DGS

MEMORANDUM

Date: December 30, 2008 File No.: 7185

To: Kimberly Hunt, Chief
Office of Risk and Insurance Management
707 3rd Street, 1st Floor
West Sacramento, CA 95605

From: **Department of General Services**
Office of Audit Services

Subject: **FINAL AUDIT REPORT: OPERATIONAL AUDIT OF NATURAL GAS SERVICES PROGRAM**

Attached is the final report on our operational review of the Natural Gas Services Program (NGS), which is administered within the Office of Risk and Insurance Management (ORIM). The objective of our audit was to review the NGS' operations to determine whether current systems of operational control could be improved.

The ORIM's written response dated December 12, 2008 to a draft copy of this report is included as an attachment to the report. The report also includes our evaluation of the response as an attachment. We are pleased with the actions being taken to address our recommendations.

As part of its operating responsibilities, the Office of Audit Services (OAS) is responsible for following up on its recommendations. Since operational reviews primarily result in the identification of economy and efficiency recommendations whose implementation are solely the responsibility of program management, the follow-up activity for these reviews is comprised of periodic status reports. Therefore, please submit a status report on the implementation of the recommendations to the OAS by June 30, 2009. The necessity of any further status reports will be determined at that time.

We greatly appreciated the cooperation and assistance provided by ORIM's personnel.

If you have any questions, please call me at 376-5058.

Rick Gillam

RICK GILLAM, CPA, CIA
Chief, Office of Audit Services

Attachment

cc: Scott Harvey, Chief Deputy Director
Deborah Baker, Deputy Director, Administration Division
Marshall Clark, NGS Program Manager, ORIM

DGS

MEMORANDUM

Date: December 30, 2008 File No. 7185

To: Kimberly Hunt, Chief
Office of Risk and Insurance Management
707 3rd Street, 1st Floor
West Sacramento, CA 95605

From: **Department of General Services**
Office of Audit Services

Subject: **OPERATIONAL AUDIT OF NATURAL GAS SERVICES PROGRAM**

This report presents the results of our operational review of the Natural Gas Services Program (NGS), which is administered within the Office of Risk and Insurance Management (ORIM). This audit was requested by ORIM. The objective of our audit was to review the NGS' operations to determine whether current systems of operational control could be improved. Due to their significance, our in-depth audit testing was primarily focused on the systems of internal control used for payments of commodity costs to gas suppliers and transportation costs to local gas utility companies and the subsequent recovery of those costs, plus a NGS administrative fee, from program customers. Our review was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing.

Although overall we concluded that ORIM has established adequate and effective policies and procedures for the payment of NGS' gas suppliers and utility companies and the associated cost recovery activities from program customers, as discussed under the Review Results section of this report, we identified a number of areas for improvement in NGS' operations. Recommendations to address the following issues are presented in this report.

- Written operating procedures have not been developed to govern NGS' program and administrative operations.
- Current recordkeeping policies and procedures are not ensuring that adequate data is always maintained to support NGS' transactions.
- ORIM's operating practices do not provide that its Office Chief review NGS Transaction Confirmation agreements involving the purchase of under $6 million of natural gas.
- ORIM has not developed a formal crisis recovery plan for NGS to assist in ensuring the maintenance of ongoing operations if the NGS Program Manager and/or the contracted natural gas services advisor were for some reason to become unavailable to perform and/or administer program functions and activities.

During our review we also identified other matters requiring attention that we discussed with ORIM's management but are not included in this report. However, these issues were included in a written summary of all of our preliminary audit findings that was provided to the NGS Program Manager in August 2008.

BACKGROUND

In brief, NGS is a program located within the Energy Contract Services section of ORIM. The NGS manages a statewide natural gas procurement program for a wide range of State and other public sector organizations (129 at the time of our review). The NGS serves as a central purchasing organization, buying gas collectively for all program participants and arranging delivery of that gas to participant facilities. The program offers an active risk management program, which focuses on minimizing price fluctuations.

The NGS is primarily designed to supply gas procurement services to large gas users – facilities that use more than 250,000 therms per year. Participation in NGS is optional and is based on long-term agreements with customers, most of which are for three or more years. NGS competitively bids for gas supplier services and, at the time of our review, used BP Energy Company as its primary provider of natural gas. The following costs are recovered from customers: commodity costs (paid to gas suppliers); transportation/delivery costs (paid to local gas utility companies); and, a NGS administrative fee (at the time of our review, $.0065 per therm). During the 2006/07 fiscal year, NGS purchased approximately 310 million therms of gas and billed customers approximately $236 million for program costs and associated administrative fees.

