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**REVIEW OF
GRU FUEL/COAL CONTRACTS**

JANUARY 2009



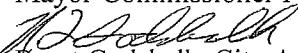
**CITY AUDITOR'S OFFICE
CITY OF GAINESVILLE, FLORIDA**

City of
Gainesville

Inter-Office Communication

January 5, 2009

TO: Audit, Finance and Legislative Committee
Mayor Pegeen Hanrahan, Chair
Mayor-Commissioner Pro Tem Jack Donovan, Member

FROM: 
Brent Godshalk, City Auditor

SUBJECT: Review of GRU Fuel/Coal Contracts

Recommendation

The Audit, Finance and Legislative Committee recommend the City Commission:

- 1) Accept the City Auditor's report and response from the General Manager for Utilities, and
- 2) Instruct the City Auditor to conduct a follow-up review on recommendations made and report the results to the Audit, Finance and Legislative Committee.

Explanation

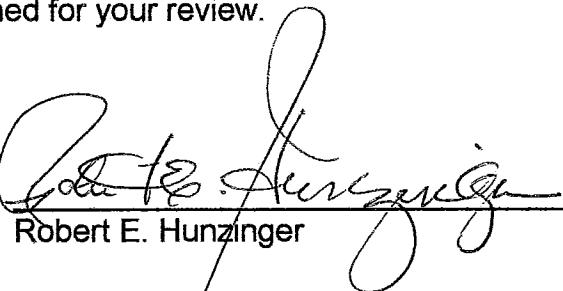
In accordance with our Annual Audit Plan, we have completed a Review of GRU Fuel/Coal Contracts. Our report, which includes a response from the General Manager for Utilities, is attached for your review.

We request that the Committee recommend the City Commission accept our report and the General Manager's response. Also, in accordance with City Commission Resolution 970187, Section 10, Responsibilities for Follow-up on Audits, we request that the Committee recommend the City Commission instruct the City Auditor to conduct a follow-up review on recommendations made and report the results to the Audit, Finance and Legislative Committee.

DATE: December 16, 2008
TO: Brent Godshalk, City Auditor
FROM: Robert E. Hunzinger, General Manager
SUBJECT: Review of GRU Fuel/Coal Contracts – GRU Response

This memo is in response to the recently completed GRU Fuel/Coal Contracts audit. GRU is appreciative of the approach used by the City Auditor's Office (CAO) wherein the audit staff took the time to learn the basics of the industry, identify relevant industry performance data, review extensive documentation of policies and procedures and test results relative to the procedures. The auditor took the time to interview Staff and understand how operations were actually being conducted. This is an indication the Audit was conducted with a high level of thoroughness and professionalism. It appears from my review both the audit and the final report are fair and balanced. All issues/findings will be addressed and resolved. I am confident our Energy Supply Fuels Management (FM) staff members are dedicated to performing the fuel procurement function at a high level of proficiency to maximize fuel expense savings for GRU customers. We appreciate any recommendations that might help us to execute at an even higher level.

A detailed response to the Audit Report is attached for your review.



Robert E. Hunzinger

Attachment

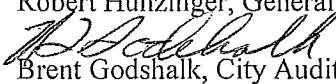
REH:jjh

cc: John Stanton
Karen Alford
Thomas Foxx

City of
Gainesville

Inter-Office Communication

October 30, 2008

TO: Robert Hunzinger, General Manager for Utilities

FROM: Brent Godshalk, City Auditor
SUBJECT: Review of GRU Fuel/Coal Contracts

In accordance with our Annual Audit Plan, we have completed a Review of GRU Fuel/Coal Contracts. During our review, we interviewed key personnel, analyzed financial and operating information, and tested management controls. The primary objective of this audit was to evaluate the adequacy of management controls over Energy Supply fuel expenditures and to test vendor billings for compliance with contract provisions, rules and regulations.

Based on our review, we believe that GRU Fuels Management has strong internal controls in place and uses sound approaches to coal purchasing and contract administration. They also have well-developed and documented Fuel Procurement Policies and Procedures, which help to ensure that a consistent approach is used by staff regarding:

- procurement of coal supplies and selection of suppliers
- scheduling of train loadings and deliveries
- volumetric accounting and quality control of coal delivered
- invoice processing, coal supply and transportation contract administration controls
- tracking coal inventories and costs

The attached draft report provides two recommendations we believe will assist management in continuing to control fuel expenses. Our recommendations have been reviewed with John Stanton, Assistant General Manager - Energy Supply and Karen Alford, Administrative & Fuels Operations Director. We would like to acknowledge their professional courtesy and cooperation during our review and we look forward to continuing to work together with them to finalize this report and management's response.

In accordance with Commission Resolution 970187, Section 9, please submit your written response to the recommendations presented in the attached report and indicate an actual or expected date of implementation for each recommendation. Our final report, which will include your written response, will then become public record and be submitted to the City Commission's Audit, Finance and Legislative Committee for review and approval. The next meeting is scheduled for November 24, 2008. If your response can be completed prior to that date, we will place this item on that agenda. Otherwise, the report will go on the January 5, 2008 meeting.

