award of contracts, poor planning and executions of projects and management's bad business decisions, which led to significant delays in the commencement and completion of projects. The details relating to these projects are outlined in **Case Studies 3(a)-(d)**. In awarding contracts, Petrojam frequently contravened the terms of the procurement law and good practice by utilizing the Direct Contracting (DC) and Direct Contracting Emergency (DC-E) procurement methodologies without meeting the allowable circumstances, thus depriving itself of value for money.

5. **PCJ failed to undertake adequate due diligence prior to the engagement of an Architectural Firm to develop a design at a cost of $22.6 million, for the redevelopment of the resource centre.** PCJ paid the the Firm $10.76 million for the conceptualization phase and obtained the related documents and subsequently decided to undertake the project in manageable phases as it did not have the financial capability to pursue the revised scope. PCJ, however, did not recover the mobilization advance of $2.26 million.

6. **We also noted deficiencies in human resource recruitment and management practices at both PCJ and Petrojam, which included explicit acts of nepotism.** While Petrojam has policies that guide its recruitment and employment, its application of these policies was not always consistent. For example, we found instances where two individuals closely connected to employees of Petrojam were employed despite being rejected by the interviewing panel (Case Study 5). In addition, Petrojam's recruitment and promotion activities were not guided by an approved staff listing from the Ministry of Finance and Public Service.

   At PCJ, from a sample of 27 officers, we found that 11 of the related posts were filled without being advertised and there was no evidence that PCJ interviewed or conducted any other assessment for eight of the officers. Our investigations revealed inconsistencies in the application of the Human Resource Policy with the hiring of a Human Resource Officer/HR Specialist and the Business Intelligence Support Officer (Case Study 7). While we observed that MoFPS approved salaries and benefits for PCJ, there was no evidence that MoFPS approved the Performance Incentive and the Reimbursement of Gym fees to employees. In addition, PCJ paid travelling allowances to 29 officers without the approval of MoFPS. This resulted in unapproved payments totaling $48.4 million over the 2015-16 to 2017-18 period.

7. **Although liquidity levels were inadequate to cover current obligations, Petrojam made questionable payments related to procurement activities, had significant project cost overruns and overspent on donations, which further impaired cash flow.** Petrojam could not provide documentary evidence to substantiate payments of $14.9 million for counselling service for employees and consultancy services relating to its 35th Anniversary planning activities. Petrojam's management also spent $2.6 million (US$21,767) to host two 'birthday' parties, which were unrelated to its operations and did not conform with good corporate practices (**Case Study 6**). We also observed that the value of donations doubled between 2013-14 and 2017-18 with the largest year-on-year increase of 141 per cent occurring in 2017-18, when donations totalled $84.2 million relative to $34.9 million in 2016-17. We noted that Petrojam exceeded the donation budget in 2015-16 and 2017-18 by 33 per cent and 47 per cent respectively, without approval from the Board and in contravention of its Donation Policy, despite cash flow challenges. These expenditures underscore the need for Petrojam's management to be prudent over the costs for which it has control (**Case Study 4)**.

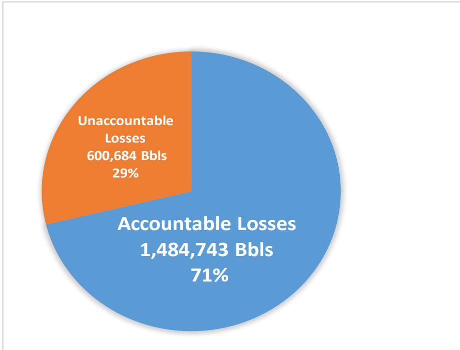


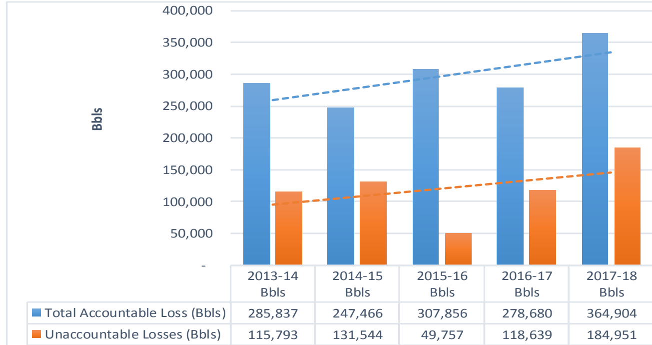
	2014-15	2015-16	2016-17	2017-18
Donation Expenditure	39,898	54,451	34,897	84,244
Donation Budget	87,704	41,059	67,200	57,120
Cash Ratio (%)	13	19	26	12

8. **Petrojam's core refinery operation remains vulnerable given the need to improve production efficiency and capacity to meet the demand for petroleum products.** Petrojam's refinery production averaged 7.4 million Bbls each year, representing 56 per cent of the total production capacity of 13.1 million Bbls; as such, Petrojam could only satisfy 49 per cent of its customers' demand for 15.2 million Bbls. Petrojam indicated that the aging refinery infrastructure, a factor which was outside of its control, not only contributed to its inability to meet its production capacity, but also to the high levels of oil losses.

