REVIEW OF THE

VIRGINIA GAS AND OIL BOARD

NOVEMBER 2010

Auditor of Public Accounts

COMMONWEALTH OF VIRGINIA

REPORT SUMMARY

We completed our review of the Virginia Gas and Oil Board's policies and procedures over the management of escrow funds arising from the pooling of coal-bed methane gas. We conducted this review to determine if the Virginia Gas and Oil Board follows best practices in the management of escrow accounts as compared to their current policies and procedures.

We recommend the Board do the following.

- Obtain Deposit and Revenue Details for Escrow Accounts to gather key information from all Gas Companies on a recurring basis so the Board can perform reasonableness tests of amounts received.

- Develop Data Standards for the electronic receipt of information from the Gas Companies and the transfer of information from the custodian's system. Having information provided electronically will eliminate staff time for data entry and increase their ability to analyze the information.

- Set Time Frames for Escrow Deposits that establish an allowable timeframe for a deposit into an escrow account after the sale of gas.

- Periodically Review the Escrow Accounts by testing the balances of escrow accounts and the management of the funds.

- Document Policies and Procedures for the management of escrow accounts and include these documents in the periodic review mentioned above.

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BACKGROUND INFORMATION

Establishing Escrow Accounts

Coal-bed methane gas is a form of natural gas extracted from coal beds. It has become an important source of energy in the United States over the past few decades. The Department of Mines, Minerals and Energy stated that coal-bed methane gas (CBM) was first produced in Virginia in late 1980. Throughout this report, we will refer to CBM and natural gas as gas. Through utilization of improving technologies, production of gas increased rapidly with a focus on coal seam de-gasing, mine safety, and development of new gas market opportunities. Today, coal-bed methane gas accounts for over 79 percent of the gas production.

The extraction of gas, coal or mineral resources in the Commonwealth requires an agreement to produce the resource between the resource owner and the company (in this case a Gas Company). Terms of exploration, extraction, transportation, production, marketing and restoration of the land are part of the language of a deed or lease. These agreements cover the ownership of the gas, the compensation, and any Gas Companies fees associated with extracting and marketing of the gas.

The extraction process begins by drilling a well from which Gas Companies allow natural flow. For coal-bed methane, water may accumulate from seams downhole, and the Gas Company removes the water to allow the gas to flow. Gathering pipelines connect to wells and join a network location where the Gas Company compresses, treats and transports the gas to major interstate pipelines.

The Board Pooling Order details the Force Pooling process. The force pooled gas owners can elect in the order to become a "working interest partner" in their gas unit. When a gas owner chooses not to be a working interest partner, the Board Order considers this a lease. A force pooled lease party receives a 1/8th (12.5 percent) royalty, net of downstream costs. When the Board receives a resolution of conflicting claims, the Board orders the disbursement of funds from the escrow account.

Gas Companies wanting to extract the gas encounter a number of issues. In some areas where the Gas Companies wanted to extract and market gas, the owner had already sold the rights to the coal underneath their land. Based on specific language of a severance deed, the ownership of coal-bed methane gas may be in conflict between the mineral owner, gas owner and the coal owner. Another issue arose from disputes among large family heirships where clear title was not evident for one or more tracts within a gas unit. Additional issues arose when Gas Companies wanted to negotiate lease agreements and extract gas from underground coal seams that was underneath land claimed by multiple parties. The General Assembly of Virginia decided to enact legislation that would help to resolve these issues by creating the Gas and Oil Board.

The Virginia Gas and Oil Board (Board) begins with Chapter 347 of the 1982 Act and amendments in 1990 put the Board in its current form. The Act gave authority to the Board to establish gas field rules to prevent waste and protect correlative rights, designate gas unit operators, approve forced pooling orders and escrowing, and approve disbursements from escrow.

The Board has seven members appointed by the Governor for six years. The Board has authority to establish an escrow account for gas or oil owners who are unknown or unlocatable.

The following circumstances will cause a pooling order.

1. When a gas tract within a unit has cloud on title.

2. When a gas tract within a unit involves a dispute of ownership regarding coal-bed methane arising from a coal severance deed claimed by the coal owner and the tract mineral / gas owner.

3. When a gas tract within a unit includes gas owners identified by deed or title that are unlocatable or unknown.

Once established, pooling orders authorize the drilling and operation of one or more wells. The gas owners receive an allocation of revenue or 1/8th royalties from the gas sales based on their acreage percentage ownership of the gas sold.

When the identity and location of the owner is unknown, the pooling order protects the potential owner by deeming the owner a party to the lease. The Board requires that the Gas Companies deposit the unknown owner's share of proceeds to an escrow account and holds the funds until the Board locates the gas owners, an heir of the family, or there is a legal determination of land ownership. Gas owners that contest the ownership of a tract of land can still enter into a cost and revenue sharing agreement with the gas well operators, but the well operator must deposit the funds into an escrow account until there is final legal determination of ownership of the land. When there is a person claiming a contested ownership interest, the gas well operator must deposit money from gas sold in an escrow account for that person. The operator must deposit into the escrow account the working interest share (profit or loss after capital recovery) or 1/8th royalty of proceeds attributable to the conflicting interests less allowed deductions for post-production costs.

