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C-4

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City Auditor

May 11, 2004

Christopher Garner, Director
Department of Oil Properties
City of Long Beach

We have applied certain review procedures to operation and accounting records of Tidelands Oil Production Company (Tidelands). The purpose of the review was to determine whether Tidelands is in compliance with its agreements with the City of Long Beach (City), follows accepted industry practices, and takes appropriate measures to safeguard the assets under its management. The areas we reviewed included: field measurement; production accounting; division of interest; expense allocation; permits/taxes; well abandonment; subsidence; vendor expenditures; fixed assets; inventory; revenue & pricing; insurance & bonds; and payroll. The scope of our review was 2002 and 2003 through May. The review was a joint effort between the City Auditor's Office and the State Lands Commission.

The review procedures we performed included:

- Reviewing unit agreements, unit operating agreements, agreements between City and Tidelands, and agreements between Long Beach Harbor and Tidelands.
- Assessing the design of specific processes Tidelands uses to administer the areas included in our review.
- Testing samples of transactions completed by Tidelands during the audit scope period to determine whether these were properly conducted.
- Recalculating certain production, revenue and expense allocations and tracing them to accounting entries.
- Verifying compliance with City ordinances as they relate to permits and taxation.
- Observing specific operations to determine whether Tidelands' practices were in accordance with industry norms.
- Touring tank farms, field operations, inventory warehouse, and injection facilities.
- Reviewing Tidelands' administration of City mandated subsidence abatement program and State of California Division of Oil, Gas and Geothermal well plugging and abandonment program.

We did not have access to Tidelands 100% accounts which include transactions not allocated to working interest owners (WIOs). Therefore, this area was not included in the scope of the review.

Based on the results of the review procedures performed, except for the effect of the scope limitation described in the preceding paragraph, if any, we found no evidence that Tidelands is not in compliance with its agreements with the City. However, we noted specific issues that we discussed with Tidelands management along with our recommendations. These are highlighted below and discussed in more detail in the attachment along with other issues and recommendations. We observe that WIOs were not materially impacted by these issues.

- Tidelands does not calibrate on a regular basis the oil measurement meters (LACT units) at the two tank farms. These meters are used to allocate sales, measured by the sales meter, back to the two tank farms. In addition, the LACT units at the two tank farms are not read simultaneously with the sales meter. Both of these factors increase allocation inaccuracy. We recommend calibrating tank farm LACT units periodically and reading them at the same time the sales meter is read at month end.
- Tidelands used oil from production in its drilling operation without allocating revenue and expense to the WIOs. We recommended making a journal entry to recognize revenue and expense incurred to the WIO. Tidelands made the entry.
- Tidelands did not account for the transfer of cable and electric submersible pumps to Centrilift, an alliance vendor, in 1995. Adjusting entries to reflect the transfer were made during the audit.
- Errors were found in Tidelands' inventory computer system. These included negative quantities, negative balances, and zero quantities with positive balances. Tidelands has corrected these errors and has implemented procedures to prevent future occurrence.

We appreciate the excellent cooperation we received from Tidelands as well as the DOP during the course of the audit.

Sincerely,

Gary L. Burroughs, CPA
City Auditor

By



Sam A. Joublat, CIA
Deputy City Auditor

cc: David Mercier, Finance and Economics Chief, State Lands Commission
Geraldine Knatz, Development Managing Director, Harbor Dept.
Curtis Henderson, Operations Manager, DOP
Michael Domanski, President, Tidelands

Background

West Wilmington Field is a mature oil field. It was discovered in 1936. In 1939, Long Beach Oil Development Company (LBOD) was selected as the first oil operations contractor. The first oil well was drilled in 1939. The peak production of the West Wilmington Field occurred in 1951 at a rate of 53,000 barrels per day (b/d) at which time it had 700 producing wells. Production had tapered to 22,000 b/d before peaking again at 45,000 b/d in 1966 as a result of the large scale water flooding that started in the late 1950's to address subsidence.

In 1989, Tidelands Oil Production Company (Tidelands) took over as field contractor from LBOD. At that time, Tidelands was a partnership owned by Neste Oil and Gas, the Finnish national oil company, and by Chanse, an independent producer. Additional oil properties were added in 1994 when the Harbor Department purchased Union Pacific Resources Company's holding in the Wilmington Field.

In 2003, Neste sold its share of ownership in the Tidelands partnership. As a result, Paramount Petroleum Corporation now holds 75% ownership and Chanse holds 25%.

Tidelands is now responsible for 701 wells of which 302 are production wells, 160 are injection wells, 2 are water source wells (subsidence), 18 are observation wells, and 219 are idle wells. Production in 2003 was 6,773 b/d of oil and 1320 mcf/d (thousand cubic feet per day) of gas.

The City of Long Beach remains the West Wilmington Field operator. Below is a summary of working interest ownership (WIO) by fault block (FB).

