

Memorandum

TO: Chairman's Executive Committee

FROM: Richard McCabe, Head, Utility Audit and Compliance Group

DATE: March 23, 2005

RE: REGULATORY AUDIT REPORT – ALTALINK LIMITED PARTNERSHIP

Attached is the audit report arising from the regulatory audit of AltaLink Limited Partnership (AltaLink) that we completed recently. Also attached is management's response to the audit report.

As noted in the report, we determined that AltaLink had effective processes for controlling inter-affiliate transactions, capital projects and related capital expenditures. In addition, transactions in these processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements. There were two significant observations arising from the audit, regarding the dispute resolution process and the calculation of AFUDC. These observations, together with management's responses, are outlined in Appendices 1 and 2 to the report.

In addition, there is a comment in the report regarding the contract for the exclusive provision of EPCM services by an affiliate to AltaLink. During the audit, it appeared that the Board had not been specific enough in its direction to AltaLink. However, this appears to have been corrected with the release of the Board's most recent Decision regarding AltaLink.

As noted in the final paragraph, we received the full cooperation of AltaLink management and staff throughout the audit process.

If you have any comments about the attached, please give me a call at 7-2316.

Richard M. A. McCabe

Restricted Distribution:
Bob Heggie, Utilities Branch
Jim Leonidas, Executive Vice President & Chief Financial Officer, AltaLink
Management Ltd.



March 15, 2005

Richard M.A. McCabe, CA, MBA
Head, Audit and Compliance Group
Alberta Energy and Utilities Board
640 - 5 Avenue SW
Calgary, AB T2P 3G4

Dear Mr. McCabe:

Re: Regulatory Audit of Inter-Affiliate Transactions and the Capital Project and Cost Management Processes

Thank you for providing AltaLink Management Ltd. the opportunity to comment on the draft regulatory audit report. It is our understanding that this response will be attached to the final version of the report, and that the report will contain both the comments of the Audit Group and the comments of AltaLink Management Ltd.

The management of AltaLink has reviewed the final draft regulatory audit report and we believe the report is complete and accurately reflects the findings that were communicated to the company during the audit and at the closing meeting. AltaLink believes that the findings in the audit further confirm our commitment to strong operational and financial controls within our inter-affiliate transactions, capital projects and cost management processes. Our commitment to controls represents a key component of our business strategy and culture. Compliance with regulatory decisions and ensuring accurate reporting of all financial transactions remain essential parts of our business.

I would like to thank the Board for accommodating AltaLink's internal commitments during our year end. I would also like to commend the members of the audit team for their professionalism and hard work throughout the audit process.

If you have any questions, please feel free to contact me directly.

Sincerely,

A handwritten signature in black ink, appearing to be 'Scott Thon', written over a circular scribble.

Scott Thon
President & Chief Executive Officer
AltaLink Management Ltd.



AltaLink Limited Partnership

Regulatory Audit of Inter-Affiliate Transactions and
the Capital Project and Cost Management Processes
for the 12-Month Period Ended December 31, 2004

March 2005

Audit Team:

Richard McCabe
Darcy Mazurkewich
Balvir Dhillon

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2005-002: AltaLink Limited Partnership
Regulatory Audit of Inter-Affiliate Transactions and the Capital Project and
Cost Management Processes

March 2005

Published by

Alberta Energy and Utilities Board
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Calgary, Alberta
T2P 3G4

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Web site: www.eub.gov.ab.ca

Objectives and Scope

The overall objective of the assignment was to conduct a regulatory audit of the financial and operational controls over three key activities of AltaLink Limited Partnership (AltaLink). The key activities that were the subject of this audit were the Inter-Affiliate Transactions process, the Capital Project Management process and the Capital Cost Management process.

The audit included a review of the linkage between the operations of these activities, and the related financial information and the regulatory process. The audit covered sample transactions and reviews of the key components of each process for the 12-month period ended December 31, 2004, resulting in the expression of an opinion on the effectiveness of the controls and procedures with respect to these key activities as well as an indication of whether the activities conform with regulatory requirements.

This audit is the first of a series of annual audits that will be carried out at AltaLink as part of a three-year regulatory audit plan. The plan has been developed to audit key activities of utilities that are regulated by the Alberta Energy and Utilities Board (Board) that have been determined to be of interest to stakeholders in the regulatory process. The key objective of the audits is to instill greater confidence in the regulatory process on the part of all stakeholders through the conduct of an independent, professional review of these activities. At the end of the three year period, a new plan will be developed to address the next three-year cycle.