According to Section 45.1-361.22 of the Code of Virginia, there are only three ways to resolve conflicting ownership and have the proceeds of the escrow account paid to the appropriate owners. The first way is a final decision of a court of competent jurisdiction adjudicating the ownership of gas. The second way involves arbitration. The third method is an agreement between all conflicting claimants owning the tract, to enter into a voluntary split agreement. Once the parties reach an agreement, the claimants file a petition with the Board within 30 days for disbursement of the funds held in escrow. The petition should include a detailed accounting of all funds held in escrow that are subject to disbursement. The disbursement of the escrow account uses the percentage of ownership interest described in the pooling orders, the operator's records of deposit attributable to those tracts, and the records of the escrow account for the gas drilling unit. The Board will order payment of the principal and accrued interest, less escrow account fees within 30 days of their decision to release the funds. Any funds not resolved through an agreement or judicial decision will remain in the escrow account.

External Review of Accounts

In early 2009, the Board issued a Request for Proposal (RFP) for audit services to examine the escrow account under the Board's supervision. The request for audit services was a response to concerns about escrow funds. The audit was requested because the Board and its Staff were concerned that 10 years had passed since an audit had been completed for the growing Escrow Account. After receiving an initial response to its request for audit services, the Board reissued the RFP in September 2009, again received responses, and in December 2009 entered into a contract with a Certified Public Accounting (CPA) firm to do the audit.

The original contract required the CPA firm to review 35 individual, randomly selected escrow accounts. For the selected accounts, the CPA firm would audit the flow of the funds from the Gas Companies to the escrow account and determine the accuracy of the balance of each account for the period from calendar year 2004 through the date of the review and any other financial and operational activities during that period.

In October 2010, the Board voted to extend the contract and audit period with the CPA firm to December 31, 2011, expand the audit to cover all unit accounts in the audit and approved the hiring of independent contractors to perform a reconciliation of all escrow accounts for the period beginning January 1 2000 through January 31, 2010. The Board is hiring independent contractors and expects to have them by December 1, 2011.

Change in Escrow Custodian

The Board's contract with its escrow custodian since 2001expired on December 31, 2009 and the Board decided to issue a RFP for these services. The Board issued a RFP in September 2009 and required the submission of proposals by the end of October 2009. The Board selected a new escrow custodian who has a contract for the period January 1, 2010 to December 31, 2014.

BEST PRACTICES REVIEW

On April 13, 2010, the Virginia General Assembly enacted legislation requiring an operational review of the Board's policies and procedures for the collection and disbursement of escrow account funds. This legislation requires the determination of best practices for the collection and disbursement of escrowed funds, a comparison of best practices to current Board practices, and requires the Auditor of Public Accounts to recommend any improvements in order to bring existing policies in line with identifiable best practices. Additionally, if the review identified any need for legislative changes, to recommend those statutory changes.

We did not duplicate the efforts of the CPA firm reviewing the escrow accounts. We did, however, consider the results of their work in developing our recommendations. Our review addresses how the Board should keep it records and manage the escrow accounts but does not review or comment on prior practices.

Through the course of our review, we compiled a listing of best practices from multiple sources to compare to those practices currently used by the Board and its staff. The following recommendations are the result of our review of the Board's adherence to best practices. Appendix A describes in detail the Best Practices used during this review along with the sources used to develop the best practices. Appendix B details the practices the Board currently uses and how they compare to the best practices identified during out review.

Obtain Deposit and Revenue Details for Escrow Accounts

The only information the Board receives with an escrow deposit is the escrow account, well head number, Virginia Gas and Oil Board (VGOB) unit/tract number, and amount. Currently, there is no requirement that the Gas Companies provide any additional information to assist in determining if the amount is correct.

The Board should consider having the Gas Companies provide the Board with the following information for escrow account deposits.

- Escrow account number
- Well head number
- Well head production volume
- VGOB unit/tract number and production by volume
- Deductions and fees assessed by the Gas Company
- Sales price by volume for the gas sold
- Other data that the Board, staff and Custodian believe is appropriate.

As discussed in the following recommendations, the Board should receive this information electronically and it should undergo periodic review.

MANAGEMENT RECOMMENDATION #1

The Board should develop a process to gather key information from all Gas Companies on a recurring basis. The Board should, at a minimum, include the elements mentioned above to enable reasonableness tests of amounts received. Several electronic methods exist, which should allow the Gas Companies to transmit this information and allow the Board to perform overall reasonableness tests.

Develop Data Standards

To accurately manage escrow account collections and disbursements, the Board needs to have certain select data and should receive this information electronically from the Gas Companies. Currently, the Board and the Escrow Custodian receive information manually from the Gas Companies and enter the data either into the Board's system or the Custodian's on-line banking system.

With over 800 escrow accounts, manually entering and verifying this information increases the risk of error. The Board needs to receive the electronic information from the Gas Companies as noted in the previous recommendation and some information from the Custodian for subsequent review as noted in the next recommendation.

MANAGEMENT RECOMMENDATION #2

The Board should develop data standards for the electronic receipt of information from the Gas Companies, and the transfer of information from the custodian's system. Having information provided electronically will eliminate staff time for data entry and increase their ability to analyze the information.

