

MINUTE ITEM

This Calendar Item No. 45
was approved as Minute Item
No. 45 by the State Lands
Commission by a vote of 3
to 0 at its 5-29-80
meeting.

MINUTE ITEM

5/29/80
W 40207
Maulorico
Schreiman

45. INTERNAL CONTROL AND OPERATIONS AUDIT

During consideration of Calendar Item 45 attached, Mr. James F. Trout, Assistant Executive Officer, explained the scope of the audit as set forth in the item. He also advised the Commission had received two letters from Robert Fronke, City Auditor, City of Long Beach, dated May 7 and May 27. In his letters Mr. Fronke questioned the need for the audit but offered his cooperation. He also suggested that the City and State audits be audited instead of THUMS. Mr. Northrop advised he would reply to Mr. Fronke generally stating that the Commission appreciated his help and will be looking to it, but that it is the staff's feeling the audit must address issues of primary interest to the State. This, however, in no way implies that the City's audits are not adequate. Mr. Northrop stated it the staff's intent is two-fold: 1) to ensure the State's best interest is served; and 2) to set a pattern to follow on future audits. In addition, the staff hopes the City will set up their procedures and audits to facilitate the continuing State audit.

Upon motion duly made and carried, the resolution as adopted as presented in Calendar Item 45 was approved by a vote of 3-0.

Attachment: Calendar Item 45

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CALENDAR ITEM

45.

5/80
W 40207
Trout

OPERATIONAL AUDIT OF
LONG BEACH TIDELANDS OIL OPERATIONS
THUMS

At its meeting of April 24, 1980, the Commissioners expressed a desire to conduct an operational audit in the Long Beach tidelands of the Long Beach Unit Oil Operations, and specifically of THUMS (Texaco, Humble-now Exxon, Union, Mobil, and Shell), the Field Contractor for the Long Beach Unit. Following a discussion, the Commission requested staff to report on the scope of such an audit for its review and evaluation.

Following the April 24 meeting, staff contacted eight of the nation's leading CPA firms. These were: Price Waterhouse and Company; Coopers and Lybrand; Arthur Young and Company; Peat, Marwick, Mitchell and Company; Deloitte Haskins and Sells; Touche Ross and Company; Arthur Andersen and Company; and Ernst and Whinney.

In the initial contacts, the basic consideration of staff was the elimination of those firms presently providing services to one or more of the corporations comprising the Field Contractor. The rationale in so doing was to ensure objectivity of audit in the firm eventually selected. No evidence, factual or inferred, was discovered that any of the firms to be contacted could not retain its integrity despite providing a current service to a THUMS participant.

On this basis, five of the eight firms were found to be providing consultant services to a member of THUMS. The three not presently providing such services were Ernst and Whinney (E & W); Peat, Marwick, Mitchell and Company, (PMM); and Touche Ross and Company. Two of these three, E & W and PMM have shown an interest in conducting the desired operational audit and meetings were held with the firms on May 2, 1980, and May 6, 1980, respectively. The suggested scope of audit before the Commission today (Exhibit A) represents an amalgam of the suggestions of the two firms and of the staff.

It should be noted that on May 7, 1980, Mr. Robert E. Fronke, City Auditor of the City of Long Beach, directed a letter to the State Lands Commission questioning whether the contemplated audit would be fruitful given his office's

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audit experience and expertise in the area, but nonetheless offering his complete cooperation (Exhibit B). In this context, staff, on May 23, 1980, delivered to Mr. Fronke's office a draft of the scope of the audit for his comment.

The office of the Legislative Auditor was also advised of the possible implementation of an audit of THUMS.

Since the cost of the audit is not included in the current budget or the proposed 1980-81 budget, a budget augmentation will have to be requested. The amount of such an augmentation is estimated at approximately \$200,000.

EXHIBIT A: Proposed scope of the THUMS audit.