9. **Over the last five years, Petrojam recorded total estimated oil losses of two million Bbls valuing approximately $18 billion.** The total oil loss included 1.5 million Bbls utilized during refinery production and flaring[2]. However, Petrojam could not account for 600,684 Bbls valuing $5.2 billion. The reported unaccountable losses increased over the period by 60 per cent to 184,951 Bbls in 2017-18 from 115,793 Bbls in 2013-14. Petrojam's average annual unaccountable oil loss of 0.75 per cent was almost two times its own Key Performance Indicator (KPI) of 0.4 per cent. However, while Petrojam identified the sources of the unaccountable oil loss, it was not successful in addressing the problem despite spending US$990,811 to implement measures aimed at minimising oil loss, for which it had control. Petrojam's failure to act in implementing corrective works to improve working conditions at the Refinery also resulted in Petrojam having to pay monthly discomfiture allowances to staff, totaling $57 million between April 2015 and July 2018.

[2] **Flaring:** Burning of unwanted or excess gasses and liquids release during normal operation (accounted for 93,226 Bbls)

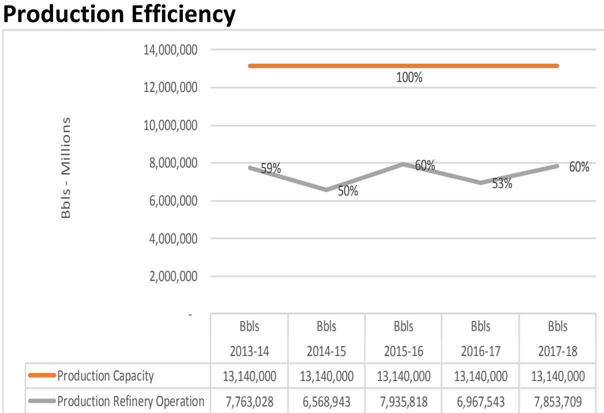




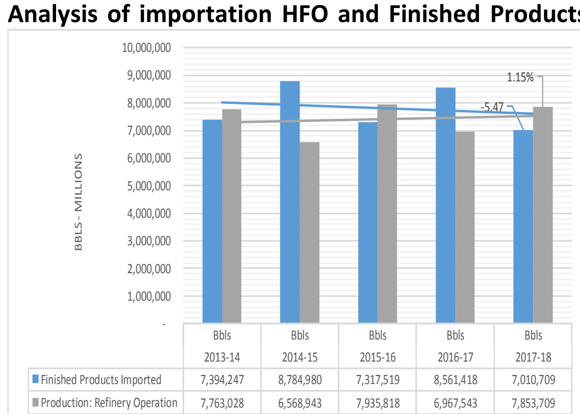
10. **Petrojam did not have an efficient system to validate the volume of products received against the volume ordered.** Consequently, Petrojam made payments for the volumes billed on the suppliers' invoices without validating the actual volumes received. In keeping with industry practice, Petrojam used independent cargo surveyors to gauge the actual volume of product off-loaded by observing the pre and post-product volume readings of the ship. However, this method did not accurately compensate for normal temperature adjustment, which would have contributed to inventory inaccuracies. In an attempt to minimise the reported losses during custody transfers for one of its products, Liquefied Petroleum Gas (LPG), Petrojam acquired a meter and prover system in 2010, at a cost of US$495,611, to accurately measure the volume of LPG received. However, Petrojam has not commissioned it into use and an assessment conducted in February 2018 at a cost of US$11,100 revealed that a major component is now obsolete, rendering the system unusable.

11. **Petrojam relied on imported finished products as refinery production fell below customers' demand.** Although Petrojam reported that the yield (throughput) from imported crude oil averaged 94 per cent, over the last five years, 2013-14 to 2017-18, refinery production averaged 7.4 million Bbls each year, representing 56 per cent of the annual total production capacity of 13.1 million Bbls. This could only satisfy 49 per cent of its customers' demand for 15.2 million Bbls. To ensure the availability of petroleum supplies, Petrojam relied on imported finished products to meet the shortfall, which averaged 7.8 million Bbls each year.