Data Standards set uniform guidelines for the electronic transmission of information and its content. Setting Data Standards also sets the minimum expectation for the nature and type of data needed by both the Board and Custodian, and provides an electronic means of testing the content and completeness of the data. Numerous organizations use data standards for reporting tax information to both the State and Federal governments, and all electronic banking depends on the use of data standards. Also, certain forms of electronic banking would allow the Gas Companies to transmit this data with their payments to include other information than just payee and amount.

Set Time Frames for Escrow Deposits

Currently, the Board does not have a policy that sets the timeframe from when a Gas Operator receives revenues to when a Gas Operator deposits those collections in the escrow account. Without a policy in place requiring the time frame for the deposit of funds after a sale, the Board can neither enforce nor measure the Gas Companies timely deposit of funds.

MANAGEMENT RECOMMENDATION #3

The Board should develop a policy that sets an allowable timeframe for a deposit into an escrow account after the sale of gas. As part of the following recommendation, the Board should periodically determine that Gas Companies are complying with this timeframe.

Periodic Review of Escrow Accounts

Proper management of escrow funds requires the periodic review of the collection and disbursement cycles, including account balances and other data collection processes to ensure that both the Custodian and the Board are following up on their responsibilities. The Board has found that depending on the scope of the review and materials reviewed, the cost of an audit may be prohibitive, since the audit bill would be an administrative fee to the escrow accounts.

However, several alternatives exist, which the Board should examine in addressing the need for a review of their activities. Alternatives, which we believe the Board should consider, include employing a CPA firm on a periodic basis to review the collection of information from the Gas Companies for certain accounts, reviewing internal policies and procedures to determine that they are working, and reviewing the Custodian's management of the accounts. A part-time internal auditor or the payment to another state agency for the use of their internal auditor are other alternatives.

Further, after implementing the recommendations in this report and those of the external auditors, we believe that a review, which includes all the processes, can occur over a two or three year period. However, adopting this approach would require that the review determine that there has been an implementation of the recommendations.

MANAGEMENT RECOMMENDATION #4

The Board should develop and implement policies and procedures for a periodic review of the escrow accounts. These reviews should test the balances of escrow accounts to ensure accuracy and completeness. Enacting policies and procedures for a periodic review should ensure that the Board has some level of assurance over the financial and data collection procedures for the escrow accounts.

Document Policies and Procedures

Policies and Procedures set out how any organization conducts its business and the duties and responsibilities of the staff and how they should conduct themselves. Documenting those policies and procedures helps ensure that everyone within an organization can gain an understanding of how to accomplish their tasks and how those tasks relate to the other work an organization performs.

The Board does have written policies in place for its operations and most of its procedures; however, there are some policies and procedures that require refinement and several will need to reflect changes from this report and that of the external auditor. Further, the Board should maintain all of their policies and procedures in one central location. The Board needs to review and address the following areas:

- Access and authorization to the escrow accounts
- Monthly disbursement tracking and reconciliations
- Escrow account payouts, closure, and tracking acreage for the allocation of the accounts

MANAGEMENT RECOMMENDATION #5

The Board should document all policies and procedures for continued operations. The specific areas noted above should receive attention first. Further, as part of the review process noted above, the external reviewer should, at least every other year, determine if the Board is properly maintaining these policies and procedures and that they reflect the current operating environment of the Board.

Commonwealth of Virginia

Walter J. Kucharski, Auditor

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

November 18, 2010

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission

We have reviewed the **Virginia Gas and Oil Board** (Board) policies and procedures for maintaining escrow accounts with industry best practices. We conducted our review 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 objectives.

This review compared a set of best practices for the management of collections and disbursements for escrowed accounts with those currently used by the Board. Recommendations indicate areas where enhancement to the Board's policies and procedures could improve the management of the accounts.

Audit Objectives

Our objectives for this review were as follows:

- To determine the current regulatory and statutory requirements governing the Board
- To determine the best practices for the administration and protection of escrowed funds
- To determine the Board's current practices for the administration and protection of escrowed funds
- To compare the Board's practices to the Best Practices
- To make recommendations based on the results of the comparison

Audit Scope and Methodology

Our review examined the current policies and procedures in place over the management of escrowed funds. Our review included a review of generally accepted best practices from multiple sources over the management of escrow accounts as well as a review of the escrow account custodial

sources over the management of escrow accounts as well as a review of the escrow account custodial services, the Board's enabling legislation from the Code of Virginia, the Virginia Administrative Code, and Board activities through meeting minutes. Our review determined whether the Board management of the escrow fund followed the best practices for the management of escrow accounts.

Our work consisted mostly of reviewing the policies and procedures used by the Board and gathering documentation to support both the best practices and the practices currently in use by the Board.

Conclusion

Overall, we found that the Board adequately manages the administration and protection of the escrow accounts, specifically in the collection of funds and the distribution of funds for the escrow accounts. However, we found areas in the Board's practices that did not adhere to best practices. We made recommendations to the Board based on these instances. We recommend the Board do the following.

- Obtain Deposit and Revenue Details for Escrow Accounts
- Develop Data Standards
- Set Time Frames for Escrow Deposits
- Review Escrow Accounts Periodically
- Document Policies and Procedures

Exit Conference and Report Distribution

We discussed this report with The Virginia Gas and Oil Board members and staff on November 18, 2010. The Virginia Gas and Oil Board members and staff response to the findings identified in our audit is included in the section titled "Agency Response."

