

PERFORMANCE AUDIT

**OKLAHOMA CORPORATION COMMISSION  
OIL AND GAS CONSERVATION DIVISION -  
TECHNICAL SERVICES  
SURETY AND E-PERMITS DEPARTMENT**

For the period July 1, 2013 through June 30, 2015



Oklahoma State  
Auditor & Inspector  
Gary A. Jones, CPA, CFE

**Audit Report of the  
Oklahoma Corporation Commission  
Oil and Gas Conservation Division - Technical Services  
Surety and E-Permits Department  
For the Period  
July 1, 2013 through June 30, 2015**



## Objectives & Scope

Determine whether internal control procedures provide reasonable assurance that oil and gas surety receipts and related expenditures are accurately reported in the agency accounting records.

Determine whether internal control procedures provide reasonable assurance that the OGCD Intent to Drill (ITD) fees collected are accurately reported in the agency accounting records.

The scope of this audit includes the period July 1, 2013 through June 30, 2015.

This audit was performed in response to the OCC's request in accordance with **74 O.S. § 213.2(B)**

# Oklahoma Corporation Commission Oil and Gas Conservation Division – Technical Services Surety and E-Permits Department

August 11, 2016

## Background

The Oil and Gas Conservation Division (OGCD) – Technical Services purpose is to provide permitting, document handling, and compliance services to the oil and gas industry and the general public to ensure timeliness of information processing and authorizations to drill and produce oil and gas wells. The Surety and E-Permits department makes certain all operators in the state maintain surety for plugging wells and remediating sites which are required under **52 O.S. § 318.1** by ensuring applications and orders meet criteria for approval under Commission rules.

## What We Found

The Agency's internal control procedures do not provide reasonable assurance that surety receipts and expenditures or Intent to Drill (ITD) fees are accurately reported in the accounting records. Our procedures identified the following:

- No complete Surety listing is not maintained to enable analytical procedures on the test data, resulting in a lack of assurance that all funds received are deposited.
- Management does not perform an independent reconciliation of Surety receipts or expenditures.
- No independent reconciliation of ITD fees received and permits issued to actual funds deposited is performed to determine if OCC collected associated fees for all permits issued.
- Inconsistent documentation, inadequate communication, and lack of reconciliation between participating divisions contribute to the issues identified in these areas.

OCC did not comply with **52 O.S. § 318.1**.

The Finance division must continue to improve its internal processes and coordinate with the contracted IronData- STAR system representatives to ensure significant surety and ITD internal control processes are formalized and automated as appropriate.

GARY A. JONES, CPA, CFE  
OKLAHOMA STATE AUDITOR & INSPECTOR

## Background

According to 52 O.S. § 318.1(A) *Agreement to Drill, Operate and Plug Wells*, any person who drills or operates any well for the exploration, development, or production of oil or gas, or as an injection or disposal well, within this state to submit on a Commission-approved form his or her agreement to drill, operate and plug wells in compliance with the rules of the Commission and the laws of this state, together with evidence of financial ability to comply with the requirements for plugging, closure of surface impoundments, and removal of trash and equipment as established by the rules of the Commission and by law.

Per 52 O.S. § 318.1.A .1. & 2., to establish evidence of financial ability, the Commission shall require one of the following forms of surety:

Category A: Financial statements proving a net worth of at least \$50,000 and a general release that the information may be verified with financial institutions.

Category B: An irrevocable commercial letter of credit (LOC), cash<sup>1</sup>, a cashier's check, a certificate of deposit (CD), bank joint custody receipt, other negotiable instrument, or a blanket surety bond. The surety shall be in the amount of \$25,000 unless otherwise ordered by the Commission. Any instrument constitutes an unconditional promise to pay. The amount may be less than \$25,000 if the operator's statewide well plugging liability is less than that amount.

Commission rules (OAC 165:10-1-7) prescribe required forms supplied by the Commission to be filed by the operator and OAC 165:5-3-1 lists the Oil and Gas fees.

- The Form 1000 - *Notice of Intent to Drill (ITD)* application shall be filed by all operators with the Oil and Gas Conservation Division (OGCD) before any oil, gas, injection or disposal, service well or stratigraphic test hole is drilled, recompleted, re-entered or deepened. The standard permit fee is \$175 or \$500 for operators filing an emergency application. Upon approval, the operator has six months to commence the permitted operations. A copy of the approved permit must be posted at the well site.
- The Form 1006B- *Operator Agreement to Plug Oil, Gas and Service Wells within the state of Oklahoma*. The operator shall agree to plug well(s) in compliance with Commission rules. This agreement must accompany the operator's elective choice of surety (Form 1006, 1006A, or 1006C). The operator is required to file a Form 1006B with the OGCD once every twelve months.