The activities examined during this audit were selected following a review of financial information provided to the Board by AltaLink, as well as a review of Decisions arising from applications made to the Board by AltaLink during the two-year period ended December 31, 2004. These applications dealt with the purchase by AltaLink of TransAlta's electricity transmission assets, regulated rate tariffs, and Code of Conduct issues.

The Audit and Compliance group of the Board's Utilities Branch carried out the assignment between February 14 and 25, 2005, when the closing meeting was held with management.

Overview

AltaLink, which was formed as a limited partnership in 2001, is in the business of owning and operating regulated electricity transmission facilities in the Province of Alberta. AltaLink owns and operates approximately 12,000 km of high-voltage transmission lines and approximately 260 substations, comprising approximately 53% of the transmission lines used in Alberta's high-voltage electricity transmission system, and is the principal transmission services provider to most major urban centres in Alberta. AltaLink also owns and operates the interconnection facilities which connect its network with the transmission system in British Columbia, and allow electricity to flow into and out of Alberta.

The corporate structure for the operation and ownership of the transmission facilities is based on the creation of two limited partnerships. The first limited partnership, AltaLink Limited Partnership, was created and registered in Alberta for the purpose of acquiring ownership and operation of regulated transmission lines and related facilities within Alberta. AltaLink Management Ltd. is an Alberta company and acts as the general partner of the AltaLink limited partnership. The sole limited partner of AltaLink is another Alberta limited partnership, AltaLink Investments Limited Partnership (AILP).

The ultimate parent entities that own AltaLink are an international engineering and construction company (SNC-Lavalin Inc. - 50%), a Canadian pension fund (Ontario Teachers Pension Plan Board - 25%), a Canadian subsidiary of an Australian investment bank (Macquarie North America Ltd. - 15%) and a US based transmission asset company (Trans-Elect Inc. - 10%).

Until April 30, 2004, AltaLink had operated with a fiscal year that ran from May of one year until April of the next. However, in Decision 2003-061, which was the result of the hearing into the general tariff application by AltaLink for approval of its revenue requirements for 2002/2003 and 2003/2004, the Board directed AltaLink to maintain its regulatory records on a calendar year basis and to explore with the Canada Customs and Revenue Agency the possibility of changing its financial year-end as well, to reduce costs.

With effect from January 1, 2005, AltaLink has moved to a calendar year basis for both regulatory and financial reporting purposes. Accordingly, this audit covered two time periods. The first was the final four month period of the previous fiscal year, i.e. from January to April 2004, while the second was the stub period from May to December 2004.

Audit Coverage

Inter-Affiliate Operating Transactions

AltaLink has developed a number of inter-affiliate service agreements that are designed to define the relationship between the entities that are parties to the agreements. These arrangements have been modified, where necessary, as a result of the requirements arising from the Board's Decision 2003-040, the Inter-Affiliate Code of Conduct Decision. AltaLink also applies the provisions in the inter-affiliate agreements to all suppliers involved in projects carried out under these agreements, not just to the affiliates that are parties to the agreements.

AltaLink has two types of inter-affiliate transactions – capital and operating transactions. The capital transactions, and the related audit work and conclusions, are discussed in the Cost Management Process section below. The operating transactions, and the related audit work and conclusions, are discussed in this section.

AltaLink has approximately 250 individuals, who are engaged in management, technical, administrative and general labour activities in connection with its transmission business. However, the General Partner (AltaLink Management Ltd.), rather than AltaLink, employs these individuals. Consequently, there is an agreement between the General Partner and AltaLink for the provision of accounting, finance, treasury, business development, regulatory, operational, and administrative services and for reimbursement of related costs and expenses, which tend to be employee-related, such as payroll, benefits, bonus, and health care costs. For the eight-month period ended December 31, 2004, these costs amounted to approximately \$17.5 million.

There is also an agreement between AltaLink and AltaLink Investments Limited Partnership (AILP) for the provision by AltaLink to the latter entity of various accounting, business development, regulatory, operational, and administrative services. This agreement was subsequently amended to provide the services to another related entity. The agreement calls for AILP to pay fees to AltaLink, based on hourly rates, for the provision of the services noted in the

agreement. For the eight-month period ended December 31, 2004, these costs amounted to approximately \$169,000.