Summary Schedule of West Wilmington Field Ownership Percentage

Area	State	City	Harbor	LBUSD	Individuals	Total
FB I			100			100
FB II Unit	10		89.5		0.5	100
FB II Unit Steam	10		90			100
FB III Unit	18		82			100
FB IV Unit	55	18	26		1	100
FB V Ranger Zone Unit	72.8	15	3	0.2	9	100
FB V, FB VI Non Unit	100					100

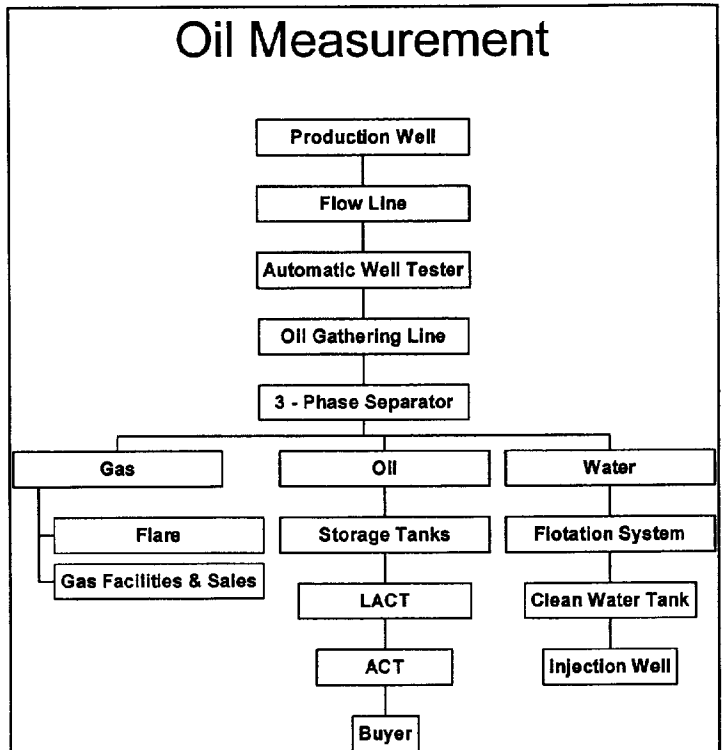
Field Measurement

Production Wells

Our review included a comparison of the 302 oil producing wells appearing on Tidelands accounting reports and the individual production wells appearing on engineering maps. No discrepancies were noted.

The number of production wells can change based on the price of oil, maintenance problems, and new well installation. Low oil prices cause some wells to become idle as the price of oil falls below the cost of production. Well components, such as pipe casing, tubing, pumps and electrical components can fail leading to downtime during repair. Of the 302 oil producing wells, 144 use rod pumps, 125 use Electrical Submersible Pumps (ESPs), and 33 use hydraulic pumps.

Oil is measured at the time it is sold to buyers. Measurement meters, known as ACT units (Automatic Custody Transfer) are used to measure oil pumped from Tidelands' tank farms to the buyer's pipeline. During March 2003, 203,609 barrels of oil were sold to buyers. (See Production Accounting).



There are two ACT units located near the intersection of Broadway and Pico Avenues (aka Broadway-Mitchell site) that alternatively measure the amount of oil shipped. These ACT units are connected to five separate buyer's pipelines, including, ARCO (two lines), Mobil, Conoco/Phillips, and Equilon. Run tickets are used to document the transfer of ownership of oil.

Automatic Well Testers

There is no continuous measurement of fluid pumped from individual wells. Tidelands maintains reports on production by well; these reports are based on allocation formulas, and meter readings from ACT units, LACT units (Lease Automatic Custody Transfer) and AWTs (Automatic Well Testers).

Periodic measurement of fluid from individual wells is performed using AWTs. There are 28 permanent AWTs, and 3 portable AWTs. The portable AWTs are used for 25 oil wells that are not connected to a permanent AWT.

The AWTs indicate production rate and percentages of water and oil content from a specific well for a limited period of time. This type of testing requires isolation from other wells by using shut-off valves.

3-Phase Separation

Oil is pumped from the wells into gathering lines where it is routed to horizontal gas/oil/water separators. Some vessels use heat to assist in the separation of oil from water. The produced fluid contains 97% water. Following the separation process, gas is sold or burned, depending on its quality, water is cleaned and injected back into the field (see Subsidence), and the oil is stored in tanks, until sold.

Tank Farms

The two tank farms, known as Z1-2 and XY, typically hold only 10% of daily production capacity, or approximately 600 bbls of oil. The pipelines carry another 435 bbls of oil. The excess capacity in these tanks is for use in emergencies. For example, if the ACTs fail, or other shipping equipment malfunctions, well production and processing can continue, with the tank farms then filling up to maximum capacity.

Issue:

Our review of the tank farms indicated that physical security, especially in light of tightened security nationwide, needs a comprehensive review. Fences and gates enclose the Z1-2 tank farm, however the gates are not closed or locked. The XY tank farm has no gate. This leaves both installations open to acts of vandalism, sabotage or terrorism.

Recommendation:

Evaluate the security at each of the two tank farms. Keep these gates locked at all times. Consider the feasibility of installing surveillance equipment at both facilities.