IT IS RECOMMENDED THAT THE COMMISSION:

1. REVIEW AND APPROVE THE SCOPE OF THE AUDIT SUBSTANTIALLY AS WRITTEN.
2. AUTHORIZE THE STAFF TO DRAFT A REQUEST FOR PROPOSAL (RFP) AND THE CRITERIA FOR EVALUATING THOSE RESPONSIVE PROPOSALS WHICH ARE SUBMITTED.
3. AUTHORIZE THE STAFF TO SEND OUT SAID RFP AND BRING ALL PROPOSALS BACK TO THE COMMISSION FOR ITS AWARD OF THE CONTRACT.
4. AUTHORIZE THE STAFF TO PROCESS A BUDGET AUGMENTATION FOR THE PURPOSE OF FUNDING THE CONTRACT FOR THE AUDIT REPORT AS AWARDED.

EXHIBIT "A"

PROPOSED SCOPE OF SERVICES

Review and Audit Report of Internal Controls
And Operations-THUMS Long Beach Company
For California State Lands Commission

A. OBJECTIVES - The objectives of the project are to:

1. Determine if the interests of the State of California in the Wilmington Oil Field are being adequately protected by effective programs, procedures, and internal controls.
2. Determine if the Unit Operator (City of Long Beach), Field Contractor (THUMS), and other parties to the existing Unit Agreement, Unit Operating Agreement and Contractors' Agreements are complying with the appropriate provisions of the contracts.
3. Determine how the systems, controls, procedures, and practices used by the various parties compare with those which are generally followed in the petroleum industry.
4. Identify deficiencies in the internal controls or failures to meet the objectives noted above.
5. Obtain recommendations for correcting any deficiencies noted and for establishing or improving policies, procedures, or internal controls where appropriate.

B. SCOPE OF THE ENGAGEMENT (GENERAL) - The Consultant shall:

1. Review those contracts, agreements and other documents which are pertinent to the operation of the Long Beach Unit to insure that the interests of the State of California are being protected.
2. Review and evaluate the systems and procedures which are presently employed by the City of Long Beach, by the Field Contractor and where applicable, by the State, which are used to maintain internal control, accountability, and reporting development of the Wilmington Oil Field.
3. Ascertain if the City of Long Beach, the Field Contractor and other parties have complied with the provisions of existing contracts and agreements.
4. Determine whether or not existing systems and procedures are being followed.

5. Prepare a final report which will

- a. describe the procedures which were used to accomplish the objectives identified above;
- b. comment on any deficiencies identified by the audit;
- c. furnish recommendations for improving the existing systems and procedures;
- d. make any other recommendations which result from performing the audit.

Recommendations are to be made without attempting to establish systems needed to implement those recommendations.

C. SCOPE OF THE ENGAGEMENT - SPECIFIC

1. The audit report must look to the Unit Agreement, the Unit Operating Agreement and the Contractors' Agreement, to determine contract compliance. Particular emphasis will be given to the following:

a. Pricing procedures:

- 1) Review procedures for identifying "continuing" and "substantial" oil purchasers as defined in the Contractors' Agreement.
- 2) Review procedures for determining if purchases and/or exchanges were made at prices higher than the valuations calculated or described in the Contractors' Agreement. Such review will not include activity covered by the Commission's anti-trust litigation.

b. Accounting systems and methods of control:

- 1) Determine compliance with provisions related to accounting for revenue and expenditures. Particular emphasis will be given to Exhibit "F" of the Unit Operating Agreement.
- 2) Determine compliance with the budgetary control provisions throughout each agreement.

c. Personnel policies and procedures:

- 1) Determine compliance with provisions of the Contractors' Agreement related to salaries, wages, and fringe benefits of THUMS employees.

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2) Determine consistency with industry standards.

2. Contract policies and procedures should be reviewed with emphasis on the following:

a. Procurement policy.

1) Determine policy and adequacy of procedures regarding quantity and method of purchasing.

a) Evaluate competitive bidding and vendor selection policy and procedures.

b) Evaluate policy and procedures related to procurement by negotiation.

c) Evaluate purchases not based on negotiation or competitive bids.

2) Review and evaluate policy regarding procurement from related parties such as parent firms of the contractor.

3) Review systems and procedures applicable to purchasing and receiving, documenting and supporting disbursements.

b. Evaluate policy regarding utilization of fixed price contracts with features such as escalators, performance specifications, adjustments, incentives and redeterminations.

c. Administration of contracts.

1) Evaluate policy and procedures related to handling and pricing of change orders.