The NGS is comprised of only four staff members: a program manager who has the responsibility for overseeing program operations and three employees that focus on office administrative functions, such as processing gas supplier and utility payments and recovering program costs from customers. The program is assisted by two contracted consultants: one for legal services and one for natural gas advisory services. Further, the program receives legal assistance from an assigned attorney within the Department of General Services' (DGS) Office of Legal Services. The contracted legal consultant provides numerous advisory services including those involving the regulatory aspects of the program. The contracted natural gas advisory services consultant has been with the program over 15 years and is of primary importance to the success of the program. This individual, who works with NGS staff on almost a daily basis, provides a wide range of program support services required in the overall natural gas supply process as well as direction and guidance in commodity purchases and program design and implementation.

SCOPE

Upon completing a preliminary survey of operations, we selected NGS' fiscal operations for in-depth review. Specifically, due to their significance, we examined the systems of internal control used for payments of commodity costs to gas suppliers and transportation costs to local gas utility companies and the subsequent recovery of those costs, plus a NGS administrative fee, from program customers. We also reviewed the processes used to pay program consultants, accumulate program statistics and plan for recovery in case of a crisis impacting ongoing operations.

Due to a lack of expertise, our audit did not include an evaluation of the success of the NGS' risk management program, including the program's strategies used to develop the natural gas portfolio in order to protect customers from the extreme volatility of gas prices. To evaluate this area, ORIM would need to contract with a consultant(s) who has extensive experience in natural gas commodity purchases and program design and implementation.

METHODOLOGY

To determine the adequacy and effectiveness of the systems of internal control over NGS' fiscal operations, we performed the following audit activities:

- reviewed policies and procedures;
- observed fiscal operations;
- examined management and accounting systems;
- verified compliance with administrative requirements;
- tested records and transactions;
- conducted interviews with appropriate management, staff and consultants; and,
- performed other tests as deemed necessary.

The following information was developed based on our fieldwork that was primarily conducted during the months of May 2007 through May 2008.

REVIEW RESULTS

Overall, we concluded that ORIM has established adequate and effective policies and procedures for the payment of NGS' gas suppliers and utility companies and the associated cost recovery activities from program customers. The ORIM's systems of internal control provide reasonable assurance that those transactions are properly executed and recorded in accordance with management's authorization. Reasonable assurance is provided when cost-effective actions are taken to restrict deviations to a tolerable level. These actions should result in material errors and improper or illegal acts being prevented or detected and corrected within a timely period by employees in the normal course of performing assigned duties.

Although overall we concluded that ORIM has established adequate and effective policies and procedures governing the fiscal activities noted above, we identified the following areas for improvement in NGS' operations. Our recommendations are presented to aid management in improving systems of operational control.

- ***Written Operating Procedures*** – written operating procedures have not been developed to govern NGS' program and administrative operations. At the time of our audit tests, the primary method to obtain information on ongoing NGS processes was through the direct interview of staff, which is an obviously inefficient and disruptive process. As noted in State Administrative Manual Section 20050, a condition where operational manuals are either not currently maintained or are nonexistent is indicative of a poorly maintained or vulnerable control system.

  The maintenance of up-to-date and comprehensive written operating procedures is of an especially critical nature for a program as complex and dynamic as the NGS. These procedures would offer all NGS' employees and other interested parties a common reference point on the program's policies and procedures for the conduct of ongoing activities.

  It should be noted that during our review NGS was actively working on developing written operating guidelines. However, as of the completion of our audit fieldwork, the guidelines were still in draft form and did not completely address all of NGS' primary operating procedures and processes.

- ***Recordkeeping Process*** – current recordkeeping policies and procedures are not ensuring that adequate data is always maintained to support NGS' transactions. Specifically, during our sample testing of transactions and supporting documents, including those involving payments to gas suppliers and utility companies and recovery activities from customers, we often had to obtain further documentation or information from the NGS Program Manager and/or the program's contracted gas advisory services consultant to fully understand a transaction. For example, information identifying the agreements, Transaction Confirmations, with gas suppliers acknowledging the details of a gas purchase was not always available within transaction supporting records and could only be identified after further research by the contracted consultant. Further, when we noted a deviation from an expected result, e.g., the actual payment to a gas supplier differing from the file calculation, documentation was not always maintained to explain this occurrence. The deviation could only be explained to us after additional research by NGS' staff.