We were informed that Tidelands has recently completed a Security Vulnerability Assessment (SVA) of its facilities as part of a comprehensive audit conducted by the State Lands Commission. As a result of this SVA, additional fencing and other barriers will be installed over the next few months.

Proving

To ensure the ACTs are accurately measuring the amount of oil sold to buyers, meter proving is performed on a regular basis. Proving of the ACTs is performed each month, and whenever there is a change in buyers. Tidelands uses an outside contractor, Century Calibrating Company, to provide the proving service.

Proving is witnessed by gaugers (employees) of the buyer, Tidelands, and the DOP. As part of the proving process, the sample pot is pulled and tested for Basic Sediment and Water (BS&W) and API gravity.

The sample pot contains a representative sample of oil being shipped by extracting small amounts over the time period of oil shipment. The gauger takes samples to a lab to obtain the API gravity and BS&W. The resulting API gravity is reflected on the run ticket (the document evidencing transfer of ownership).

Century Calibrating uses a portable proving unit. The calibrator carries a Certificate of Prover Volume and a Certificate of Calibration. A proving report is printed by Century, and distributed to those in attendance. Using a laptop computer, the calibrator enters the names of the attendees into the proving report.

Issue:

The buyer's gauger, Tidelands, and the DOP do not sign proving reports. During our observation of the proving activity, we noted that the reports are printed with names of those in attendance, however the report should still be signed to evidence witnessing of the proving.

Recommendation:

Require signatures of those in attendance on the proving reports.

Net Meter Factor

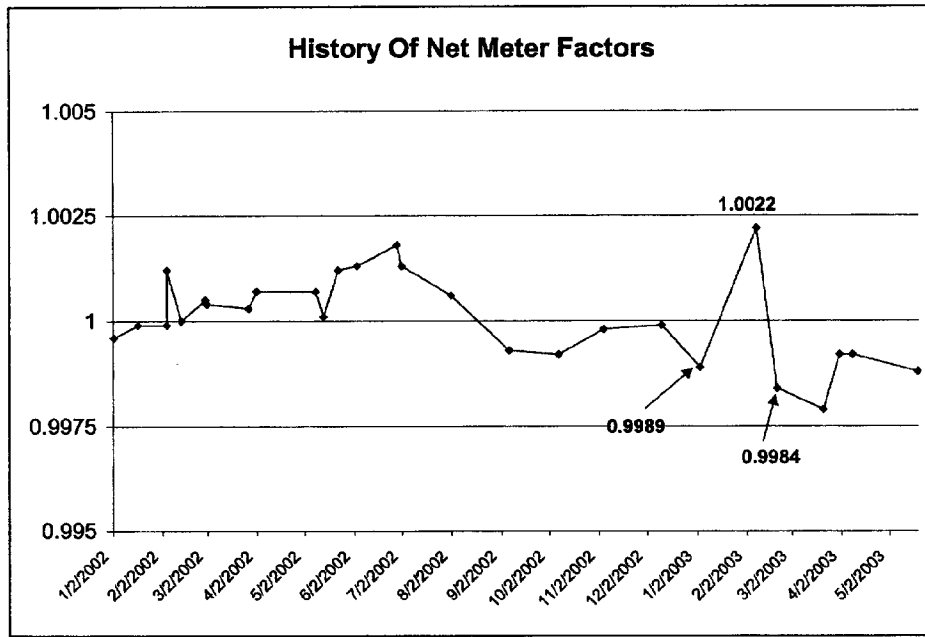
The proving report identifies a net meter factor, which is used to adjust the fluid volume. According to API standards, comparisons should be made between the current and prior (proving) report's net meter factors to identify excessive meter factor deviation. If deviation exceeds 0.0025 since the last proving, an average of the present and prior net meter factor should be used.

Issue:

During our review of the past 12 months of proving reports, excessive meter factor deviations were noted on consecutive reports at ACT unit #1 on February 7th and February 20th 2003. The proving reports show a net meter factor drift of 0.0033 and 0.0038.

The deviations were not documented on the proving reports, and adjustments were not made. The net meter factors should have been adjusted to 1.0005 $((0.9989+1.0022)/2)$ and 1.0003 $((1.0022+0.9984)/2)$ respectively to compensate for the deviation.

Date	Net	Deviation (Current vs. Prior)
February 20, 2003	0.9984	-0.0038
February 7, 2003	1.0022	0.0033
January 3, 2003	0.9989	



Recommendation:

Consider comparing the current net meter factor with the prior net meter factor appearing on the proving reports and using a corrected net meter factor when the absolute value of the net meter factor drift exceeds 0.0025.

Run Ticket

At the time of ownership transfer, the volume of oil sold is measured and recorded on a run ticket (physical evidence of purchase). Run tickets are 'pulled' on the 1st of each month to facilitate oil inventory counts for the prior month. Run tickets are also pulled at each change in buyer.

The buyer's gauger removes the run ticket from the ACT unit, where it is time and date stamped. After completing a sample analysis in the lab, the cut percentage and API gravity are confirmed by Tidelands, the DOP and the buyer's gauger. Completed run tickets are used by Tidelands in the final billing to the buyer.