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

DIVISIONS
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GAS AND OIL
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MINED LAND RECLAMATION
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MINES
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COMMONWEALTH OF VIRGINIA

Department of Mines, Minerals and Energy
P. O. Drawer 900
Big Stone Gap, Virginia 24219-0900
(276) 523-8100 FAX (276) 523-8148
www.dmme.virginia.gov

November 29, 2010

Mr. Walter J. Kucharski
Auditor of Public Accounts
P. O. Box 1295
Richmond, Virginia 23218

Re: Audit of Virginia Gas and Oil Board Processes

Dear Mr. Kucharski:

My office has received the final APA report relative to a review of the Virginia Gas and Oil Board's policies and procedures over the management of escrow funds. We find your report to be a thorough analysis and concur with its findings.

In recent months, the Board has taken a number of actions that will boaster resources needed to complete the on-going account audit. Additionally, the Department of Mines, Minerals and Energy is in the process of hiring an additional staff person to assist the Board. If funding allows, this temporary two year position will become permanent and boaster staff support for work related to the Board's escrow account monitoring.

The Board must consider the availability of additional resources when deciding what additional actions may be put in place to improve escrow practices that are discussed in the report. The APA report will be provided to board members at their December 14, 2010, monthly meeting. The Board's January 18, 2011, meeting will include a docketed item for further discussion and action regarding the APA recommendations and best practice standards.

The Board offers the following responses to the recommendations:

MANAGEMENT RESPONSES #1

The Board on its own motion will review available resources, time schedules and possible actions at its January 18, 2011 meeting to:

1. Require electronic (ACH) reporting of monthly escrow payments and details to the Escrow Agent.

EQUAL OPPORTUNITY EMPLOYER
TDD (800) 828-1120 --- Virginia Relay Center

2. Require a second copy of supporting monthly payment details to the Board in electronic format so to allow enhanced monitoring and reasonableness tests for random accounts by staff.

3. Receive, compile and store monthly data in a consistent electronic format so to better serve stakeholder/customer requests and improve account audit efficiency.

4. Discuss the adoption of best practices as indicated by the audit.

During regular monthly meetings in 2009 and 2010, the Board reviewed proposals and discussed reporting standards for working interest and royalty interest payments into escrow. The Board has addressed consistent formatting from gas producers and has requirements in place for payments to the escrow agent. Of those items listed, the Escrow Agent currently receives:

- The VGOB Order number with last four digits of the order matching the last four digits of the escrow account number.
- The producing well or wells operations ID number.
- A listing of production from individual wells within a gas unit for which payment is made.
- Sales production volume rather than well head production is included in financial statements. Producers are required to report wellhead production to the Division of Gas and Oil monthly for gas resource extraction reporting.
- The sales price, gross sales volume sold, gross sales value and net owner sales value applicable to their royalty and tract interest in the gas unit.
- A column and account summary of post production deductions.
- A column and account column for applicable tax deduction.

MANAGEMENT RESPONSES #2

The Board on its own motion will review possible actions at its January 18, 2011 meeting to:

1. Develop a written policy that addresses a time certain for the deposit of funds after the first arms-length sales transaction.

2. Develop a monitoring process between the gas producers, staff, and the Escrow Agent to ensure compliance of the written policy (Item #1).

3. Address staff resource and funding needs so to adequately compile, monitor, analyze and report information from gas producers and the Escrow Account to the Board.

4. Discuss the adoption of best practices as indicated by the audit.

MANAGEMENT RESPONSES #3

Completion of the historical payments audit and on-going supervision of the escrow account is a dual-track management function.

At its regular monthly meeting held October 19, 2010, the Gas and Oil Board took the following actions regarding the on-going review of historical accounts by Robinson, Farmer, Cox Associates:

1. Extend the audit engagement with Robinson, Farmer, Cox Associates through December 31, 2011.
2. Expand the Escrow Audit work to include all gas unit accounts approved for escrowing beginning January 1, 2000.

To accomplish the historical audit activity for the time period of January 2000 through January 2010, the Board approved the hiring of independent contractors. The hiring process has begun and is expected to be in place by January 2011. Robinson, Farmer, Cox Associates lead auditor will assist in the initial establishment of the individual account audit process. The process will include oversight from DMME's Internal Auditor and direct supervision by the Division of Gas and Oil Director. Funding for the expanded audit will be paid from the escrow accounts' cumulative interest income.

Additionally, on June 15, 2010, the Gas and Oil Board approved a procedure to require gas operators to reconcile and provide details of all gas units in the escrow account at least annually. Chairman Bradley C. Lambert wrote gas operators on June 23, 2010, detailing that the first report for the calendar 2009 year would be due to the Board on December 1, 2010, and subsequent calendar years would be due on or before July 1 for the preceding year.

The Board on its own motion will review funding sources and possible actions at its January 18, 2011, meeting to:

1. Ensure the independent contractor process is in place for the expanded audit of historical accounts.
2. Evaluate positions needed and funding options for additional Board staff to compile, analyze and report current and on-going activities of the escrow account.
3. Discuss the adoption of best practices as indicated by the audit.