Production Efficiency

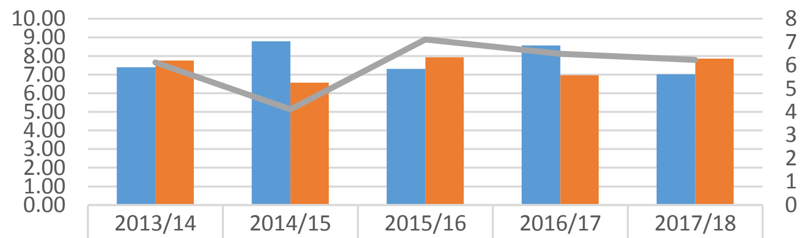


Analysis of importation HFO and Finished Products



13. **Petrojam gained greater financial benefit from its core refinery operations even with its aged plant infrastructure.** We observed an inverse relationship between gross profit margin and imports, which was demonstrated in FY2014/15 when gross profit margin fell in response to a sharp increase in imported finished products. Conversely, there was a direct relationship between gross profit margin and refinery production, where in FY2015/16 gross profit increased significantly in response to an increase in production from crude oil. The adverse impact of the importation of finished products underscored the importance of Petrojam improving its core refinery operations for sustainability.

Impact of importation of Finished Products on Gross Profit Margin



	2013/14	2014/15	2015/16	2016/17	2017/18
Finished Products Imports (In millions of unit)	7.39	8.78	7.32	8.56	7.01
Production: Refinery Operation (In millions of unit)	7.76	6.57	7.94	6.97	7.85
Gross Margin US$ per Barrel	6.13	4.11	7.11	6.49	6.23

We noted a marginal five per cent reduction in importation of finished products in FY2017/18, relative to FY2013/14. Petrojam indicated that this decline was partly related to a reduction in customer demand for automotive diesel oil and Heavy Fuel Oil from industrial customers and power generating companies. On the other hand, Petrojam's refinery production only increased by one percent over the same period. (Financial Statement Analysis).

14. **Following two consecutive years of losses, Petrojam recorded minimal net profits for the last three years, albeit with a declining trend.** Net profit declined to US$18.6 million in FY2017/18 from US$34.98 million in FY2015/16, following a net loss of US$13.53 million in FY2014/15. Petrojam's net profit margin ratio was 0.02 for FY2017/18 indicating that Petrojam recorded 2 cents of profits for each dollar of income received. Petrojam experienced a 42 per cent decline in sales over the review period largely reflected the effects of falling world oil prices. This coupled with an observed reduction in demand from Petrojam, particularly for automotive diesel oil and heavy fuel oil from industrial customers and power generating companies, would have influenced the revenue/expense composition. The entity also continued to face growing competition in the sale of Liquid Petroleum Gas, arising from increased importation by the multinational corporations.

15. **Against the background of declining sales, Petrojam's most liquid assets, cash and cash equivalents, covered only an average of 17 per cent of its current liabilities over the 5-year period.** Hence, in an effort to support working capital, Petrojam borrowed US$35 million from the Petrocaribe

Development Fund in FY2014/15, augmented by a bank overdraft facility of J$101.5 million. Further, in FY2015/16 Petrojam converted dividends previously declared to PCJ, its majority shareholder, to a loan as it did not have adequate cash to meet this obligation. In light of liquidity challenges, Petrojam sought to tighten its management of trade receivables. Accordingly, Petrojam's trade receivables turn over ratio fell to 10.17 in FY2017/18 from 10.99 in FY2013/14. Further we noted that the days receivable outstanding fell to 31 in FY2016/17 from 34 in FY2013/14, but increased to 44 days in FY2017/18 given an expansion in sales that year.

16. **Petrojam experienced reduced efficiency in the utilization of its assets to generate sales.** Although fixed assets increased to US$164.9 million in FY2017/18 from US$117.2 million in FY2013/14, Petrojam's total asset turnover ratio fell based on declining sales over the five-year period. Total asset turnover ratio averaged 2.6 over the review period, given a reduction to 2.3 in FY2017/18 from 2.9 in FY2013/14. This fall in the ratio suggested reduced efficiency by Petrojam in the utilization of assets to generate sales despite an increase in fixed assets.