Production Accounting

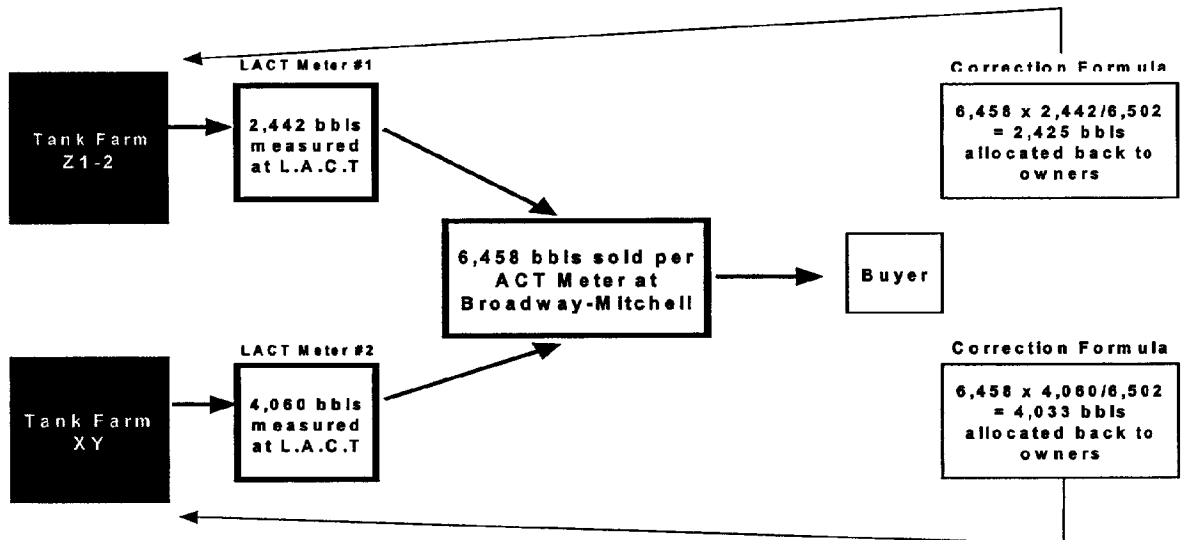
Oil and gas production is allocated to each well based on AWT results. The AWT data are logged in a Daily Well and Production Field Report. Tideland's accounting staff reviews results of the well tests for reasonableness based on comparison to past production levels. Well test results that appear abnormal, generally any test result that varies by more than 10% from the previous reading, are reported to Tideland's engineering department for further investigation. At the end of each month, an Individual Well Production Ledger (IWPL) is generated for each active and idle well. The IWPL indicates the segment, tank farm, fault block unit and gravity for each particular well and reflects the estimated daily production. In addition, this estimated production data are summarized by segment and tank farm in the Summary Production Ledger (SPL), also generated at the end of each month.

Oil production flows into one of Tideland's two tank farms, depending upon well location. Wells located within Segment I flow into both the XY and the ZI-2 tank farms, while those located within Segment II are routed to the XY tank farm. Each tank farm is equipped with two LACT meters that gauge volume of production shipped. As in the case with individual wells, a Daily Tank Farm Production Report is utilized to log the daily volume shipped to Broadway-Mitchell, the point-of-sales delivery. Broadway-Mitchell also has two ACT meters that measure actual volume of production sold. Total sales per month as recorded by the Broadway-Mitchell ACT meters are used to generate the monthly Coordinator's Allocation Report of Oil Production and Deliveries, which is used to allocate production for the month among the WIOs.

Information from the daily LACT and ACT readings is input on a spreadsheet by Tideland's accounting staff and compared for variance in daily production. As the run ticket does not reflect separate production from each of the two tank farms, the calculation of a tank farm correction factor (TF Factor) is necessary to allocate actual production to each respective tank farm. AWT data are then used to allocate actual production per tank farm to the individual wells. The following illustration demonstrates how the TF Factor was calculated to allocate actual production of 6,458 bbls shipped as measured at Broadway-Mitchell (per ACT meters) to the two tank farms.

The tank farms (per LACT meters) reflected a combined production volume of 6,502 bbls that was sold from Broadway-Mitchell on that day:

TIDELANDS PROCEDURE TO CALCULATE TANK FARM CORRECTION FACTOR



To verify that the documented production accounting procedures were in place and functioning properly, we selected a random sample of wells and confirmed the accuracy of production allocated to those wells.

Issue:

As stated above, the run ticket generated at Broadway-Mitchell does not reflect separate production from the XY and Z1-2 tank farms. Therefore, the ratio of tank farm production per LACT readings at XY and Z1-2 is used to allocate total oil sales registered per the ACT reading observed at Broadway-Mitchell. We noted that Tidelands does not calibrate the LACT meters on a regular basis and therefore, readings observed from those meters may not be precise. The two LACT units in Z1-2 tank farm were calibrated last in March 1998 and August 1999 and the two LACT units in XY tank farm were calibrated last in May 2001 and June 2003. Not having properly calibrated LACT units may cause inaccuracy in the allocation of production between the two tank farms.