2) Determine compliance with contracts and agreements.

3. Management of materials and equipment.

a. Material control.

1) Evaluate physical security of inventoriable material.

2) Evaluate material control policy and procedures.

3) Review physical inventory policies and results of recent physical inventories.

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b. Equipment utilization.

1) Evaluate equipment control and equipment disposition policy and procedures.

2) Review equipment utilization.

4. Evaluate Manpower Management.

a. Contract incentives.

1) Review and assess the relationship between the administrative overhead and net profit percentage in the various contracts.

2) Review financial policy (e.g. lease vs. purchase decisions) in view of contract incentives.

b. Budgetary control process.

1) Review plans and budgets submitted by the City and the role of the Field Contractor in preparing preliminary estimates for the City including augmentation and transfers.

2) Review and assess actual vs. planned performances

3) Review authorization for expenditures (AFE) procedures to determine extent and reasons for possible overruns.

c. Evaluate adequacy of management reporting at THUMS.

d. Other.

1) Review net profit distributions for compliance with agreements.

2) Determine propriety of expenditures by THUMS.

3) Review results of THUMS cost reduction studies.

4) Review maintenance management policies and procedures on such things as repairs vs. replacement.

5) Review accounting for materials and supplies such as perpetual records, inventory counts, use of material transfers, and pricing conditions.

D. EXCLUSIONS - The following areas will be excluded from the scope of the audit report:

1. United States Department of Energy Regulations.
2. Equity Determinations.
3. Issues raised by the Commission anti-trust litigation, City of Long Beach vs. Standard Oil.
4. Detailed systems needed to implement the recommendations of the report.

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(Added, 5/28/80)

EXHIBIT "B"



ROBERT E. FRONKE, CPA
CITY AUDITOR

OFFICE OF THE CITY AUDITOR
CITY HALL
LONG BEACH, CALIFORNIA 90802

May 7, 1980

MAY 12 1980
STATE LANDS COMMISSION

State Lands Commission
1807 13th Street
Sacramento, California 95814

Dear Commissioners:

We have been advised by your local staff of a plan to engage a contract auditor to conduct another audit of Long Beach tidelands oil operations.

As statutory auditor of the City of Long Beach, my office has conducted regular audits of tidelands operations, including the contract with THUMS Long Beach Company since its inception. The audit reports are a matter of public record and contain numerous findings and recommendations pertaining to the management, contract compliance and financial aspects of these operations. Copies of our reports have regularly been provided to the State Auditor General, State Finance Department and your local staff.

I am a CPA, as are many of my professional staff, and we conduct our audits in accordance with professional auditing standards. I am elected to office and consequently am completely independent of the other elected officials and management of the City. My office has been recognized by the State Board of Accountancy as qualified to provide the experience needed for the CPA Certificate in California.

The State Auditor General, pursuant to the requirements of Chapter 138, has also conducted audits on Long Beach tidelands operations. After some years of duplication, the Auditor General recognized that the nature and scope of our audits were sufficiently broad for him to place reliance on our audit work in lieu of conducting his own. This has been the case for the past three or four years.

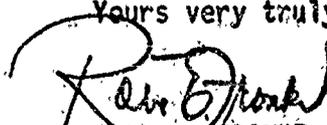
Under these circumstances, we wonder whether another audit would be fruitful. If there are any aspects of the Long Beach tideland

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operations which you are especially concerned with or feel require more audit attention, we will be pleased to cover them in future audits. Based on our extensive experience over many years, we feel we have a unique combination of professional auditing experience and technical knowledge that will be hard to find in another audit organization. However, should you decide to proceed with an outside firm, we will do everything possible to cooperate, including making our past workpapers available.

Yours very truly,


ROBT E. FRONKE
City Auditor

REF:aoh

cc: Kenneth Cory, State Controller
David G. Ackerman, Deputy Executive
Assistant to the Lieutenant Governor
William F. Northrop, Executive Officer,
State Lands Commission
W. M. Thompson, Chief, Long Beach
Operations, State Lands Commission
D. E. Craggs, General Manager,
THUMS Long Beach Company
L. W. Brock, Director of Oil Properties,
City of Long Beach

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