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<sup>1</sup> OAC 165:10-1-10 (a) (2) technically includes cash as an "approved negotiable surety instrument" but cash is not accepted for any OGCD fee or payment.

Depending on the type of surety financial evidence submitted to OGCD by the operator prior to drilling, the applicable Commission-approved form must be submitted with the original 1006B to the OGCD:

- Form 1006 – *Surety Bond for Oil, Gas, Injection or Disposal Wells*
- Form 1006A – *Financial Statement for Oil, Gas, Injection or Disposal*
- Form 1006C – *Irrevocable Commercial Letter of Credit (LOC)*
- Form 1006D – *Cashier's Check (CC), Certificate of Deposit (CD), or other negotiable Instrument*

The Commission's OGCD division utilizes the Risk Based Data Management System (RBDMS) developed by the Ground Water Protection Council through grant funding from the Department of Energy. The RBDMS is a client/server data information system for tracking oil, gas, injection wells, and source water protection activities for regulatory agencies to use in managing and analyzing oil and gas program data and water resources management information. Currently, Oklahoma is one of approximately twenty-two states whose regulatory agency has adapted the RBDMS to incorporate federal guidelines and customize based on state laws and regulations.

The Surety department is responsible for retention of surety financial evidence and processing of ITD applications. New operators must mail to the Surety Department the original signed Form 1006B. New operators must provide evidence of surety before electronic filing access is granted. Existing operators have the capability to file the annual form 1006B online and surety information updates automatically in the RBDMS. No hard copy is retained.

The ITD application is the only form with a fee associated that is available to submit electronically.

**Objectives**

The objectives of this audit were to:

- 1) Determine whether internal control procedures provide reasonable assurance that oil and gas surety receipts and related expenditures are accurately reported in the agency accounting records, and
- 2) Determine whether internal control procedures provide reasonable assurance that the OGCD Intent to Drill fees collected are accurately reported in the agency accounting records.

**Scope**

Our audit was requested by OCC in accordance with **74 O.S. § 213. 2(B)**, which requires the State Auditor and Inspector to examine all books and accounts of all public entities specified by statute, upon receiving a written request to do so by the chief executive officer of the governmental entity or another authorized requestor. In planning the audit, we focused on our assessment of materiality and risk for the period July 1, 2013 through June 30, 2015.

The scope of this audit included operators' annual Forms 1006B, evidence of surety, surety revenue, surety release payments (expenditures), and the Commission's approved surety forms. Also included were the ITD-Forms 1000 and associated fees and supporting documentation for the period July 1, 2013 through June 30, 2015.

**Methodology**

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

In planning and conducting our audit we obtained an understanding of the surety process, specifically the process of how revenue is collected and transferred, and the Intent to Drill receipting process. Audit procedures included inquiries of Oil and Gas Conservation Division management and Surety and E-Permitting staff; online surveys for a random sample of OGCD employees; review of relevant state laws, Oklahoma Administrative Code, and Commission administrative procedures; and data reviewed from the Surety Department surety hard copy files, the Commission's internal surety-imaging system, the RBDMS database, and Finance Department surety hard copy files and electronic files.

We identified specific attributes for testing each of the objectives. The random sample methodology was used to ensure the samples were representative of the population and provided sufficient, appropriate evidence, including random samples of operators' surety financial evidence and Intent to Drill (ITD) applications within the audit period. Our procedures were to determine if the receipting process for OGCD Surety receipts, related expenditures, and ITD fees collected are accurately reported in agency records.

Because of the inherent limitations of an audit, combined with the inherent limitations of internal control, errors or fraud may occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

## AUDIT RESULTS

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**Conclusions** The OCC's internal controls over the receipting process for Oil and Gas Surety receipts and related expenditures do not provide reasonable assurance that funds are accurately reported in the agency accounting records. Notably, the Surety department does not utilize the RBDMS reporting module as a management tool to perform reconciliations of Surety receipts to Finance deposits.

The Agency's internal controls also do not provide reasonable assurance that ITD fees collected are accurately reported in the agency accounting records. Again, no internal comparison is performed between permits issued in RBDMS and ITD fees received, Finance deposits.

OCC is not compliance with **52 O.S. § 318.1**, partially due to missing documentation.

Based on our procedures, we identified several areas for possible improvement at the Commission, as detailed in the following findings and recommendations.

