THE UNIVERSITY of TEXAS SYSTEM
FOURTEEN INSTITUTIONS. UNLIMITED POSSIBILITIES.

Audit Office
210 West 6th Street, Suite B140.E
Austin, Texas 78701
512-499-4390 | Fax: 512-499-4426
WWW.UTSYSTEM.EDU

June 9, 2017

Sharon Mosher, Ph.D., Dean
The University of Texas at Austin
Jackson School of Geosciences
2305 Speedway, Stop C1160
Austin, TX 78712

Dear Dr. Mosher:

We have completed our audit of the Geology Foundation's management of the oil and gas interests and royalty payments received from the bequest of the John A. and Katherine G. Jackson's estate. The detailed report is attached for your review.

We conducted our audit in accordance with the guidelines set forth in The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*.

We will follow up on recommendations made in this report to determine their implementation status. This process will help to enhance accountability and ensure that audit recommendations are implemented in a timely manner.

We appreciate the assistance provided by the Geology Foundation at The University of Texas at Austin.

Sincerely,

J. Michael Peppers

J. Michael Peppers, CPA, CIA, QIAL, CRMA
Chief Audit Executive

cc: Terry Newman, Assistant Dean for Financial Affairs, UT Austin
Mike Vandervort, Chief Audit Executive, UT Austin

The University of Texas System Administration

The University of Texas at Austin
Geology Foundation's Jackson Estate
Trust Mineral Audit Report

June 2017

THE UNIVERSITY OF TEXAS SYSTEM AUDIT OFFICE
210 W. 6TH STREET, SUITE B.140E
AUSTIN, TEXAS 78701-2981
(512) 499-4390

Audit Report

June 2017

EXECUTIVE SUMMARY

In 2003, John A. Jackson bequeathed 95 percent of his residuary estate to the Geology Foundation (Foundation), which is an internal foundation of The University of Texas at Austin (UT Austin) that supports the Bureau of Economic Geology, the Institute for Geophysics, and the Department of Geological Sciences. At that time, the gift was valued in excess of $250 million—the largest single gift in UT Austin history. Approximately 34 percent of the bequest was based upon the valuation of the oil and gas mineral interests. By the end of fiscal year (FY) 2016, the estimated value of the mineral interests was $56 million. Currently, over 20 operators produce oil and gas from approximately 1,400 wells. From initial transfer of the of the John A. and Katherine G. Jackson Estate (Jackson Estate) to the Foundation in 2003 through the end of FY 2016, the Foundation had collected approximately $55 million in oil and gas royalties.

On December 19, 2003, The University of Texas (UT) System Board of Regents (Board) waived Regents' *Rules and Regulations* 70301, Section 8, to authorize UT Austin's Foundation to manage the oil and gas royalties received from the Jackson Estate. A condition of the waiver included periodic audits by the UT System Audit Office to ensure compliance with the Foundation's Royalty Financial Management Procedures.

AUDIT OBJECTIVES & SCOPE

The objectives of this audit were to determine whether the Foundation was:

- Complying with royalty management and other applicable institutional policies and procedures, and
- Following their monitoring procedures to ensure operators were accurately reporting and paying oil and gas royalties.

The scope of this audit included the period from September 1, 2015 through August 31, 2016.

RESULTS

The Foundation was adequately complying with its royalty management procedures and other applicable institutional policies and procedures. Additionally, the Foundation was generally following its monitoring procedures to ensure operators are accurately reporting and paying oil and gas royalties. However, we noted opportunities for the Foundation to enhance internal controls for managing the royalty interests, which include:

1. Updating internal process documentation,
2. Enhancing the reconciliation processes and administration of ownership records,
3. Ensuring that the transfers of funds to The University of Texas/Texas A&M Investment Management Company (UTIMCO) are completed as required,
4. Encouraging electronic funds transfer instead of checks,
5. Updating its disaster recovery plan (DRP) biennially, and
6. Eliminating back up of information to an external hard drive.

CONCLUSION

Overall, the Foundation was adequately complying with royalty management procedures, applicable university policies and procedures, and generally following its monitoring procedures to ensure operators are accurately reporting and paying oil and gas royalties. However, opportunities exist to enhance internal controls for managing the royalty interests, and the Foundation has agreed to take action to implement the recommendations in this report.