MANAGEMENT RESPONSES #4

The Board on its own motion will review staff sources and possible actions at its January 18, 2011, meeting to:

1. Review policies and procedures in place for possible enhancements of escrow account monitoring, account reconciliation, and timely disbursements.
2. Review on-line security, electronic access and authorization levels to the escrow account provided by First Bank and Trust Company.
3. Discuss procedures for the annual escrow account reconciliation from all gas producers with payments reporting to escrow.
4. Review staffing requirements to accomplish the task of annual account reconciliation for more than 900 accounts that currently reside in escrow.
5. Discuss the adoption of best practices as indicated by the audit.

MANAGEMENT RESPONES #5

The Board on its own motion will review staff sources and possible actions at its January 18, 2011, meeting to:

1. Discuss available resources and a policy relative to escrow account monitoring, reconciliation and a timeliness of account audits.

2. Discuss the adoption of best practices as indicated by the audit.

Sincerely,

Bradley C. Lambert, Chairman
Virginia Gas & Oil Board

c: Virginia Gas & Oil Board Members
Stephen A. Walz
David E. Asbury, Jr.
Diane J. Davis
Sharon M.B. Pigeon

APPENDIX A

BEST PRACTICE ESCROW ACCOUNT COLLECTIONS AND DISBURSEMENTS

The Auditor of Public Accounts developed the following list of best practices from the sources below. This listing is a composite of all of these sources.

Develop Policies and Procedures for Managing Escrow Accounts

- Define roles of parties involved
- Ensure compliance with applicable laws and regulations

Establish Contractual Agreement with Custodian for Escrow Funds

- Define overall objective/board expectations
  - Timely access to all records and accounts
  - Timely updates of account investment status
- Ensure that the Custodian adequately safeguards and holds separately all assets.
- Ensure reasonableness of fees to be assessed/Establish Fee Structure
- Define Investment parameters/rate of return
- Establish Confidentiality Requirements

Approve Operating Fees Assessed by Gas Companies

- Obtain each Gas Operator's Fee Structure
  - Gain an adequate understanding of the fee structure, and determine how the Board assesses and approves them
- All changes in fee structure should have the Board's approval before changing (to include new fees)
- Resolve disputes over fees between Gas Companies and Gas owners

Properly Establish Escrow Accounts

- Define Purpose for establishing escrow accounts
  - Claimants shall have accounts to receive payments of costs and proceeds attributable to the conflicting interests and held for their interest.
  - Ensure escrow account is only established for instances of conflicting interest (as defined in purpose)
- Ensure reasonable efforts have been made to resolve any conflicting interest (i.e. public notifications)
- Ensure that Board approval is obtained over all escrow accounts
- Ensure, using ownership rights, the proper assignment of allocation percentages for the escrow accounts

Ensure Proper and Timely Deposits into Account

- Obtain production/expense/sale reports from Gas Companies (Board should ensure reliability)
  - Production to include: Well head production, quantity of impurities, and compression ratio
  - Expense to include: Allowable Cost, Cost Allocation, and Production Cost
  - Sales to include: Volume Sold and Revenue Generated
- Review Pooling Order related to Escrow Account
  - Determine acres in drilling unit and lease status
- Ensure reasonableness of expense deductions taken by the Gas Companies and agree to board-approved fees
- Ensure reasonableness of production (from the production report) to the Sales Report (Volume Sold)
- Ensure deposits are timely, using when revenue generation occurs
- Ensure accuracy of amounts and receipt of income into escrow accounts
- Ensure account transactions agree to source documents
- Ensure prompt investing of cash receipts

Perform Timely Reconciliations

- Gas Companies should reconcile the individual escrow accounts monthly and provide the reconciliation to the Board
- Ensure that custodian has prompt ledger control of assets to track receipt of deposits, including interest.
- Reconcile Bank balance to the Board's book balance monthly
  - Ensure custodial rates were charged in accordance with posted/filed rates
  - Ensure the custodian records all deposits and disbursements timely and to the proper accounts

Ensure Maintenance of Supporting Documentation:

- Retain records which reflect the following:
  - Designation of the account
  - Account numbers
  - Amounts of the principal and interest and escrow funds paid
  - Dates the Custodian received and deposited funds
- Each unit operator shall maintain records of production, income, payments made to lessors and escrow agents, any suspended payments, and other information prescribed by the Board

Ensure Escrow Accounts are Closed/Disbursed Timely

- Receive affidavit of all conflicting claimants affirming the final decision of a court of competent jurisdiction or court-appointed arbitrator or confirming agreement of all claimants owning conflicting estates in the tract in question or any undivided interest.

- Disburse payment of the proportionate share of principal and accrued interest from the escrow account, less escrow account fees to all legally entitled entities timely
- Review disposition of funds/payments made to gas owners and ensure that all disbursements are supported by appropriate source documents.
- Ensure proper closing of account by custodial agent

Perform Periodic Reviews of Accounts

- Conduct periodic compliance reviews and audits that include individual escrow accounts
- Conduct annual analysis to ensure reasonableness of account balances

SOURCES OF BEST PRACTICES

Note – Best Practices from these sources were compiled and then re-worded or modified to facilitate our review.