AltaLink also entered into an agreement with AILP for the supply of \$85,000,000 in long-term debt financing, effective January 28, 2003. The due date for repayment of the principal amount is October 1, 2012 and the interest rate is a fixed rate of 8%, payable quarterly. The bonds are unsecured and payments of the principal and interest are subordinated to all senior bonds. Interest paid during the eight-month period ended December 31, 2004 amounted to approximately \$3.4 million.

A main focus of the audit work in this section was to test the effectiveness of the controls and procedures related to the transactions carried out in accordance with these agreements. In addition, the audit tested the completeness and accuracy of, and support for, these inter-affiliate operating transactions during the 12-month period to December 31, 2004, including whether they were based on a valuation approved by the Board.

The following is a summary of the significant procedures tested and the audit work done.

- The key components, procedures, control points, issues, and risks associated with inter-affiliate operating transactions were identified.
- These items were reviewed to determine whether related procedures and controls were adequate and tests were conducted to determine their effectiveness in practice.
- A review was performed to determine whether management had adequate procedures to identify services that had been provided and whether the related costs were charged to the correct entity.
- Inter-affiliate service agreements were reviewed to determine whether they covered all of the services that were provided and whether they had been properly approved.
- Board Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of inter-affiliate transactions for the period was selected, and tests were carried out to verify that the selected items were complete, properly supported and accurate; were recorded in the correct entity and in the correct time period; had been properly authorised; and were in accordance with regulatory requirements.

The audit conclusion was that AltaLink has an effective process for controlling inter-affiliate operating transactions, and that inter-affiliate operating transactions were complete and accurate, properly authorised and supported, were priced appropriately, and were in accordance with regulatory requirements.

Inter-Affiliate Agreement between AltaLink and SNC-Lavalin ATP (SNC-ATP) Inc. Engineering, Procurement, and Construction Management (EPCM) Services

Transactions arising from the above noted contract were audited, as indicated in the Cost Management Process section below. However, the audit work did not extend to a review of whether the charges that were levied were at a fair market value, as this type of review was considered to be outside the scope of this audit.

In the application leading to Decision 2003-061, AltaLink had applied to the Board for approval of an executed ten-year exclusive contract with a subsidiary of SNC-Lavalin Inc., a 50% partner in the AltaLink partnership, to provide engineering, procurement, and construction management services for all capital projects undertaken by AltaLink. These were expected to be primarily the

“direct assign” contracts AltaLink receives from the AESO, potentially amounting to hundreds of millions of dollars over the life of the contract. The contract included pricing based on an hourly rate for various types of personnel as well as a 3% fee on the cost of materials and a 4% fee on the cost of labour. The Board was satisfied that the contract clearly represents a major affiliate transaction.

Based on the evidence considered at the hearing that led to Decision 2003-061, the Board stated that it was not satisfied that AltaLink had met the onus of clearly and indisputably demonstrating that the EPCM services, which are the subject of the inter-affiliate agreement, will be provided to customers at fair market value. The Board went on to state that:

“ It is the Board’s view that if this particular contract had been fairly tendered in the open market (the Board does not accept that only SNC-ATP has the capacity to provide the services), the heavy onus on AltaLink to establish that the terms were fair market value would have been made considerably easier. AltaLink may wish to reconsider such an option for its next GTA.”

However, the Board did not deny the use of this arrangement by AltaLink. Nor did it give AltaLink a firm date by which to provide the information to support its contention that the arrangements are being carried out at fair market value. Accordingly, AltaLink is operating in accordance with the terms of the agreement, but has not yet provided support to the Board to demonstrate that the related transactions are at fair market value. During the course of the audit, it appeared that the Board had not been sufficiently clear in its direction to AltaLink.

However, subsequent to the completion of the audit fieldwork, the Board addressed this issue in Decision 2005-019. In this Decision, the Board directed AltaLink

“ to perform a review of the ongoing prudence of its outsourcing arrangements with SNC-ATP in light of the Board’s findings in this decision and to file the results of such a study as part of its Application in respect of its next GTA.”

The Board also outlined a number of parameters that it directed AltaLink to reflect in its filing. This filing is expected to allow AltaLink the opportunity to demonstrate that, and the Board to determine whether, such services are being provided at fair market value.