J. Michael Peppers

J. Michael Peppers, CPA, CIA, QIAL, CRMA
Chief Audit Executive

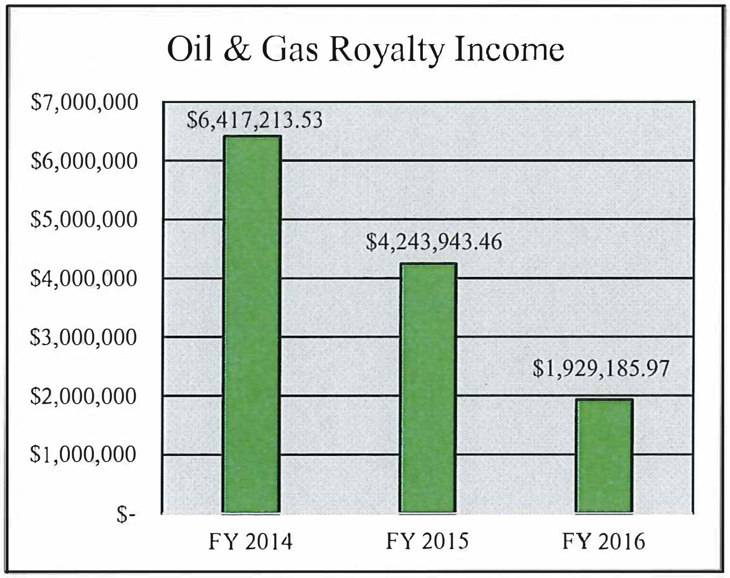
Eric J. Polonski

Eric J. Polonski, CPA, CIA
Director of Audits

BACKGROUND

The Geology Foundation (Foundation) is an internal foundation of The University of Texas at Austin (UT Austin) that was created in October 1953. The Foundation supports the Bureau of Economic Geology, the Institute for Geophysics, and the Department of Geological Sciences. Created on June 15, 2001, The John A. and Katherine G. Jackson Endowed Fund (Jackson Fund) is a permanent endowment established to support the Jackson School of Geosciences (Jackson School). On February 27, 2002, Mr. Jackson confirmed his intent to commit 95 percent of his residuary estate to the Jackson Fund, which is administered by the Foundation at UT Austin. The transfer of the Jackson Estate to the Foundation was initiated after Mr. Jackson passed away on March 21, 2003 and was originally valued in excess of $250 million.

The endowment includes overriding royalty interests, as well as 21 working interests, from oil and gas properties. The Foundation's average royalty interest is approximately two percent. The mineral interests are derived from wells covering 177,000 acres located primarily in Wise County, Texas. Currently, over 20 operators produce oil and gas from roughly 1,400 paying wells.



By the end of FY 2016, the Foundation had collected approximately $55 million in oil and gas royalties since the initial transfer of the Jackson Estate in 2003. However, over the last three fiscal years, royalties collected have declined. As illustrated in the chart to the right, the Foundation received just over $1.9 million in royalty payments in FY 2016, which represents a decrease of 54 percent in comparison to royalty payments received in FY 2015. Price and production are the primary components that affect royalties received. In FY 2016, the average oil price received per barrel was $41 and the average gas price received was $2.30 per thousand cubic feet (MCF); whereas, the average price of oil received per barrel was $98 and the average gas price received was $4.40 per MCF in FY 2014. The decreases in oil and gas prices over the last couple of years has led to less drilling activity, less production, and ultimately less royalties collected by the Foundation.

Most of the royalties are based on natural gas sales. Devon Energy Corporation (Devon) is the largest payer of oil and gas royalties to the Foundation, accounting for approximately 88 percent of royalties the Foundation has received. ConocoPhillips Company's and Texxol Operating Company, Inc.'s payments accounted for 5 percent and 4 percent, respectively. All the other operators combined only accounted for 3 percent of total royalty payments received.

On December 19, 2003, The University of Texas System Board of Regents waived Regents' *Rules and Regulations* 70301, Section 8, to authorize the Foundation to manage the oil and gas royalties received from the Jackson Estate. A condition of the waiver included periodic audits by the UT System Audit Office to ensure compliance with the Royalty Financial Management Procedures developed by the Foundation. According to these procedures, the frequency of the audits is to be determined based on the assessment of the risks associated with this operation relative to other audit risks of the University, but in any event, audits are to be conducted at a minimum of every three years. The UT System Audit Office conducted an audit during the summer of 2004 to establish that procedures were in place and being followed by assigned personnel. Since then, the UT System Audit Office has performed four additional audits of the Foundation's management of its mineral interests in FY 2007, FY 2010, FY 2013, and FY 2017.