Recommendation:

Tidelands should calibrate the LACT meters at the tank farms on a periodic basis to ensure accurate allocation of production.

Issue:

Tidelands measures the volume of production from the ACT unit and LACT units. However, we noted that there is a timing difference in when these meters are read. The ACT meter at Broadway-Mitchell is read by 7:00 a.m., while readings from the LACT units at the tank farms are taken at various times of the day. At month-end, when sales are allocated back to the respective tank farms, this results in a difference between the ACT and LACTs that is attributable to the difference in timing of the readings and thereby results in imprecise allocation. We note, however, that this difference is due to timing of readings, and will not result in a significant impact over a prolonged period of time.

Recommendation:

To eliminate this artificial difference between production as measured at the ACT and LACTs, month-end readings of meters in all three locations should be taken simultaneously. This will remove the variance in measurement caused by timing differences and enhance the accuracy of production allocation to the tank farms.

Division of Interest

Allocation of revenue and expense among the WIOs, on the basis of tract participation, is maintained and updated by Tidelands as part of its responsibilities as the field contractor of the West Wilmington Field. Changes in percentage of ownership are reported to Tidelands by DOP on a monthly basis. These changes are then applied to the WIO percentages by Tidelands and a revised distribution of interest table is then generated. The two most common types of changes reported are (1) transfer of interest and (2) surrender of interest. Transfer of interest is simply a transfer in ownership of a specified working interest and does not affect the ownership percentage of other WIOs. Conversely, a surrender of interest, as stipulated in Article 17.3 of the Unit Agreement, involves the allocation of surrendered working interest among the remaining WIOs.

We reviewed the process for distributing surrendered working interest among the remaining WIOs and judgmentally tested a sample of surrenders to ensure the equitable allocation thereof. Based on the procedures performed, no exceptions were found. Please refer to the Background section of this report for a summary of West Wilmington field ownership interest.

Issue:

During our review of field operations, we noted that 460 barrels were used in the drilling of seven new wells in 2003. We found that Tidelands had not accounted for the disposition of this oil in the allocation of revenue and expense to the WIOs.

Recommendation:

We recommended that an adjustment in allocation of interest be made to recognize this effective transfer of ownership and that any such activity in the future be recorded in the Joint Interest Billing (JIB).

Tidelands concurred with our recommendation, recorded an adjusting journal entry of \$12,282.05 to charge the WIOs for the oil used and established procedures to account for the oil used in drilling operations.

Expense Allocation

Expenses incurred by Tidelands are allocated to the various fault blocks, unitized and non-unitized. Fault blocks are further divided between Segments I and II. Segment I includes any part of fault blocks that lie south of Ocean Boulevard in the City. Segment II includes that portion of fault blocks that lie north of Ocean Boulevard. The City is paid an administration fee of 6% of expenses incurred as stipulated by Article 5.5 of the Unit Operating Agreement.

The City pays Tidelands 4% of the Segment II expenses as compensation for services performed as field contractor of that segment. Segment I is operated in the capacity of trustee for the State of California and Segment II is operated in a proprietary capacity.

	City	Tidelands	Total
Segment I	6%	-	6%
Segment II	2%	4%	6%

Chargeable Costs

Chargeable costs include all matters of unit expense incurred in connection with unit operations and general facilities. Costs are direct charges to unit wells or facilities or result from services provided.

We reviewed Tidelands' general ledger of expenses incurred from January 2002 through March 2003 and randomly selected 60 transactions to verify appropriateness of expense and accuracy of allocation. Based on our review of the selected transactions, we found no exceptions in the allocation of expense among the WIOs. In addition, we judgmentally selected one month from the same period of time to test the validity of Tidelands' electrical expense allocation, as this represents the largest recurring expense, over \$1,000,000 per month. Electricity costs incurred to pump fluid from wells, is allocated to those wells based on the percentage of gross fluid produced. We selected March 2003 and used production reports to validate the basis for allocation. We found no discrepancies in the allocation of electricity expense to the various fault block units.

Permits/Taxes

Section 3.80.221 of the Long Beach Municipal Code requires payment of fifteen cents (\$0.15) per barrel production tax on oil produced from any well located in the City. Payment of oil production tax is due on a quarterly basis and reported to the City on the Quarterly Report of Oil Production Tax (Form F535). To verify that Tidelands paid production tax on all barrels produced, we judgmentally selected two quarters (1st Quarter 2003 & 3rd Quarter 2002) and compared total production reported to the City for those quarters to the number of barrels reported to the California Division of Oil, Gas and Geothermal Resources (DOGGR) during the same period. The DOGGR has oversight responsibility of oil and gas production in the State and monitors the reporting of field production. Based on our review of production as reported to the DOGGR, we found no exceptions in Tidelands' field production as reported to the City for tax purposes.

Section 12.12.200 of the Long Beach Municipal Code requires payment of an annual well permit fee for the operation of any well used in petroleum operations located in the City. We reviewed the number of active and idle Tidelands wells listed by the DOGGR and compared that to the number of wells for which Tidelands paid the requisite permit fee. Based on this comparison, we found no exceptions.