"FDIC: Trust Examination Manual." *FDIC: Federal Deposit Insurance Corporation.* May 2007. Web. May 2010.
http://www.fdic.gov/regulations/examinations/trustmanual/index.html

"Handbook on Client Trust Accounting for California Attorneys." *Ethics*. California State Bar, 2009. Web. 29 Oct. 2010.
http://ethics.calbar.ca.gov/

"Safeguarding Client's Assets Under Management Through Asset Verification and Reconciliation." http://www.sec.gov. SEC, Apr. 2009. Web. May 2010.
http://www.sec.gov/info/iaiccco/iaiccco-custody.pdf

"Trust Audit Guidelines." *www.osbckansas.org*. Office of the State Bank Commissioner of Kansas, Mar. 2004. Web. May 2010.
http://www.osbckansas.org/DOB/DOBGuidelines/trustaudit.pdf

"West Region Escrow Audit Checklist." *WestRegion.com*. LandAmerica/Fidelity National Financial, Sept. 2005. Web. May 2010.
http://westregion.com/escrow/EscrowAuditInformation.pdf

APPENDIX B

BEST PRACTICES COMPARISON RESULTS

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
1.00	**Develop Policies and Procedures for Managing Escrow Accounts**			
1.10	Define roles of parties involved.	The enabling legislation as well as the Virginia Administrative Code details the roles of the involved parties. The contractual agreement with First Bank and Trust for custodial services, and within the Original, Supplemental, and Disbursement Orders used for each docket item that comes before the Board.	**Yes**	
1.20	Ensure compliance with applicable laws and regulations.	Staff ensures compliance with all policies, procedures, and practices in place, by using the enabling legislation and the Virginia Administrative Code as a basis coupled by a review by the Attorney General's Office. All Orders use templates developed with the assistance of the Attorney General's Office.	**Yes**	
2.00	**Establish Contractual Agreement with Custodian for Escrow Funds**			
2.10	Define overall objectives/ Board expectations, including timely access to all records and accounts as well as timely updates of account investment status.	The Board created the Request for Proposal (RFP) stating the objectives and expectations the Escrow Custodian needed to meet to be an acceptable proposal. First Bank and Trust submitted a proposal that met those objectives and offered the lowest cost and provided an acceptable risk tolerance for the Board. On-line banking allows 24/7 access to the funds and the investments. The staff prepares a monthly update and the Escrow Custodian provides quarterly investments updates for the Board. The Escrow Custodian also provides more frequent information on investment options upon request from the Board. However, the Board does not have adequate documentation of these practices.	**Yes**	**#5**