AUDIT OBJECTIVES

The objectives of this audit were to determine whether the Foundation was:

- Complying with royalty management and other applicable institutional policies and procedures, and
- Following their monitoring procedures to ensure operators were accurately reporting and paying oil and gas royalties.

SCOPE AND METHODOLOGY

The scope of this audit included royalty financial management activities from September 1, 2015 through August 31, 2016. We conducted our audit in accordance with the guidelines set forth in The Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing.*

To accomplish the audit objectives, we reviewed existing policies and procedures, interviewed Foundation staff, reviewed and tested the cash handling and reconciliation processes, selected and tested a sample of new wells added to the Foundation's portfolio of mineral interests, selected and tested a sample of royalty payments, and conducted other procedures deemed necessary for this audit.

CRITERIA

- UTS166 – *Cash Management and Cash Handling Policy*
- UT Austin's Handbook of Business Procedures
- UT Austin's Information Resources Use & Security Policy Standard (IRUSP) 6: Backup & Disaster Recovery
- The Jackson School's Royalty Financial Management Procedure, Royalty Periodic Reporting Procedure, Annual Financial Report Procedure, Royalty New Well Activity Procedure, Royalty Gross Value Reconciliation Procedure, Royalty Decimal Reconciliation Procedure, Royalty Production Reconciliation Procedure, Tax Reconciliation Procedure, Royalty Check Processing Procedure, and Contingency Plan Procedure

RESULTS

Royalty Financial Management Procedures

The Foundation has developed and documented comprehensive Royalty Financial Management Procedures that provide instructions for management of the mineral interests and royalty payments. These procedures describe processes to manage the legal documents concerning ownership and royalty rights and to account for receipt and deposit of payments. In addition, the Foundation has developed a standard periodic process for analyzing new well activity, production, prices, taxes withheld, and gross value to ensure that appropriate royalties are being received. The Foundation's efforts in managing the mineral interest and royalty payments are commendable. However, the majority of the Foundation's procedures have not been updated in several years. Some of the procedures include outdated information and do not consistently reflect current practices.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

> **Recommendation:** The Foundation should periodically review and, as necessary, update information in the procedures to accurately reflect current practices.
> **Management's Response:** *The Foundation agrees with the recommendation and will review and update procedures annually, or earlier if they experience any organizational change which may impact their processes.*
>
> **Anticipated Implementation Date:** September 30, 2017

Reconciliations

As part of its monitoring plan, the Foundation performs a variety of reconciliations for a sample of properties to ensure the accuracy of royalty payments. These include, but are not limited to, quarterly production reconciliations, gross value reconciliations, and decimal reconciliations. The production reconciliation is a comparison of the sales volume reported by the operator to the Foundation with the sales volume reported to the Railroad Commission of Texas (RRC). The gross value reconciliation is a comparison of the gross value of sales reported by the operator to the Foundation with the gross value reported to the Texas State Comptroller (Comptroller). Finally, the decimal reconciliation is a comparison of royalty interest percentages as reported on check stubs to the relevant division orders. Comprehensive check stubs accompany the operators' payments and detail the volumes sold, commodity pricing, gross values, taxes and deductions, and the royalty decimal interest.

We found that the Foundation is not performing the gross value reconciliations, decimal reconciliations, and production reconciliations in accordance with the frequency established in the royalty management procedures. Also, for the decimal reconciliation, the Foundation is only sampling 10 properties from Devon instead of 20 properties as expressly stated in the procedures. However, since drilling activity and production have been decreasing over the last few years, the frequency of control activities required by the procedures could be revised to commensurate with the associated risk.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

> **Recommendation**: The Foundation should review current procedures to determine whether the sampling methodology and frequency of reconciliations is appropriate given current risks and available resources. If the Foundation determines that no changes should be made, then the Foundation should ensure that the reconciliations are executed with the frequency required by current policies and procedures.
>
> **Management's Response:** *Based on current risks and resources, the Foundation will run their reconciliation reports on a tri-annual basis instead of quarterly, with a focus on a sample of ten properties for Devon, and they will include four additional properties from the other two top producers: ConocoPhillips and Texxol.*
>
> **Implementation Date: December 31, 2017**