The Project Management Process

AltaLink, after starting operations in May 2002, has incurred a high amount of capital expenditures compared to levels observed in the previous few years. AltaLink management contends that there are two factors leading to this occurrence. Firstly, there is a need to increase the capacity of the Alberta Interconnect Electric System (AIES) as a result of increasing demand for power. Secondly, there is the age of the transmission system that AltaLink purchased. Much of the system is thirty to forty years old and is approaching the end of its useful life. These two factors, expansion and replacement, are responsible for two of the three types of capital projects which AltaLink manages. The third type consists of corporate infrastructure projects, such as information technology.

The amounts of proposed capital expenditures sought by AltaLink for the 2002/2003 and 2003/2004 periods were approved by the Board, with the added direction that AltaLink in its

next filing is to provide sufficient details of its capital expenditures to allow the Board to properly assess the reasonability of AltaLink's application as their forecast expenditures have been significantly higher than the historical trend of the past few years.

At the time of the audit in February 2005, AltaLink's 2004 "stub period" through 2007 General Tariff Application was still before the Board pending a decision. As a result, AltaLink used the "applied for" capital expenditure amounts as the budget to manage their expenditures.

At any given time, AltaLink is managing from 30 to 40 active capital direct assign projects. Costs for these projects range from \$300,000 to \$12 million, with an average value of about \$5 million. Total capital expenditures for the eight-month period ended December 31, 2004 amounted to approximately \$74.9 million.

The audit objective was to determine the effectiveness of the procedures and controls over the capital project management process and whether capital projects are being handled in compliance with regulatory decisions.

The following is a summary of the significant procedures tested and the audit work done.

- The key components, procedures, control points, issues, and risks associated with the capital project management process were identified.
- Board Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of capital projects started in the audit period was selected, and tests were carried out to verify that the selected items were properly approved based on AltaLink's signing authority matrix, prior to initiating activity or incurring commitments or expenditures.
- A sample of completed capital projects was selected, and tests were carried out to verify that adequate closure procedures exist and were effectively used in a timely manner. The tests included a review of variance explanations, appropriate sign offs on performance and completion, and the use of project reviews.
- The procedures used for generating change orders to approved capital projects were evaluated and a selection of change orders were examined to determine if they were reviewed and approved by an appropriate member of management.

The audit conclusion was that AltaLink has an effective process to manage its capital projects and that capital projects are being handled in compliance with regulatory decisions.

The Cost Management Process

One of the key inter-affiliate agreements is between SNC-Lavalin ATP Inc. (SNC) and AltaLink, for the provision of EPCM services related mostly to the direct assigned projects work. The agreement is a Master Services Agreement, which outlines the terms and conditions under which both parties have agreed to do business with each other. The actual service to be provided is outlined in an Annex A contract, which is created for each new construction project. The agreement calls for AltaLink to pay fees to SNC, based on hourly rates as outlined in Schedule A to the agreement, for the provision of the services noted in the agreement. Payments to SNC under this agreement during the eight-month period ended December 31, 2004 amounted to approximately \$47.6 million, which has been included in AltaLink's capital assets.

In addition, there is a related agreement that appoints SNC as the exclusive supplier of EPCM services for AltaLink and outlines the terms and conditions under which such services will be provided.

A main focus of the audit work in this section was to test the effectiveness of the controls and procedures related to the transactions carried out in accordance with these agreements. In addition, the audit tested the completeness and accuracy of, and support for, these inter-affiliate capital transactions during the 12-month period to December 31 2004, including whether they were based on a valuation approved by the Board.

The following is a summary of the significant procedures tested and the audit work done:

- The key components, procedures, control points, issues, and risks associated with inter-affiliate capital transactions were identified.
- Board Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of invoices was selected, and tests were carried out to verify that the selected items were complete, properly supported and accurate; were recorded in the correct entity and in the correct time period; had been properly authorised; and were in accordance with regulatory requirements.
- A sample of completed capital projects was selected, and tests were carried out to verify that adequate closure procedures exist and were effectively used in a timely manner. The tests included a review to ensure that completed projects were moved from construction accounts to in-service accounts, and that the appropriate depreciation charge had been set up and expensed to the project, in a timely manner.

The audit conclusion was that AltaLink has an effective process for controlling inter-affiliate capital transactions, and that inter-affiliate capital transactions were complete and accurate, properly authorised and supported, were priced appropriately, and were in accordance with regulatory requirements.