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
2.20	Ensure that the Escrow Custodian adequately safeguards and holds separately all assets.	The contractual agreement with First Bank and Trust outlines the methods for safeguarding the funds in escrow. All funds have some level of security in their investment through either the FDIC or the use of federal government bonds as the investment vehicle. The Escrow Custodian accounts separately for all principal amounts and pools all interest earnings for allocation using acreage percentages of the escrowed units for the allocation.	**Yes**	
2.30	Ensure reasonableness of fees to be assessed/Establish fee structure.	The RFP uses costs as an evaluation criterion for all proposals. First Bank and Trust's proposal offered the lowest cost per year of all proposals. Basis points for the costs are part of the investment rate of return within the accepted proposal. The Escrow Custodian cannot assess any other fees outside of the basis points charged on a yearly basis.	**Yes**	
2.40	Define investment parameters/ rate of return.	In the RFP, the Board defined the acceptable investment vehicles as well as the safeguarding requirements. The Board allowed the proposers to generate rates of return based on the investment practices they would use to satisfy the safeguarding requirements and the acceptable investment vehicle requirements. The Board then selected the proposal that offered the lowest cost and that met their requirements.	**Yes**	
2.50	Establish confidentiality requirements	As part of the requirements and expectations set forth in the RFP, the Board set requirements for the confidentiality of the financial records for the escrow accounts. First Bank and Trust met these requirements in their proposal.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
3.00	**Approve Operating Fees Assessed by Gas Companies**			
3.10	Obtain Gas Company's fee structure and determine how the Board assesses and approves them.	Virginia Administrative Code, Chapter 160-100, establishes allowable Gas Company operating fees, which shows a listing of all allowable costs without assigning a specific dollar amount per type of cost. Original petitions and Orders for each gas pooling request include a breakdown of estimated drilling and completion costs. The Board must approve these estimated costs before a Gas Company may charge them.	**Yes**	
3.20	All changes in fee structure should have the Board's approval before changing (including new fees.)	If there are any changes to the fees, the Gas Company must present the changes to the Board and obtain approval before charging the new fee or the changed fee amount.	**Yes**	
3.30	Resolve disputes over fees between Gas Companies and Gas owners.	Disputes between landowners and Gas Companies, where funds are in an escrow fund and not paid directly to landowners, result in a presentation to the Board of the grievances and any supporting documentation for the claims. Any legal disputes must have a legal determination before presentation to the Board. The Board will then make a decision based on the supporting documentation as to what else the parties can do to resolve the dispute.	**Yes**	
4.00	**Properly Establish Escrow Accounts**			
4.10	Define the purpose for establishing escrow accounts.	The purpose of establishing the escrow accounts is in the Code of Virginia and the Virginia Administrative Code. The Board can set up escrow accounts in situations where there is a non-locatable or unknown landowner, a conflicting claim to ownership to mineral rights, or a dispute over the land ownership. The escrow accounts allow the Gas Companies to extract gas while continuing to identify the legal landowner.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
4.11	Claimants shall have accounts to receive proceeds attributable to the conflicting interests and held for their interest.	The process for establishing an escrow account begins with a pooling request from a Gas Company. In order to complete this request, the Gas Company must file a petition with the Board detailing in the request the parties involved and the financial aspects of the operation. Upon granting the petition and processing of the order, the staff directs the Escrow Custodian to establish an escrow account for that particular order. The Gas Companies must pay funds into escrow for working interest partners or royalty payments based on proportionate acreage share of the unit.	**Yes**	
4.12	Ensure escrow accounts are only established for instances of conflicting interest (as defined in purpose).	The Board must hear and approve the reason to create an escrow account in detail before the approval of a pooling petition and subsequent establishment of the escrow account. The Board only creates escrow accounts in the event that there is a non-locatable or unknown landowner, where there is an unresolved, conflicting claim to ownership of the mineral rights, or there is an unresolved, conflicting claim to land ownership.	**Yes**	
4.20	Ensure reasonable efforts occur to resolve any conflicting interest (i.e. public notifications).	The burden of ensuring the need for an escrow account falls on the Gas Company requesting a pooling petition. The Gas Company must present details of their due-diligence in determining the legal landowner/s and the issues in doing such that resulted in the request for a pooling petition, and after Board approval, the Board issues a pooling order.	**Yes**	
4.30	Ensure the Board has approved all escrow accounts.	The creation of an escrow account ties directly to the Board's approval of the petition and recordation of the pooling orders. The Escrow Custodian cannot create an account or receive funds from Gas Companies for deposit into an escrow account without receiving direction from the Board’s Staff to establish the account.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
4.40	Ensure, using ownership rights, the proper assignment of allocation percentages for the escrow accounts.	Ownership percentages of the escrow accounts use the total acreage of the escrowed units. The landowner's percentage of the acreage under escrow correlates to the percentage of the funds paid to a respective landowner from the escrow account. The Board's staff as well as the Escrow Custodian and the Gas Companies use the acreage proportionate share of a gas unit as basis for payment. The Board must approve any escrow payouts.	**Yes**	
5.00	**Ensure Proper and Timely Deposits into Escrow Accounts**			
5.10	Obtain production/expense/ sales reports from Gas Companies (Board should ensure reliability.)	The Board currently can receive the well head production volume upon request from the Escrow Custodian for each deposit into escrow. The Board does not receive any information from the Gas Companies related to sales of gas or when revenues generated from gas occur and does not receive any detailed breakdown of fees and revenues with the deposits.	**No**	**#1 & #2**
5.11	Production to include: well head production, quantity of impurities, and compression ratio.	The Board can receive well head production upon request from the Escrow Custodian but does not receive compression ratio or the quantity of impurities for the produced gas.	**No**	**#1 & #2**
5.12	Expenses to include: allowable costs, cost allocation, and production costs.	The Board does not receive a breakdown of costs applied to deposits made into escrow accounts.	**No**	**#1 & #2**
5.13	Sales to include: volume sold and revenue generated.	The Board does not receive any form of sales reporting or revenue reporting from the Gas Companies for the deposits made into escrow accounts.	**No**	**#1 & #2**
5.20	Review pooling order related to escrow accounts (determine acres in drilling unit and lease status).	The Board’s staff reviews pooling orders before recordation. The Board's staff prepares an acreage history for all funds escrowed by gas unit and ensures proper accounting for all unit acreage.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
5.30	Ensure reasonableness of expense deductions taken by the Gas Companies and agree to Board approved fees.	Allowable Gas Company operating fees are part of the Virginia Administrative Code. The Gas Companies do not submit the actual detailed charges for working interest partners with the deposits.	**No**	**#1 & #2**
5.40	Ensure reasonableness of production (from production report) to the sales report (volume sold).	The Board receives well head production but does not receive sales figures from the Gas Companies.	**No**	**#1 & #2**
5.50	Ensure deposits are timely, using when revenue generation occurs.	The Board does not have a policy in place to enforce timely deposits by the Gas Companies.	**No**	**#3**
5.60	Ensure accuracy of amounts and receipt of income into escrow accounts.	The Board does not receive sufficient detailed information with escrow deposits to ensure the accuracy and reasonableness of the deposits made into escrow accounts.	**No**	**#1**
5.70	Ensure account transactions agree to source documents.	All escrow account transactions require an approved Board Order. Without an approved Order, the Board and its staff can take no action. After majority vote, only the Board has the authority to move funds to different investment vehicles or make changes to escrow accounts.	**Yes**	
5.80	Ensure prompt investing of cash receipts.	The Board outlined the requirements for investing funds in the RFP. First Bank and Trust submitted a proposal that met these requirements and received Board approval. The custodial agreement ensures timely investment of deposited funds. The Escrow Custodian provides quarterly reports with testimony before the Board for investment monitoring.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
6.00	**Perform Timely Reconciliations**			
6.10	Gas Companies should reconcile the individual escrow accounts monthly and provide the reconciliation to the Board.	The Board does not receive monthly reconciliations from the Gas Companies. They will be receiving the first yearly reconciliations from the Gas Companies on Dec. 1, 2010 and then on July 1 every following year.	**No**	**#1**
6.20	Ensure that the Escrow Custodian has prompt ledger control of assets to track receipt of deposits, including interest.	First Bank and Trust maintains records of all deposits, interest, investment changes, and disbursements for all escrow funds. First Bank and Trust has prompt ledger control over all escrowed funds. There is also an Internal Audit function at First Bank and Trust to perform reviews over the escrow accounts and there is a contractually required reconciliation of all escrow accounts every quarter that the Escrow Custodian must present to the Board.	**Yes**	
6.30	Reconcile bank balance to the Board's book balance monthly.	The Board's staff performs a monthly reconciliation of disbursements with the Escrow Custodian's balances for the escrow accounts. The Board's staff obtains the total deposits from the Escrow Custodian of all deposits by account and then performs a reconciliation starting with the ending balance from the prior month to arrive at the current month's ending balances. However, the Board does not have adequate documentation of this practice.	**Yes**	**#5**
6.31	Ensure custodial rates are charged in accordance with posted/filed rates.	Custodial rates come from the pooled interest earned from the escrow investments. The Escrow Custodian reduces pooled interest by the fees and then allocates the remaining amount using total escrowed acreage and the corresponding acreage percentages of the escrowed units for each escrow account.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
6.32	Ensure the Escrow Custodian records all deposits and disbursements timely and to the proper accounts.	The Escrow Custodian tracks all deposits and monthly the Board's staff reconciles all disbursements. This provides assurance of the timely recording of disbursements in the escrow accounts. However, the Board does not have adequate documentation of this practice.	**Yes**	**#5**
7.00	**Ensure Maintenance of Supporting Documentation**			
7.10	Retain records which reflect the following: name of the accounts, account numbers, amounts of the principal and interest and escrow funds paid, and dates the Escrow Custodian received and deposited funds.	The Board maintains all supporting documentation according to the Code of Virginia. The Board maintains all financial transaction documentation, Board minutes, Board Orders, contractual agreements, and any other formal communications about an escrow account for a minimum of 24 months after the final disbursement of monies from the escrowed funds. Any escrow accounts with funds remaining have documentation maintained until final disbursement and account closure as directed by the Board.	**Yes**	
7.20	Each unit operator shall maintain records of production, income, payments made to lessors and escrow agents, any suspended payments, and other information prescribed by the Board.	Gas Companies must maintain documentation on the formation of a pooling agreement and the subsequent depositing of funds for five years after the disbursement of the funds into escrow and the discontinuation of deposits into the corresponding escrow account.	**Yes**	
8.00	**Ensure Escrow Accounts are Closed/Disbursed Timely**			
8.10	Receive affidavit of all conflicting claimants affirming the final decision of a court of competent jurisdiction or court-appointed arbitrator or con-firming agreement of all claimants owning conflicting estates in the tract in question or any undivided interest.	The Board must receive and review a legally binding determination of ownership from Court Order, an agreement between the parties (split agreement), or an arbitrated ruling before approving a Disbursement Order. The Board will only approve disbursements when these claims are resolved using one of the three aforementioned processes.	**Yes**	

