

memorandum

DATE: March 23, 2006

Audit Report Number: OAS-L-06-09

REPLY TO

ATTN OF: IG-32 (A06OR040)

SUBJECT: Audit of "The Department of Energy's Management of the Northeast Home Heating Oil Reserve"

TO: Deputy Assistant Secretary for Petroleum Reserves

INTRODUCTION AND OBJECTIVE

The Energy Act of 2000 authorized the Secretary of Energy to create a Northeast Home Heating Oil Reserve (Reserve). The Reserve was established as an "emergency buffer" to supplement commercial supplies should a severe supply disruption occur in the heavily heating oil-dependent northeast United States. The Reserve consists of 2 million barrels of emergency home heating oil, enough to provide Northeast consumers adequate supplies for approximately 10 days or the approximate time required for ships to carry heating oil from the Gulf of Mexico to the New York Harbor.

The Department of Energy (Department) entered into contracts with Amerada Hess Corporation (Amerada Hess), Morgan Stanley Capital Group Inc. (Morgan Stanley), and Motiva Enterprises LLC (Motiva) to store the 2 million barrel Reserve at private facilities. The contracts extend from October 2002 through September 2007 and are valued at \$14.5 million. In recognition of the need to continuously monitor Reserve inventories, the Department entered into an agreement with the Defense Energy Support Center (DESC) to provide assurance services for the Reserve. Under the agreement, DESC ensures that the heating oil inventory meets both the established quantity and quality standards by requiring quality representatives to complete monthly reviews on Reserve inventory.

The objective of our review was to determine whether the Department's contractors are accurately reporting the Reserve inventories.

CONCLUSIONS AND OBSERVATIONS

The Department's contractors are accurately reporting Reserve inventories and the Department implemented an effective system of internal controls to ensure that adequate inventory quantities and quality are maintained at each location. In addition, the Department maintained a culture that promptly remedied past audit findings and had taken swift action to increase accountability in reporting. As a result, we concluded that the current control environment provides reasonable

assurance that the Reserve contains the amount and quality of heating oil mandated by the Energy Act of 2000.

The Department's internal control structure for the Reserve included adequate independent monthly and annual reviews. In January 2006, we accompanied the DESC quality representatives as they manually gauged the tanks and calculated inventory levels. We found the DESC review process and subsequent certification report to be a valuable control for the Department. In addition, Serna and Company, P.C. (Serna) performs an independent compliance review annually for the Department. Serna's procedures include: interviewing terminal managers to determine their procedures for receiving, storing and circulating the Department's inventory; observing the physical measurement of inventory; recalculating inventory volumes; and examining oil analysis for compliance with quality commitments. The Office of Inspector General concluded that this work was adequate.

Finally, the Department took timely action to make improvements to the internal control structure. During the planning phase of the audit, we identified minor discrepancies in the methodologies used by contractors for preparing monthly inventory certification forms. Prior to initiating the audit, we discussed our concerns with Department management and suggested improvements to increase contractor accountability. The Department promptly revised the inventory certification form to address our concerns, thereby increasing accountability.

SCOPE AND METHODOLOGY

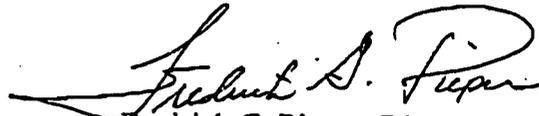
The audit was performed from November 2005 through March 2006, at the Morgan Stanley trading floor in Purchase, New York; the Amerada Hess terminal in Woodbridge, New Jersey; the Magellan terminal in New Haven, Connecticut; the Motiva terminal in Providence, Rhode Island; and the Motiva terminal in New Haven, Connecticut. The audit scope included activities related to the management of the Reserve since 2000.

We evaluated internal controls through assessments of independent reviews, discussions with Department and contractor personnel, use of an internal control questionnaire, and tours of Reserve sites. The questionnaire was designed to provide an overview of the control environment at each contractor facility. For example, the questionnaire examined the physical safeguards at the facilities, procedural requirements, inventory turn over, and inventory control. A thorough analysis of the completed questionnaires was followed by a tour of each Reserve contractor's facility.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objective. Accordingly, we evaluated the Department's implementation of the *Government Performance and Results Act of 1993* and determined that performance measures related to the Reserve had been established. The *Department of Energy Annual Performance Plan for FY 2004* contained performance measures requiring the Department to maintain a 2 million barrel

Reserve with the ability to drawdown within 12 days of a Presidential decision. The Department's FY 2005 performance report noted that the program goal of establishing a 2 million barrel Reserve in the Northeast had been met. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. Also, since we did not rely upon computer generated data to accomplish our audit objective, therefore we did not conduct an assessment of the reliability of computer processed data.

The Deputy Assistant Secretary for Petroleum Reserves waived the exit conference. Because no formal recommendations are being made in this letter report, a formal response is not required.



Fredrick G. Pieper, Director
Energy, Science and Environmental
Audits Division
Office of Inspector General

cc: Chief of Staff
Team Leader, Audit Liaison Team, CF-1.2
Audit Liaison, FE-3