Principal Audit Findings and Overall Conclusion

Appendices 1 and 2 contain details, including management's response, of two observations arising from the audit work that were considered to be sufficiently significant that they warranted disclosure in this report.

Nevertheless, overall, the financial and operational controls over the selected key activities of AltaLink were effective and the related transactions were in accordance with regulatory requirements. Some minor exceptions were noted in a small number of transactions. These items were brought to the attention of management, who provided a response, including an appropriate timetable for dealing with the matters noted. Some suggestions were also made to management to help improve the effectiveness of the related procedures.

The audit fieldwork was carried out at a busy time for management and staff in AltaLink. Nevertheless, they made time to provide the audit team with explanations and answers to our queries. We would very much like to thank the management and staff of AltaLink for their very valuable help and cooperation during the audit.

<p>Auditee: AltaLink Limited Partnership Audit Time Period: January - December 2004</p>	<p>Done By: Darcy Mazurkewich Management Response By: Jim Leonidas Response Date: February 24, 2005</p>
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Appendix 1 - Dispute Resolution Process

Observation:

In the Master Services Agreement between SNC – Lavalin ATP Inc. and AltaLink, there is a provision for a dispute resolution process whereby a senior management member for each party will attempt to resolve any dispute before going to arbitration.

In Decision 2003-061, the Energy and Utilities Board stated that “in the Board’s view, an independent decision maker, such as an arbitrator under the Arbitration Act, should resolve disputes in this type of circumstance.”

It was noted that the Master Services Agreement had not been updated to reflect the ruling of the Board in Decision 2003-061.

Impact:

Failure to comply with Board directives may result in unforeseen regulatory consequences.

Recommendation(s):

It is recommended that the Master Services Agreement, and supporting Procedures Manual, be updated to reflect the directive of the board in Decision 2003-061.

Management Response:

In Decision 2003-061, the referenced statement by the Board is related to the Board’s concerns with the dispute resolution process within the Master Services Agreement between SNC-ATP and AltaLink, and the statement is found within the Summary of Approvals, Key findings and Conclusions section of the Decision on page 157, point 42, not within the Summary of Directions starting on page 147. AltaLink interpreted the Board’s concern as being related to not having a code of conduct in place, given the following statement in the Decision: “In the absence of a code of conduct being filed in this proceeding, it is difficult for the Board to conclude that such a procedure would not tend to result in ...”. AltaLink filed and received Board approval of AltaLink’s Code of Conduct in 2004. Nevertheless, within 60 days of the completion of the EUB’s audit, AltaLink will amend its Master Services Agreement with SNC-ATP so as to include an independent arbitrator in the dispute resolution process.

Estimated Completion Date:

May 15, 2005

Auditee: AltaLink Limited Partnership Audit Time Period: January - December 2004	Done By: Balvir Dhillon Management Response By: Response Date:
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Appendix 2 - AFUDC Calculation

Observation:

It was noted that the AFUDC calculation for 2004 was not in compliance with the method prescribed by the Energy and Utilities Board in Decision 2003-061.

AltaLink's AFUDC calculation for 2004 was made in two parts, using balances related to assets under construction at the end of April and at the end of December. The December calculation was made using rates approved by the Board in the Generic Cost of Capital Decision (2004-052), while the April calculation was made using management's best estimate of rates likely to be approved by the Board in Decision 2004-052. The April calculation was subsequently adjusted to reflect the impact of Decision 2004-052 after it had been released by the Board.

In Decision 2003-061, the Energy and Utilities Board stated that "Based on the Board's long standing practice in Alberta to calculate AFUDC on a mid-year convention, the Board denies AltaLink's request to change the calculation of AFUDC on a monthly balance basis and directs AltaLink to recalculate the AFUDC on the mid-year basis of year-end CWIP for the 2002/2003 and 2003/2004 test periods".

As it happens, AltaLink's net calculation of AFUDC for the 2004 8-month "stub" period was \$1,169,834, which is very close to the calculation that results from using the method prescribed by the Board.

Impact:

Failure to comply with Board directives may result in unforeseen regulatory consequences.

Recommendation(s):

It is recommended that AltaLink change its AFUDC calculation method to comply with the Board's directive in Decision 2003-061.

Management Response:

Agreed

Estimated Completion Date:

April 15, 2005