FINDINGS AND RECOMMENDATIONS

*Inadequate  
Segregation of  
Duties in  
Receipting of  
Intent to Drill Fees*

The United States Government Accountability Office's *Standards for Internal Control in the Federal Government* (2014 Revision)<sup>2</sup> (GAO *Standards*) states, "Key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event."

The Oil and Gas Administrative Assistant is responsible for receiving payments and posting operator information into the RBDMS for ITD permits. This creates an opportunity for someone in this position to misappropriate funds received and to conceal the misappropriation by improperly recording receipts. In addition, management does not perform an independent reconciliation sufficient to ensure all payments received by the agency are deposited. Although the finance division performs fund reconciliations, there is no comprehensive reconciliation of payments received to permits issued.

It appears management was not aware of the risks created by this arrangement of duties or the lack of appropriate reconciliation controls.

**Recommendation**

We recommend management ensure that all payments for ITD permits are received by the central cashier's cage and then posted into the RBDMS system by the Oil and Gas Administrative Assistant. In addition, we recommend someone independent of the receipting, posting and depositing process reconcile ITD permits issued to deposits recorded by the State Treasurer. This reconciliation would provide assurance that all payments posted in agency database were deposited.

**Views of Responsible Officials**

The OCC Finance division will implement a new payment receipting procedure, Central Processing, when the STAR software system goes live this year. All mail containing checks will be delivered and processed in a secure location off of the mailroom, while walk-in payments will continue to be handled at the cashier window. Payments will be recorded into STAR and deposited by Finance staff within 24 hours of receipt.

<sup>2</sup> Although this publication addresses controls in the federal government, this criterion can be treated as best practices. The theory of controls applies uniformly to federal or state government.

Once the payment is recorded in STAR, Oil and Gas staff will be responsible for reviewing the scanned image of the payment for accuracy. The application and payment will then be processed and posted in RBDMS. Oil and Gas will create a daily invoice in STAR for each ITD application processed in RBDMS and apply payments that were recorded by Finance to satisfy the invoices. Any overpayments or refunds will be initiated in STAR after payments are applied.

Monthly, Finance will provide Oil and Gas a STAR report with the total ITD revenue collected for the month. An Oil and Gas employee, independent of posting and applying payments, will reconcile the STAR report to the RBDMS system for accuracy and notify Finance of any discrepancies. A copy of the reconciliation, signed by the reviewer, will be sent to Finance for internal record keeping. Finance will perform monthly reconciliations to the State Treasurer's bank statements, merchant services statements, and STAR-generated reports.

The RBDMS system cannot currently generate the necessary report for Oil and Gas staff to reconcile against the daily report from Finance. The agency will create an internal log to reconcile data from RBDMS to STAR, until a permanent solution of an RBDMS-generated report can be developed, to ensure that all payments received by the agency are accounted for and processed into the RBDMS system.

*Inadequate  
Segregation of  
Duties Related to  
Surety Receipts*

The GAO *Standards* state, "Key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event."

The *Standards* also state, "Documentation is required for the effective design, implementation, and operating effectiveness of an entity's internal control system."

Based on procedures performed, we noted the following:

- The Finance Accountant IV had the opportunity to receive deposits and was responsible for posting surety cashier's check payments to CORE.
- Management does not perform an independent reconciliation sufficient to ensure all payments received by the agency are deposited. Although the Finance Accountant IV performs a clearing account reconciliation, there is no comprehensive reconciliation of payments deposited to surety activity in the RBDMS.

This creates an opportunity for someone in this position to misappropriate funds received and conceal the misappropriation by improperly recording receipts.

It appears management is not aware of the risks created by this arrangement of duties or the lack of appropriate internal reconciliation controls.

### **Recommendation**

Management should ensure that no one individual can receive and post surety cashier checks to CORE. Also, an independent reconciliation should be performed of surety payments deposited to those posted as received in the RBDMS. Example of a mitigating control could include reconciling surety receipts deposited to new 1006B applications processed.

### **Views of Responsible Officials**

Finance's Central Processing effort consists of multiple layers and securities. The data entry level will include staff processing the actual payments into STAR. The oversight level will review the daily data entry reconciliations, prepare the deposit, reconcile to STAR-generated daily reports, and input deposits into the agency's clearing accounts via PeopleSoft. The financial reporting level will reconcile monthly reports from STAR to OST bank statements and merchant services statements, review reports reconciled by Oil and Gas staff to RBDMS, and input transfers to agency funds via PeopleSoft, based on above monthly reconciliations. Finance employees will not be assigned to multiple levels to ensure proper segregation of duties.