Monitoring Plan

As previously mentioned, the Foundation performs a variety of reconciliations for a sample of properties as part of its monitoring plan. We selected a sample of these properties to determine whether the Foundation is following its monitoring procedures to ensure that operators are accurately reporting and paying oil and gas royalties. We compared volumes on check stubs for a sample of properties to the RRC and to the Comptroller. The volumes recorded in the check stubs materially agreed to the volumes reported to the RRC and Comptroller. In addition, we compared the gross value on check stubs for a sample of properties to gross value reported to the Comptroller. We found that the gross value recorded in the check stubs materially agreed to the gross values reported to the Comptroller. Lastly, we compared the royalty decimal interest recorded in the executed division orders to the royalty decimal interest recorded in the check stubs and database. The database is the key resource the Foundation uses to monitor and track lease activity. We identified three properties that had an incorrect royalty decimal interest recorded in the database. We notified the Foundation of the errors, and they were immediately corrected.

We also selected 10 new wells that had been added to the Foundation's portfolio of wells since September 1, 2015, to determine whether the correct royalty decimal interest had been entered into the database. We identified one property that had an incorrect royalty decimal interest recorded in the database. We notified the Foundation of this error, and it was corrected immediately.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

Recommendation: The Foundation should enhance its monitoring processes to ensure that royalty decimal interests entered into the database are periodically reviewed and corrected.

Management's Response: *The Foundation agrees with the recommendation and will update decimal information recorded in the database to enter, as the new decimal, the sum of all decimals associated with a particular property, instead of considering only one of the decimals documented in the division orders.*

Implementation Date: September 30, 2017

Ownership Records

A division order is a revocable document that provides the source for determining the basis of payment. It indicates the ownership of the Foundation's royalty decimal interest in proceeds from the property. Once a new well starts producing, the operator will send a division order to the Foundation. If there are any significant changes to a division order, such as a change in operator or royalty decimal interest, a new division order will be issued. The Foundation inputs the royalty decimal interest shown on the division order into the database.

We selected a sample of 35 properties to determine whether the division orders were obtained, appropriately executed, and maintained. Twenty-five were from wells that had been producing prior to September 2015. The remaining 10 were new wells added to the Foundation's portfolio of wells since September 2015. From the 25 older wells, we identified one property for which the Foundation did not retain a copy of the executed division order. We notified management of this error and subsequently a copy of the executed division order was obtained from the operator.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

Recommendation: We recommend that the Foundation enhance its process to ensure all executed division orders are retained.

Management's Response: *The Foundation agrees with this recommendation. The Foundation will request missing division orders and will update decimal information as indicated in the previous recommendation.*

Implementation Date: September 30, 2017

Payment Process and Transfer Process

The Foundation receives wire transfers and checks for royalty payments. Both check and wire transfers are recorded in the database and deposited with UT Austin's Bursar Services. The Foundation reconciles monthly amounts it records in the database to amounts recorded in the Foundation's royalty account in the general ledger, i.e., Departmental Financial Information Network (*DEFINE). After deposit, the entire amount is transferred from UT Austin to The University of Texas/Texas A&M Investment Management Company (UTIMCO). In accordance with the Uniform Principal and Income Act, an equitable portion of the royalty payment must be retained as principal in the Jackson Endowment. Due to the complexity of calculating the required portion retained as principal, UTIMCO retains 25 percent in the endowment principal account and transfers 75 percent of the royalties received back to the Foundation. This 75 percent of the royalty income is used to fund the Jackson School's program initiatives and administration. The remaining 25 percent that is retained by UTIMCO is reinvested in the Jackson Endowment. UTIMCO performs this transfer quarterly.

The Foundation reconciles its royalties recorded in *DEFINE to the detail of royalty deposits recorded by UTIMCO, to the Foundation's check log, and to amounts recorded in the Foundation's database. In addition, the Foundation reconciles the quarterly transfers it receives from UTIMCO as recorded by UTIMCO to the quarterly transfers recorded in *DEFINE.