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
8.20	Disburse payment of the proportionate share of principal and accrued interest from the escrow account, less escrow account fees, to all legally entitled entities timely.	Before approving a Disbursement Order, it must contain a detailed breakdown of the acreage covered by the escrow account. The Gas Company, within their petition, will provide a reconciliation of deposits and compute the percentage of acreage covered by the escrow account, which it presents to the Board for consideration. Once approved, the acreage percentage applies to all escrow transaction amounts. However, the Board does not have adequate documentation of this practice.	**Yes**	**#5**
8.30	Review disposition of funds/ payments to gas owners and ensure that all disbursements are supported by appropriate source documents.	The Board's staff reviews the approved petition for disbursement and prepares a disbursement order. Staff ensures the acreage in escrow is correct as approved by the Board from the original petition and subsequent disbursement orders before recordation. This review ensures that all disbursements have adequate supporting source documents and agree with prior testimony and Board actions. However, the Board does not have adequate documentation of this practice.	**Yes**	**#5**
8.40	Ensure the proper closing of account by the Escrow Custodian.	The Escrow Custodian closes escrow accounts only upon direction of the Board. The Escrow Custodian reviews the order alongside of the escrow account. In the event that the disbursement order will disburse all remaining funds in the escrow account, the disbursement order will have documentation directing the Escrow Custodian the authority to close the escrow account. The Escrow Custodian maintains the documentation of the escrow account closure along with the rest of the documentation of deposits and disbursements from the escrow account. However, the Board does not have adequate documentation of this practice.	**Yes**	**#5**

#	Best Practice	Virginia Gas and Oil Board Practice	Satisfies Best Practice	Recommendation
9.00	**Perform Periodic Reviews of Accounts**			
9.10	Conduct periodic compliance reviews and audits that include individual escrow accounts.	The Board has no policies or procedures for conducting a periodic review of the escrow accounts for accuracy and compliance with regulations and practices.	**No**	**#4**
9.20	Conduct annual analysis to ensure reasonableness of account balances.	The Board has no policies or procedures for ensuring account balance reasonableness for the escrow accounts.	**No**	**#4**