Well Abandonment

The abandonment of wells usually occurs when the well is no longer needed for operations. Typically, abandonment consists of placing cement plugs at various levels in the well casing to prevent leakage.

During 2003, Tidelands identified 232 wells as idle. The decision to abandon takes into consideration the future use of the well in reducing subsidence, the overall integrity of the well, and its physical proximity to other City projects, and the likelihood of use in future oil production. Individual well abandonment costs were estimated by the DOP at approximately \$57 thousand dollars. The DOP reviews abandonment prospects every quarter in the DOP Management Report. This report contains an abandonment strategy for the fault block units.

Tidelands is responsible for abandonment in the fault block units. The program reviews idle wells and wells that are located in construction project areas, such as the Long Beach Harbor. In the 2001 Report, an assessment of 262 wells was made and 25 were determined to have no future use and are recommended for abandonment over the next two years. DOP recommends abandonment of wells that are no longer productive and cannot be used in the subsidence program. Significant discussion takes place between DOP engineers in making the decision to abandon. Recommendations for well abandonment may come from either Tidelands or the DOP.

Recent Activity

During the calendar year 2001, Tidelands completed abandonment on 31 wells. In 2002, ten wells were abandoned. Tidelands has abandoned wells as required by the DOP. Our review of abandoned well files indicates that proper documentation is maintained that identifies the original abandonment request, DOP engineers' approval and the State's approval of the abandonment procedures.

Subsidence

Subsidence is the sinking or gradual settling of the earth's surface. Long-term oil production has been blamed as the major cause of subsidence in Long Beach. In the 1950's, the DOP began a water injection program to halt subsidence, which resulted in increased oil recovery.

Change in Methodology

On July 22, 2002, the DOP changed its subsidence control from the I/P (Injection/Production Ratio) method to the net injection method. The primary reason for the change was due to the loss rebound (increase in surface elevation) and continued subsidence in Long Beach over preceding years.

Under the old I/P method, water was injected at a rate of 105% of the volume of fluids produced (extracted). For example, if 1,000 barrels (bbls) were produced, 1,050 bbls were injected. During periods of constant oil production, this appeared to be adequate replenishment. However, in periods of reduced production, injection dropped correspondingly, resulting in inadequate injection.

After several years of monitoring the results of the I/P method, the DOP determined that injection of 105% of production did not stabilize the area. Adjacent pools or fields sharing a common aquifer, and the insufficient injection by offset operations caused subsidence, and in many cases, the 5% additional injection was insufficient to cover water migration. DOP engineers reviewed these conditions and determined that minimum amounts of water over and above production must be injected to maintain surface elevations, regardless of the amount of fluids that were removed. This means that even in times of no production, specific amounts of water must be injected to maintain sufficient elevations. These minimum amounts are referred to as net injection.

Field Practices

Each day, Tidelands' operators measure and record the amount of water that has passed through the injection plants and individual injection pumps. If adjustments to volume or pressure must be made, it is done at this time. This information is collected by visual inspection of the pump meter display and input into the computer at the field office. The field office generates a report showing the activity at the injection plant and individual pumps. These reports are delivered to the Tidelands accounting department where they are used to generate reports for the DOP. These data are accumulated to develop the Net Injection Production/Balance Report.

Malfunctioning injection wells appear on a daily report (Rig Work List) received by Tidelands senior management. The report contains both injection and production wells. The most common problem for an injection well is a tubing or packer failure. In some cases, accumulated scale deposits block the outlets. Acid is then used to

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dissolve the scale deposits and the well may become operational again. Based on our review, no exceptions were found in this area.

Vendor Expenditures

Article 4.2.3 of the Unit Operating Agreement requires Authorization for Expenditure (AFE) on projects that exceed twenty thousand dollars (\$20,000) in cost. We selected a random sample of vendor expenditures incurred during the period January 2002 through March 2003 to determine whether:

1. AFE was issued by Tidelands and approved by DOP.
2. Charges were allocated to correct unit.
3. Expenditures were supported by sufficient documentary evidence.

We noted that there were no exceptions in the expenditures reviewed. Additionally, we agreed each payment to the supporting documentation to verify the appropriateness of the expense.

Although we found no exceptions in the expenditures reviewed, we did note discrepancies in the services provided by one vendor, Centrilift-Hughes, Inc. (Centrilift), under the terms of an alliance agreement.

Alliance - Centrilift

In 1995, Tidelands entered into an alliance agreement with Centrilift to provide materials and service for all submersible well pumps. The agreement includes a requirement that Centrilift install four skid-mounted, variable speed drives (VSDs) and transformers at no cost to Tidelands. Additionally, Centrilift is to provide maintenance on these items at no charge. Tidelands did not begin tracking the four items until February 2003.

The monthly fee paid to Centrilift (exclusive of other maintenance and installations) is based on oil production, specifically, the revenue stream from each well in the alliance. There are 125 wells under the alliance agreement. For the period September 2002 through August 2003, Tidelands paid \$817,379 in alliance revenue fees (an average of \$544 per well per month).