Oil and Gas will be responsible for reconciling reports of applications processed to STAR-generated reports and notifying Finance of any discrepancies. RBDMS cannot generate certain reports at this time; the agency will use a manual log for reconciliation purposes until a permanent solution can be obtained.

*Two Surety  
Release Payments  
Processed for One  
Operator*

To protect against possible errors or irregularities in an entity's financial records, an effective internal control system should provide for accurate and reliable records and adequate review of supporting documentation.

During our review of 29 surety release payments (termination of surety), we noted two payments were processed for one operator. OCC management explained that the Office of Management and Enterprise

Services had informed OCC of the duplicate warrant and a stop payment was issued to the Office of State Treasurer.

Without an adequate review of expenditure transactions posted to CORE, duplicate payments could be processed without being detected.

### **Recommendation**

Management should perform an independent review of surety expenditures and retain evidence that the review was performed. An example of this review could include an individual from Oil and Gas Division obtaining a detailed listing of all surety payments made and comparing to documentation of approved surety release requests.

### **Views of Responsible Officials**

During the course of this audit, Finance implemented a form to be completed for each surety pay-out request. This form requires certain information to be completed and an invoice is automatically generated based on that data. There will always be a unique invoice number for each surety therefore reducing the risk of duplicate payments since PeopleSoft will not allow for the same invoice to be paid twice to the same vendor; thus, eliminating the situation listed above.

Finance included a review section to be performed by another employee to ensure that the request had not previously been paid to the vendor, or forfeited to the OCC, and to ensure that the vendor was not on the bankruptcy log and was eligible for the payment (if being returned and not forfeited).

Mailing procedures were also updated, including an email being sent to Oil and Gas- Surety Department, asking for approval before any surety payment would be disbursed. The warrant does not get mailed unless Finance receives written approval from the Surety Department.

A checklist has been added to Finance's surety files to ensure that all proper documentation is obtained and reviewed before payment is submitted. All files were updated to be consistent with new practices.

Once STAR implementation is complete, refunds will be processed electronically through the system. Oil and Gas will initiate the refund from an established invoice, and Finance will process the refund on the original payment received. If the payment were previously disbursed, a refund could not be generated; therefore, eliminating the risk of a duplicate payment.

Oil and Gas will be responsible for updating RBDMS with refund information. The system's functionality needs to be improved to include

better refund tracking information, including warrant number, date, amount, and order number. A monthly reconciliation of surety payments will be performed by Oil and Gas staff, comparing PeopleSoft expenditure reports for surety payments to surety refund requests submitted in the STAR system.

*Lack of  
Documentation  
Inhibits Proper  
Control Activities  
and Statutory  
Compliance*

The GAO *Standards* state in part, “Control activities occur at all levels and functions of the entity. They include a wide range of diverse activities such as . . . the creation and maintenance of related records which provide evidence and execution . . . as well as appropriate documentation.” The *Standards* also state that management should clearly document internal controls and all transactions and other significant events in a manner that allows the documentation to be readily available for examination.

During our review of Intent to Drill and Surety documentation, we noted that information was not readily available for examination, due primarily to the following circumstances:

- Both the Finance and Oil and Gas Conservation Divisions maintain documentation in multiple locations. Some documents are scanned into the OCC Surety Imaging System, the RBDMS, some are retained in hard copy in filing cabinets in Finance and the Surety department, and others are stored in various Finance network folders.
- Surety non-compliance correspondence is retained in the Office of General Counsel (OGC). When an operator’s form 1006B or surety expires, they are sent a series of letters, culminating in a contempt letter. Non-compliant operators are turned over to OGC, who decides if and when to file a contempt case. Further correspondence and tracking is handled within that office, without clear reporting back to the Surety Department.
- When an operator submits an annual surety Form (1006B) electronically, the previous information is overridden in the RBDMS database; therefore, no historical data is maintained regarding the operator’s required operating information.

Based on our procedures and multiple discussions with Finance, OGCD, and OGC management, there is an overall lack of communication and reconciliation between the divisions in the Surety and ITD processes. The divisions do not appear to be working together to ensure appropriate flow of key information and documentation, increasing the risk that Surety and Intent to Drill information and related accounting records and reports are incomplete or inaccurate.

