



MEMORANDUM

Date: June 24, 2016

To: Honorable Mayor and Members of the City Council

From: Patrice Randle, City Auditor

Subject: Gas Revenue Audit of the Spinks Airport Unit (Audit Project #2013.022)

The Department of Internal Audit conducted a 2013 review of gas revenue at Fort Worth's Spinks Airport. An audit report was never finalized because the City filed a lawsuit against Chesapeake Operating, Inc. and Total E & P USA, Inc. Since the City of Fort Worth, Chesapeake and Total E & P have reached settlements, our audit results are summarized below.

Please do not hesitate to contact us if you have any questions or comments.

BACKGROUND

The City of Fort Worth (CFW) leased a significant portion of its acreage during the first decade of 2000 to various oil and gas companies for the right to explore for and produce natural gas and by-products from the Barnett Shale formation. Of those companies, Chesapeake Energy Corporation ("Chesapeake") became the largest lessee of the CFW's acreage and was highly successful in finding and economically producing natural gas from the Barnett Shale. Each month, Chesapeake pays royalties to the CFW for natural gas sold from the leases / wells operated by Chesapeake. As of April 2013, approximately \$200 million had been received in total gas revenue, including lease bonuses from oil and gas operators (with Chesapeake accounting for approximately \$120 million (approximately 60%) of the total).

In March 2013, Trinity Valley School filed a lawsuit against Chesapeake regarding royalty and override underpayments from the Rall Unit. Prompted by a subsequent inquiry from the City's Audit Committee, an evaluation was made as to whether the CFW performed due diligence to ensure that Chesapeake remitted the correct amount of royalties to the CFW. Internal Audit's evaluation revealed that limited due diligence had been performed by the CFW. City management and the Audit Committee then requested that the Department of Internal Audit initiate an onsite audit of the books and records of gas producing wells operated by Chesapeake.

An Audit Notification Letter (dated May 8, 2013) and a documents request was sent to Chesapeake. The Audit Notification Letter announced Internal Audit's intention to audit revenue received from the production and sale of natural gas from the Rall Unit. During the audit planning phase, the Department of Internal Audit concluded that revenue received from the Spinks Airport Unit wells produced significantly more royalty income (in excess of \$20 million) than that of the Rall Unit. The Department of Internal Audit, therefore, sent an e-mail to Chesapeake (on May 24, 2013), amending the Audit Notification Letter to include the Spinks Airport Unit. The Department of Internal Audit reserved the right to audit the Rall Unit at a later date. However, an audit of the Rall Unit was not considered necessary.

Prior to the start of detailed audit fieldwork of the Spinks wells, Internal Audit acquired the services of a specialty oil and gas consulting firm (Waterman & Co.) to serve as an audit advisor. Onsite audit fieldwork was performed during the two weeks beginning on Monday, August 26, 2013 at Chesapeake's office located in Oklahoma City, Oklahoma. Audit results indicated that Chesapeake did not comply with certain terms of the City's oil and gas lease. For the wells and months reviewed, Chesapeake deducted post production costs from the royalties paid to the CFW. Post production costs were deducted by a wholly-owned marketing affiliate ("Chesapeake Energy Marketing, Inc.") and passed through to the CFW.

The terms of the oil and gas lease specifically state that royalties paid to the CFW as lessor "shall be free of all costs of any kind, including, but not limited to, costs of gathering, production, transportation, treating, compression, dehydration, processing, marketing, trucking or other expense, directly or indirectly incurred by Lessee, whether as a direct charge or a reduced price or otherwise". The terms of the oil and gas lease further state that "Oil, gas or products may not be sold to a subsidiary or affiliate of Lessee as defined herein without the Lessor's prior written permission", which the CFW (lessor) did not at any time grant to Chesapeake (lessee).

A lawsuit was filed on October 17, 2013, on the City's behalf, against Chesapeake and Total E&P USA, Inc. The lawsuit sought damages for royalties due, the payment of attorney's fees related to the suit and breach of contract and interest on unpaid royalties.

AUDIT OBJECTIVE

The audit objective was to determine the extent to which Chesapeake was in compliance with the terms of the Spinks Airport Unit lease. Specific emphasis was directed to determining whether Chesapeake paid the full and fair amount of royalties contractually owed to the CFW for the sale of natural gas from the Spinks Airport Unit.

AUDIT SCOPE

The scope included reviewing 12 producing Spinks Airport Unit wells (which comprised approximately 78% of the total Spinks royalty revenue) for seven months during which royalty payments were received from Chesapeake.

The Department of Internal Audit reviewed activity at Spinks Wells 1H through 11H, and 15H for the following seven months: September 2008, December 2008, February 2009, June 2011, September 2011, May 2012 and November 2012. The audit did not include a review and evaluation of CFW's internal processes and procedures (including internal controls) related to royalties received from the sale of natural gas.

AUDIT METHODOLOGY

To achieve the audit objective, the Department of Internal Audit performed the following:

- reviewed oil and gas lease terms associated with the Spinks Airport (City Secretary Contract No. 33024), which included discussions with the Office of the City Attorney;
- determined whether certain key requirements of the oil and gas lease were adhered to by Chesapeake; and,
- determined, on a test basis, the accuracy and validity of the four components (volume determination, price determination, ownership percentage, and deductions) used by Chesapeake to compute royalties due CFW.

We conducted this audit in accordance with generally accepted government auditing standards, except for peer review¹. 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 objectives.

CONCLUSION

The CFW received \$21 million in lawsuit settlements. Total settled for \$6 million dollars, and Chesapeake Energy agreed to pay the City \$15 million.

c: Steve Cooke, Property Management Director
Randle Harwood, Planning and Development Director
David Cooke, City Manager
Jay Chapa, Assistant City Manager
Fernando Costa, Assistant City Manager

¹Government auditing standards require audit organizations to undergo an external peer review every three years. A peer review is planned in 2017 for the three-year period ending December 31, 2016.