The pricing table in the agreement allows Centrilift to collect a fee ranging from 3.30% of gross revenues when the market price of oil is \$9.00 or less to 3.03% if the market price of oil is \$24 or more. Each month, Tidelands provides Centrilift with a report listing individual submersible well production information, oil price, the alliance fee percentage and the total amount due (to Centrilift). Centrilift uses the report to generate an invoice to Tidelands.

Issue:

Tidelands' alliance agreement with Centrilift does not specify an upper limit for oil prices on which the respective alliance fee percentage of oil revenue will

apply. When reviewing Centrilift invoices, we noted that in practice, the alliance fee appears to be capped at \$24 per barrel.

Recommendation:

Amend the contract language or obtain a letter from Centrilift that documents their interpretation of the contract to coincide with current practice.

Subsequently, Tidelands obtained a letter from Centrilift documenting that the maximum alliance fee charged is based on \$24 per barrel of oil.

Fixed Assets

Tidelands does not track all fixed assets in the accounting system. Tidelands does track production assets for maintenance purposes only. Discussion with Tidelands indicates that there was a conscious decision to stop tracking fixed assets for accounting purposes. Article 4 of the Tidelands Parcel and Parcel "A" Oil Contract states that the contractor shall establish fixed asset accounts by charging values to asset accounts and crediting a City "control account". Additionally, there is no reconciliation of fixed asset purchases to assets on hand, or assets sold at salvage.

Issue:

Tidelands has a computer system that includes a listing of facilities and production assets. Tidelands, however, does not have a control list to ensure that all fixed assets are tracked and can be reconciled to physical assets on hand. Having a complete list of fixed assets will help safeguard assets and track their disposition.

Recommendation:

Track all fixed asset purchases above a set dollar amount, and their subsequent retirements (e.g. Computers, office equipment, etc.). This could be done through the accounting system or outside it. Conduct periodic physical verification of fixed asset existence.

Purchases Greater Than \$1,000

All vehicles, computers and other office equipment purchases greater than \$1,000 are pre-approved for purchase by the DOP. These items are initially purchased by Tidelands and subsequently sold to the State. The items are then rented to the WIOs.

Each year, Tidelands provides the DOP with a list of equipment used in the oil field and administrative operations. The DOP uses these data to calculate an equipment rental rate, which is used to allocate usage to the various fault blocks. The WIOs approve the new rate, and Tidelands updates the allocation of the charges.

The last time the DOP adjusted the rental rate was 1998. Since that time, Tidelands has provided the new annual rental data, however the DOP has not updated the rental rate for approval by the WIOs.

Issue:

Tidelands has been using the same equipment rental allocation rate since 1998.

Recommendation:

Although control over this area rests with the DOP, Tidelands should work with the DOP to ensure that proper rental rates are used in allocating charges to the

different fault blocks. Prepare adjusting entries to allocate proper rental costs to the WIOs since 1998.

Inventory

Materials held in inventory include casing, tubing, piping, pumps, motors, control valves, and other supplies and equipment. New material purchases are delivered to either the Tidelands warehouse or directly to the well site. Warehouse deliveries are immediately recorded as purchases by the State. Deliveries directed to a well site are recorded as an expense, and not included as part of inventory.

In addition to new inventory owned by the State, other inventory accounts include used and repaired materials and equipment. These accounts are tracked for the State and individual fault block units. During repairs and upgrades, old material removed from the well site is inspected and if certified becomes available for reuse as used material. All used material is available for reuse by the material owner, or may be resold for use in another well. Used material is sold at 75% of the original purchase price. Material sent for repair is recorded as repair inventory and tracked under the owner's repair inventory account.

Inventory is tracked by Tidelands, using the Material Control System in the Oracle Database.

Annual Inventory

Each year, Tidelands performs a physical inventory count of all material, new, used and repaired. Physical counts are documented by Tidelands staff on seven different types of inventory sheets, known as 'run sheets'.

1. Warehouse Rod Inventory - New
2. Warehouse Rod Inventory – Used
3. Repair Accounts
4. Tubing Inventory – New
5. Tubing Inventory – Used
6. Tubing Inventory – Repair
7. All Other Inventory

Run sheets are distributed to the staff on the day of the count. As the run sheets are completed, the supervisor reviews them for discrepancies. The supervisor confirms all discrepancies before the end of the day. Confirmed shortages are listed on an Inventory Adjustments Report. These shortages are adjusted against the unit and non-unit accounts.

Issue:

A review of the Tidelands new, used, and repair inventory as of October 2, 2003, identifies the following errors:

1. Negative quantity counts for some items.
2. Zero quantity counts with negative dollar balances.

3. Zero quantity counts with positive dollar balances.

Recommendation:

Review the discrepancies identified during the audit. The full list of these discrepancies was forwarded to Tidelands under a separate cover. Subsequently, Tidelands made the appropriate computer system updates and manual corrections to the perpetual inventory system.