As explained in the Background section on page 2, state statutes and regulations prescribe the required documentation and surety payments for oil and gas operators. We reviewed supporting documentation related to operators' surety and ITD records and noted these further problems with documentation:

- For one of the 30 randomly selected operators whose surety expired in fiscal year 2014, no documentation was maintained to support why the operator's surety expired. We were unable to verify compliance with statutory requirements because the surety data had been deleted from the system and no hard copy of the documentation could be located.
- For five of 60 existing operators randomly selected, no documentation of the operator's current surety or annual Form 1006B could be located on or before the ITD Form 1000 was filed as required by **OAC 165:10-1-7 (b) (14)**. The RBDMS comments entered on 01/23/2015 included the note: "Lost all information for this operator, input new inf."
- For four of the 30 randomly selected operators who had an "approved" surety status during the audit period, there was no evidence of compliance because there was no form 1006B to review. This included two forms that were not available because the operator's previous form 1006B had been overridden in the RBDMS database.

Although the OCC has implemented processes to record and track Intent to Drill and Surety records, it appears the processes could be improved and RBDMS reporting could be utilized more efficiently to assist in proper recordkeeping and to perform reconciliations with Finance records. Without an effective internal control system that provides for accurate and reliable records, and especially in a system in which management does not utilize the reporting module, errors or irregularities could occur and not be detected in a timely manner. In addition, the potential failure of the Agency to properly ensure operators' financial ability related to plugging, closure of surface impoundments, and removal of trash and equipment (as required by statute) increases the risk that an operator could plug or abandon a well without proper cleanup, creating a financial liability for the state.

Furthermore, failure to maintain supporting documentation impedes the ability of auditors or other independent parties to verify the appropriateness of documentation, to ensure the agency complies with **52 O.S. § 318.1(A)**.

### **Recommendation**

Management should develop policies and procedures that provide concise directions for properly and consistently documenting, maintaining, and managing supporting information for Surety and ITD data. Also, with a collaborative effort among division management, an effective communication plan should be established.

In addition, management should obtain additional training on RBDMS software in order to utilize the reporting module for day-to-day operations. This will also allow the Commission to help ensure completeness and accuracy of information when making management decisions.

In addition, management should consider a revision to the RBDMS database to improve the procedures for submission of electronic surety forms, such as retaining an imaged copy of each operator's annual 1006B form to support information entered into RBDMS.

### **Views of Responsible Officials**

The management of surety documents crosses three divisions for different management processes. Oil and Gas focuses on compliance, a vital part of multiple permitting activities that require appropriate financial assurance. OCC rules have expanded the Surety Department's responsibilities beyond the current capabilities of RBDMS. Finance's main focus is on properly accounting for all monies received and expenditures made regarding sureties, but this is exclusive of the certificates of deposits, letters of credit or financial statements that may be held as active sureties. The Office of General Counsel (OGC) focuses on collection of financial assurances directed by Commission order, which could include both divisions, or just Oil and Gas if the surety was not a cashier's check received by the agency.

The STAR implementation will greatly improve communication amongst all three divisions with the notification feature. Once a final order is processed, if it is categorized as surety bond forfeiture, the STAR system will notify OGC, Finance, and Oil and Gas staff. Testing is still in progress, but it is believed that during the final orders process, the STAR system will automatically generate an invoice if an order requires money to be paid to the Commission. This would give Finance and OGC the ability to run a report from STAR on all orders and obtain a listing of payables to OCC, on a daily or monthly basis. It will also allow for e-documents and notes to be added in STAR to the vendor's file to be viewed by all divisions, given the proper security permissions.

RBDMS training will be done routinely to improve communication and reduce the need to maintain numerous filing systems with redundant information. RBDMS does accept 1006B forms filed electronically.

However, there are current system limitations that are issues, such as the temporary file being deleted once the information has been approved and accepted and allowing for records to be deleted completely.

The agency is exploring options to overcome system restraints. The Ground Water Protection Council performed a study recently of Oklahoma's RBDMS system. A copy was provided to the State Auditor's staff, upon request. There are several areas, identified by task number, which need improvement or increased development. However, many of the tasks are costly, with the grand total of Phase I being \$1,065,000. With the current budget restraints, especially in the Oil and Gas program where revenue collections are down 22% from the previous fiscal year, it will be difficult to fund a project of this magnitude and continue to address the critical issue of seismicity, being mindful that this is only one of OCC's four program areas.

**PROSPECTIVE AREAS FOR FURTHER STUDY**

During the course of the audit, the following issues came to our attention. While further procedures related to these issues were not considered within the scope of this objective, they merit future study:

- Evaluate surety statute defining the types of financial evidence acceptable to verify operator's fiscal ability is adequate and determine if mandated amounts are equitable (to avoid a state liability).
- Review the cost effectiveness of the RBDMS database.
- Review the ePermit (electronic filing) system and associated fees to ensure appropriate internal controls are in place.



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