We compared the total royalty deposits and transfers as recorded in the royalties account in *DEFINE to amounts recorded by UTIMCO and found a total of $97,220.93 in royalty interest payments that were deposited in *DEFINE in April 2016 but not transferred to UTIMCO until after we notified management in February 2017.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

> **Recommendation:** To ensure compliance with the Uniform Principal and Income Act and to ensure that appropriate amounts are invested in the Jackson Endowment, the Foundation should enhance its reconciliation procedures to ensure all royalty interest payments are deposited in *DEFINE and subsequently transferred to UTIMCO. We also recommend that the Foundation review prior periods outside the audit scope to ensure that all royalty payments were appropriately deposited and transferred to UTIMCO.
>
> **Management's Response:** *The Foundation agrees with the recommendation. They have included additional steps in the reconciliation process (excel file) to examine whether funds are accurately deposited and transferred by Cash Management. They have added in Cognos 'Cash Out' data (new) which allows them to look at Cash Management's In/Out transactions. The Foundation will run a reconciliation including the prior fiscal year 2015-16 with their next reconciliation for the fiscal year 2016-17 to investigate potential omissions. In addition, Cash Management is now looking into having these transactions done automatically on their end.*
>
> **Implementation Date: December 31, 2017**

Check Handling Process

During FY 2016, the Foundation received approximately 200 checks from more than 20 different operators. On average, the Foundation receives approximately 20 checks per month, most of which are for oil and gas royalty interest payments. UTS166, *Cash Management and Cash Handling Policy* (UTS166), requires that all receipts totaling $500 or more be deposited within the next business day or deposited biweekly for departments that do not collect revenue each day. We tested a sample of 30 checks received, which ranged in value from $100 to $190,000. We noted that all checks selected for testing were deposited timely with UT Austin's Bursar Services in accordance with UTS166.

In FY 2016, the Foundation received approximately $1.9 million (just over $160,000 per month) in royalty payments from checks and wire transfers. Over 85 percent of the royalty amounts received were from a relatively small number of wire transfers from two royalty payers—Devon and Stephen & Johnson Operating Company. The remaining operators send royalty payments by check. According to UTS166, Section 6.2, "Electronic collections and disbursements should be instituted to minimize operational costs, reduce processing and clearing float, and increase earnings. Electronic mechanisms such as point of sale (POS) check conversion, internal check scanning, and remote deposit should be evaluated and utilized for streamlining deposits." Additionally, UTS166, Section 6.2.d. states, "All clients should be encouraged to utilize electronic transactions for payments." More wire transfers, when feasible, and fewer checks could reduce potential risks (e.g., checks can be lost, stolen, or misplaced) and the administrative burden associated with manual check processing by the Foundation's staff.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

> **Recommendation:** To reduce the risk and administrative burden associated with the manual processing of checks, the Foundation should encourage all operators to pay royalty interests with electronic transactions instead of checks.
>
> **Management's Response:** *The Foundation agrees with the recommendation and will request direct deposit to all operators offering this option for payment.*
>
> **Implementation Date: September 30, 2017**

<u>Disaster Recovery Plan</u>

The database is the key resource the Foundation uses to monitor and track lease activity. The Foundation is backing up the database by means of at least three methods—through CrashPlan, Austin Disk, and an external hard drive. The Foundation's efforts in backing up the mineral interest information and royalty payments are commendable; however, backing up to a portable external hard drive is redundant and introduces additional risks that could be avoided. These additional risks include the following: 1) the external hard drive has a higher risk of being taken or lost, and 2) the external hard drive is also located in the same physical location as the original data so any disaster impacting the original data would also impact the backup data.

The Foundation also has documented a disaster recovery plan (DRP) and a copy of the DRP is maintained on UT Ready, as required by UT-IRUSP Standard 6.2.4. This helps ensure that royalty payments can still be tracked and processed in the event the database is not available. However, the DRP has not been updated in several years. Having outdated information in the DRP could lead to important data and applications not being available in the event of natural disasters, system disk drive failures, or system operations errors.

The observation described above is considered a **low-level** finding in accordance with UT System's Internal Audit finding classification system.

> **Recommendation**: To reduce administrative burden and unnecessary risk, the Foundation should cease the practice of backing up its data to an external hard drive. The Foundation should also biennially review and, as necessary, update information in the DRP to accurately reflect current practices.
>
> **Management's Response:** *The Foundation agrees with the recommendation. They have eliminated the back-up to external hard drive and have updated the information in DRP.*
>
> **Implementation Date: December 31, 2017**