Inventory Warehouse Procedures

Warehouse staff acquires equipment and materials based on requests generated by field operators. Each day, field operators place work orders via computer to the supervisor at the warehouse. Supervisors print the work orders each morning and arrange them by priority. Each morning, supervisors meet with warehouse staff and distribute work orders.

Warehouse employees locate the parts and prepare 'tickets' identifying the parts pulled. The procedure requires tickets to be signed by the supervisor prior to release for delivery to the well site. At the end of the shift, after parts have been issued to the field, all tickets are collected by the warehouse supervisor and entered into the perpetual inventory system. The perpetual inventory system is updated for items used in the field.

Issue:

Employees that pull the parts sign the name of their supervisor to expedite the delivery of materials and equipment.

Recommendation:

Given the fact that the supervisor enters the information into the system at the end of the shift, we acknowledge there is oversight. However, the ticket requires a supervisor's approval before issuance. This control is not functioning as designed. Therefore, we recommend that supervisory approval be obtained prior to releasing material from inventory.

We were informed that Tidelands would implement a procedure whereby all material requests that have not been approved by the supervisor will be approved after the material has been issued. This practice will not disrupt operations when supervisors are not present at the time.

The alliance agreement with Centrilift allowed for the transfer of certain existing inventory, such as ESPs and electrical cable. These items and their valuations were to appear in Attachment A of the agreement. When the material and equipment were obtained by Centrilift, Tidelands did not post the transaction to transfer the materials from the WIOs.

Issue:

Attachment A of the alliance agreement was not available for review from Tidelands or Centrilift. Discussion with Tidelands indicates that Attachment A may have never been prepared. Therefore, there was no valuation of the inventory released to Centrilift.

Recommendation:

Ensure contractual documentation is complete before executing agreements.

Issue:

Tidelands did not account for the cable and ESPs released to Centrilift in 1995. The electrical cable released to Centrilift is carried on the perpetual inventory system at \$563,280. The ESPs were not on the inventory system and a valuation could not be determined. Most of this inventory had been expensed, however, it was not allocated to the proper WIO.

Recommendation:

Accounting entries should be made timely. Tidelands has made an adjustment to reflect the use of electric cable for the full amount of discrepancy, \$563,280.

Revenue & Pricing

Section 18.3, as amended, of the Long Beach Harbor Tidelands Parcel and Parcel "A" Oil Contract (No. 20596) states:

"All oil shall be valued, accounted for and paid for at the arithmetic average of the prices posted in the Field (Wilmington) and in the Huntington Beach, Long Beach, Inglewood and Midway Sunset oil fields by Union 76, ChevronTexaco, ExxonMobil Corporation, Shell Trading US and any other person, firm or corporation operating a refinery in California with a throughput capacity of at least thirty thousand (30,000) barrels per day, for oil of the like gravity on the day the oil is run into the Contractor's tanks and/or pipelines. The value shall be computed to the closest tenth of each degree of API gravity and the closest tenth of a cent per barrel."

To ensure Tidelands calculates oil prices in accordance with this requirement, the DOP receives pricing bulletins from 'posters' in the Wilmington, Huntington Beach, Long Beach, Inglewood and Midway Sunset oil fields to determine the 5-field average price of crude oil of like gravity for that day. We judgmentally selected one month to review calculation of the 5-field average by Tidelands and the DOP.

We found no exceptions in the calculation of oil value for the month reviewed. The risk of errors in oil pricing by the contractor is mitigated by DOP's and the buyer's continual monitoring of oil prices.

Insurance & Bonds

We reviewed insurance policies held by Tidelands to verify adequacy of coverage based on provisions stipulated in the City's contract and the requirements of the Unit Operating Agreement. We found the insurance coverage to be in compliance with contract requirements.

We also reviewed the allocation methodology used, which is based on an estimated percentage of unit ownership, actual barrel counts, and property replacement value. We found no exceptions in the allocation of insurance costs as required by terms of the City contract and Unit Operating Agreement.

Payroll

Tidelands has 76 hourly and 50 salaried employees. Total head count and all salary ranges are approved by the DOP. Hourly wages are set by union agreement (Paper, Allied Industrial & Energy Workers International Union, AFL-CIO). Payroll deductions include state and federal withholdings, medical insurance, union dues, 401K, various charities, garnishments and credit union allotments. Hourly employees are paid every two weeks, while salaried employees are paid twice a month.

Tidelands supervisors approve hourly employee time sheets and submit the information to the Payroll Administrator. The administrator reviews the time sheets supplied by the supervisors. These sheets are uploaded to an ADP program, which is transmitted every two weeks. Salaried employees turn in a time sheet to the administrator and this information is also transmitted to ADP. The Director of Human resources reviews the ADP uploads. ADP distributes the payroll through checks or direct deposit. Time clocks are not used.

We reviewed a sample of 10 hourly employees records for the period March 2, 2003 through March 15, 2003. The time sheets submitted were reviewed for proper supervisory approval. The ADP payroll run was compared to the supervisor approved time sheet for accuracy. The hourly pay was compared to the Union's hourly Agreement. No discrepancies were noted.