  Although we were ultimately able to obtain sufficient information to support transactions, this does not alleviate the need for NGS to improve its recordkeeping policies and procedures to ensure the maintenance of adequate documentation. Good operating practices provide that an audit trail be maintained which allows an independent party to verify the accuracy of a transaction.

- ***Review of Transaction Confirmations*** – at the time of our review, ORIM's operating practices did not provide that its Office Chief review NGS Transaction Confirmation (TC) agreements involving the purchase of under $6 million of natural gas. The NGS Program Manager had sole authorization and responsibility for reviewing and signing TC's of under $6 million, with only those exceeding that amount requiring co-signing by the Office Chief. The TC is a standardized document used to acknowledge the details of a gas purchase, with each TC functioning as an amendment to the basic contract between DGS and a natural gas supplier.

  In our opinion, to further improve program management and oversight, ORIM's Office Chief should at least on a periodic basis review a sample of TC's valued at under $6 million for compliance with program operating policies and procedures. The great majority of the approximately 150 TC's processed a year are under $6 million and, therefore, not subject to independent review by the Office Chief. In fact, we only noted four TC's exceeding $6 million in our sample tests of agreements issued during a 15 month period. By limiting the current level of Office Chief review to those TC's valued at $6 million or more, a process used to commit the State to incur over $200 million a year in natural gas purchases and delivery costs is not being actively monitored by the Office Chief and, instead, is primarily controlled by one party, the NGS Program Manager.

- ***Crisis Recovery Plan*** – to assist in ensuring the maintenance of ongoing operations, ORIM should develop a formal crisis recovery plan for NGS. Currently, NGS' operating knowledge and expertise primarily rest with two highly experienced natural gas program professionals: the NGS Program Manager who has 13 years with the program and the contracted natural gas services advisor who has over 15 years with the program. If either of these two individuals were for some reason to become unavailable to perform and/or administer program functions and activities, in our opinion, the ability of the NGS to continue to function in an effective and efficient manner would be negatively impacted to a significant degree.

  A formal crisis recovery plan would provide guidance on the actions that should be taken in specified situations to ensure that NGS' operations would continue with a minimum of disruption. It should be noted that prior to the start of our review ORIM and NGS

management identified the need for a written crisis recovery plan. However, due to other operating priorities, the plan had still not been developed as of the completion of our audit fieldwork.

Recommendations

1. Develop an action plan, which includes a timetable for completion, that addresses the prompt completion of written operating procedures governing NGS' operations.

2. Implement policies and procedures which ensure that adequate data is maintained to support NGS' transactions.

3. Implement policies and procedures which provide that ORIM's Office Chief periodically review a sample of TC's valued at under $6 million for compliance with program operating policies and procedures.

4. Prepare a formal crisis recovery plan for the NGS.

CONCLUSION

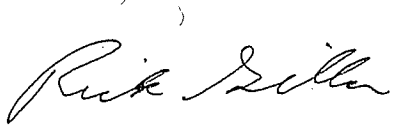
The issues presented in this report should be addressed to assist in improving operational policies and procedures. It should be noted that when advised of areas for improvement during our audit fieldwork, ORIM's management either took immediate action or indicated that immediate action would be taken to address our concerns. This provides an indication of management's significant commitment to improving operating policies and procedures.

Management should be aware that controls cannot prevent all problems because they would not be cost-effective. Moreover, the effectiveness of controls change over time. Limitations which may hinder the effectiveness of an otherwise adequate system of controls include resource constraints, faulty judgments, unintentional errors, circumvention by collusion, and management overrides. The presence of these limitations may not always be detected by an audit.

Your response to each of our recommendations (Attachment I), as well as our evaluation of the response (Attachment II), are presented as attachments to this report.

We greatly appreciated the cooperation and assistance provided by ORIM's personnel.

If you need further information or assistance on this report, please contact me at 376-5058, or Christine Pham, Management Auditor, at 376-5060.