As always, please feel free to contact me or my staff to discuss any questions or concerns regarding this draft report.

cc: John Stanton, Assistant General Manager - Energy Supply
Karen Alford, Administrative & Fuels Operations Director

OBJECTIVES, SCOPE AND METHODOLOGY

In accordance with our Annual Audit Plan, the City Auditor's Office completed a Review of GRU Fuel/Coal Contracts. The primary focus of this review was to evaluate the adequacy of management controls over Energy Supply fuel expenditures and to test vendor billings for compliance with contract provisions, rules and regulations. Management controls include the processes for planning, organizing, directing and controlling program operations, including systems for measuring, reporting and monitoring program performance. Management is responsible for establishing and maintaining effective controls that, in general, include the plan of organization, methods and procedures adopted to ensure goals are met. Specific audit objectives included evaluating the policies, procedures and internal controls related to the fuels contract process.

Our review was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and accordingly included such tests of records and other auditing procedures as we considered necessary under the circumstances. Our procedures included reviewing contracts, laboratory test results, vendor and shipping invoices, interviewing staff, reviewing professional literature and interviewing other utilities for common practices. The scope of our review was generally for coal purchased by GRU during 2007.

Based on the results of our review, we found no significant weakness in management controls in effect over the GRU fuel/coal contracts process. We believe the Fuels Management Division has strong management controls in place to ensure that coal contracts are properly administered. We have prepared two recommendations for improvement that were discussed with management. These recommendations, as well as management's written response, can be found in the following sections of this report.

BACKGROUND INFORMATION

GRU currently uses three primary fuel sources for energy. Coal typically comprises approximately 75 percent of the total fuel purchases volume, with natural gas accounting for approximately 20 to 25 percent and fuel oil ranging from one to five percent. GRU coal purchases totaled approximately \$44 million annually in 2006 and 2007, including transportation. Based on the significance of coal purchases made, we focused our testing on procurement and contract administration of coal purchases.

Coal Procurement

GRU has a coal procurement strategy that is based on meeting forecasted coal requirements through long-term and short-term fuel supply agreements with coal suppliers. This strategy helps GRU to reduce risk, decrease price volatility and insulate customers from short-term price swings, while at the same time ensuring necessary supplies of quality coal. GRU implements this strategy through a combination of long-term and short-term contracts, as well as through spot market purchases.

GRU's Fuels Management Division is responsible for purchasing fuel, scheduling delivery, processing invoices and tracking fuel inventories and costs. Fuels Management works with a list of coal suppliers and broker information when determining a supplier for long and short-term contracts. Several factors are considered including tonnage offered, guaranteed Btu/lb minimums and the origin of the freight transport, as freight costs are included in GRU's analysis when selecting coal suppliers.

GRU owns and maintains approximately 100 rail cars and, through a long-term contract with CSX Corporation, utilizes CSX rails to continuously replenish the coal supply.

Approximately 600,000 tons of coal is used annually. GRU purchases coal through several supplier contracts. This includes a combination of three-year and one-year contracts. The long-term contract typically provides 70 percent of the coal supply, while the one-year contract accounts for approximately 25 percent of the supply. The remaining coal purchases are made through spot or one-time purchases. Spot market purchases allow GRU to secure coal at market prices that are based on current market conditions. These purchases are made when coal prices are advantageous over the long or short-term contracts or for testing the reliability of future suppliers.

Each contract GRU enters into requires the supplier to meet minimum quality components such as heat content or Btu/lb, ash content, sulfur dioxide and grindability.

Sampling

GRU coal contracts require an independent laboratory paid by the supplier to pull samples for testing from each shipment to be sent to Deerhaven. Coal is quality tested for sulfur content, moisture, ash, heat content (Btu) and coal size. GRU is notified of the test results within 48 hours of the shipment loading. Laboratory results of the coal must meet minimum contract specifications. If test results indicate quality is below minimum standards, GRU can either accept it at a renegotiated price or refuse the shipment. There have been a few incidences in the past year in which the initial laboratory results caused GRU and the supplier to have results re-tested and “refereed” based on quality standards. Based on the refereed sample, a price adjustment was made.

Each contract awarded includes a minimum Btu/lb. When laboratory tested Btu/lb falls below or exceeds the minimum, a price adjustment is made to reflect coal quality. Generally, greater Btu/lb coal produces a higher heat content which reduces the amount of coal needed to burn. Although GRU pays the incremental difference between the minimum Btu and the greater Btu shipped, the higher Btu content generally requires less coal to be burned, thereby reducing the total amount of coal needed. The current contract allows for coal tested within 100 Btu/lb less than the minimum requirement, with an appropriate price adjustment to reflect the lower quality. However, if the lab sample reveals that the coal is below that level, GRU will reject shipment prior to the coal arriving at Deerhaven. Our review of the samples and calculation for price adjustments based on Btu found that there were no material deviations from this practice.

Certified Scales

All coal contracts and shipments are billed at a per-ton rate. GRU relies upon the certified scales of the suppliers. Prior to payment, GRU compares the weights and volumetrics on the waybill created by the coal supplier and agrees it to the CSX invoice. CSX also charges based on a per-ton rate from origin.

Relying upon suppliers’ scales is common practice within the utilities industry. However, it is also an area in which a client is dependent on suppliers to provide accurate data. Although GRU does have controls in place to ensure accurate weights, we noted one instance of a key control not being consistently followed. This is discussed further in Issue #2 of this report.

Inventory

GRU’s stated inventory policy is to maintain a 60 to 75 day supply of coal on-hand. We researched industry averages and found that the average inventory varies from 45 to 75 days, with many utilities using a 45 to 60 day range. However, several factors determine an optimum inventory supply, including dependency of coal as the primary energy supply, transit conditions and weather patterns. We believe that GRU’s approach of maintaining a 60 to 75 day inventory is reasonable given extreme local and regional weather conditions that can affect both transit and energy supply.