RICK GILLAM, CPA, CIA
Chief, Office of Audit Services

cc: Scott Harvey, Chief Deputy Director
Deborah Baker, Deputy Director, Administration Division
Marshall Clark, NGS Program Manager, ORIM

State of California • Arnold Schwarzenegger, Governor
State and Consumer Services Agency
DEPARTMENT OF GENERAL SERVICES
Administration Services Division -
Office of Risk & Insurance Management

MEMORANDUM

DATE: December 12, 2008

TO: Rick Gillam, Chief
Office of Audit Services
707 3rd Street, 4th Floor
West Sacramento, CA 95605

FROM: Administration Division - Office of Risk and Insurance
707 Third Street, 1st Floor, West Sacramento, CA 95605

SUBJECT: RESPONSE TO OPERATIONAL AUDIT OF NATURAL GAS PROGRAM

The audit report is well-done and a fair assessment of the Natural Gas Services program. Audits and in particular, Christine Pham, did an excellent job. The Natural Gas Program (NGS) is substantially different from most other programs, Christine had to learn a complex operation from the ground up. She did an impressive job of mastering the topic area.

We offer the following specific responses to the review results:

1. Written Operating Procedures: We are in full agreement that these documents need to be developed, reviewed, and continuously up-dated as program processes are modified. As the audit report noted, NGS is working on this, but due to lack of staff resources, progress is slower than we would like to see.

2. Record Keeping Process: We think Audits would agree that current NGS record keeping processes now assure that adequate data is maintained to support NGS transactions. The issue is that full single-source documentation was not in place for prior years. We are trying to assemble prior year records into a single file block, but again, this is not the highest priority for our limited staff resources.

   Current record keeping processes are highly dependent on staff filing practices. While current practices are adequate, what is urgently needed is a completely integrated information management system, encompassing all program data in a totally electronic data base environment.

Communication aids or services will be provided to individuals with disabilities upon request. The California Relay Service telephone numbers are (voice) 1-800-735-2922 and (TTY) 1-800-735-2929.

3. Review of Transaction Confirmations: As a result of preliminary audit comments, NGS has instituted a process in which all TC's, regardless of amount, are reviewed monthly by the ORIM Office Chief. This process, and other oversight review measures, are included in the draft Risk Management Protocol policy and practice manual, which is currently in review by senior management.

4. Crisis Recovery Plan: Under current budget and staffing conditions, development of an NGS Crisis Recovery Plan is difficult if not impossible. As the report identified, there are two key personnel whose roles have no backup currently available. Because of the highly specialized nature of a natural gas risk management program, with no other similar departmental or state programs to draw on, skills and experience of replacement staff and consultants must be developed internally within the program, while still maintaining a high level of accuracy and service in the monthly cycle.

   A plan to training a backup for the NGS Program Manager is in development, but currently requires the sacrifice of an essential working staff position. This is not possible given the critical need to maintain the monthly NGS processes. Backing up the key outside consultant also requires an additional state position within NGS at the staff level, the creation of the Manager backup (Program assistant manager), and the identification of alternative gas purchasing services.

5. Recommendations:

   1. NGS will develop an action plan to accomplish the documentation of processes. This task will of necessity, be subordinated to on-going operational performance. NGS is currently developing a formal allocation of responsibilities in this process, associated with a schedule for completion.

   2. Record keeping policies and practices are now in place and will be formally documented as part of the documentation process in #1 above.

   3. TC review processes are now in-place and will be further augmented and formally documented as part of the adoption of the Risk Management Protocol.

   4. NGS and ORIM will continue to work on development of a crisis recovery plan.

If you need additional information regarding this response, please contact me at 376-5271 or Marshall Clark at375-5990.

Kimberly Hunt, Chief
Office of Risk and Insurance Management

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cc: Scott Harvey, Chief Deputy Director
Deborah Baker, Deputy Director, Administration Division
Marshall Clark, NGS Program Manager

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ATTACHMENT II

OFFICE OF RISK AND INSURANCE MANAGEMENT
OPERATIONAL AUDIT OF NGS PROGRAM

EVALUATION OF ORIM'S RESPONSE

We have reviewed the response by the Office of Risk and Insurance Management (ORIM) to our draft report. The response indicates that appropriate actions are being taken to address our recommendations. We appreciate the efforts taken or being taken by the ORIM's personnel to improve operational controls. The promptness of these efforts continues to disclose their significant commitment to improving operating policies and procedures.