

Memorandum

TO: Chairman's Executive Committee

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

DATE: July 11, 2005

RE: REGULATORY AUDIT REPORT – ATCO PIPELINES

Attached is the audit report arising from the regulatory audit of ATCO Pipelines that we completed recently. Also attached is management's response to the audit report.

As noted in the report, we determined that ATCO Pipelines had effective processes for controlling the deferral accounts and reserves, and capital project and cost management processes. In addition, transactions in these processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements. There were seven minor observations arising from the audit, which were discussed and cleared with management during the course of the audit. The observations were not sufficiently significant that they required being included in the audit report.

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

If you have any comments about the attached, please give me a call at 297-2316.

(original signed by)

Richard M. A. McCabe

Bob Heggie, Utilities Branch
Wayne Wright, Vice President, Commercial and Finance, ATCO Pipelines

July 7, 2005

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

Dear Mr. McCabe:

**Re: Regulatory Audit of Deferral Accounts and Reserves and the
Capital Project and Cost Management Processes**

We have reviewed the draft audit report of your findings and agree with the information contained in the report. ATCO Pipelines would like to thank your group for their communication throughout this process which enabled us to respond to information requests in an efficient manner. The audit process you have implemented is well laid out and allowed us to have a very good understanding of your objectives. Your professionalism and work ethic throughout the audit were appreciated by ATCO Pipelines' staff.

Sincerely,



R.J. Brouwer
President



ATCO Pipelines

Regulatory Audit of Deferral Accounts and Reserves and the
Capital Project and Cost Management Processes for the
12-Month Period Ended December 31, 2004

June 2005

Audit Team:

Richard McCabe
Darcy Mazurkewich
Nick Iannone

ALBERTA ENERGY AND UTILITIES BOARD

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Regulatory Audit of Deferral Accounts and Reserves and the
Capital Project and Cost Management Processes

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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 ATCO Pipelines. The key activities that were the subject of this audit were the capital project and cost management processes, and deferral accounts and reserves balances and transactions.

The audit included a review of the operations of these activities, the associated financial information and the related regulatory requirements. The audit covered sample transactions and reviews of the controls over the key components of each process for the 12-month period ended December 31, 2004. The audit resulted 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 ATCO Pipelines 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 (EUB) and 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 an independent, professional review of the selected 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 EUB by ATCO Pipelines, as well as a review of Decisions arising from applications made to the EUB by ATCO Pipelines during the two-year period ended December 31, 2004. During this period, ATCO Pipelines, and in some cases, other related entities, were involved in a very significant number of applications before the EUB. These applications dealt with deferral accounts and reserves, exchange fees, general rate applications, compliance filings, generic cost of capital, and Code of Conduct issues.

The Audit and Compliance group of the EUB's Utilities Branch carried out the assignment between May 16 and June 6, 2005, when the closing meeting was held with management.

Overview

ATCO Pipelines is a member of the ATCO Group of Companies and it provides competitive natural gas transportation services to producers and end-use markets throughout Alberta. ATCO Pipelines is a division of ATCO Gas and Pipelines Ltd., which is incorporated in the province of Alberta, and it owns and operates over 8,300 kilometres of natural gas transmission facilities throughout the province. As an integral part of the provincial gas transmission system, it provides transportation services to natural gas producers in the Western Canada Sedimentary Basin, to major industrial users in Alberta, and to gas distribution companies.

Audit Coverage

Deferral Accounts and Reserves

The EUB's normal practice in setting rates for the provision of utility services is to use prospective ratemaking, wherever possible. However, in certain cases, the level of risk, arising

from uncertainty associated with forecasting revenues or costs, borne by one or more parties in the regulatory process may be such that it is more advisable to use a mechanism that protects both utilities and ratepayers from the potential impact of inaccurate forecasts. Deferral accounts and reserves are the main mechanisms that are used to provide this protection.

The EUB's practice has been to evaluate the use of deferral accounts or reserves on a case-by-case basis. As noted above, these mechanisms provide protection from uncertainty. However, there may also be negative impacts which arise from their use, including rate fluctuations and intergenerational inequity.

The typical criteria used in determining whether or not to approve the use of a deferral account or reserve are the materiality of the amount involved, the level of uncertainty regarding the accuracy of a forecast of the associated revenues or costs, the ability to control the factors affecting the forecast, and the resulting level of risk borne by the utility and the ratepayers.

In 2004, ATCO Pipelines had a small number of deferral accounts and reserves, most of which had been in existence for a number of years. Such accounts were rarely created, were for a specific purpose, and were only created after they had been approved by the EUB. The three main deferral accounts and reserves used by ATCO Pipelines are as follows.

The hearing costs reserve is used to gather costs incurred by ATCO Pipelines and other stakeholders related to participation in EUB proceedings. The costs are held in this account until they have been scrutinised and approved for payment by the EUB. The approved assessment for this account in 2004 was \$701,000. However, due to the level of regulatory activity in 2004, this account was under-funded by about \$715,000 at the end of the year.

Another major account is the reserve for injuries and damages. The EUB has approved ATCO Pipelines to record an assessment of \$200,000 each year for a five-year period, beginning in 2003, to allow it to build up a reserve to pay for a self-insurance deductible that would be incurred in the event of a major incident.

The third class of deferral accounts relates to costs and revenues associated with transactions involving the movement of gas between the ATCO Pipelines system and inter-connected pipeline systems. Some new accounts had been created in 2004 to replace exchange deferral accounts, which had been terminated.

A main focus of the audit work in this section was to test the effectiveness of the controls and procedures related to the development and operation of the deferral accounts and reserves. In addition, the audit tested the completeness and accuracy of, and support for, a sample of deferral accounts and reserves transactions during the 12-month period to December 31, 2004.

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 deferral accounts and reserves 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.
- EUB Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.

- A sample of deferral accounts and reserves transactions for the twelve-month 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 is that ATCO Pipelines has an effective process for controlling the deferral accounts and reserves and related transactions, and that such transactions were complete and accurate, properly authorised and supported, and that the deferral accounts and reserves were in accordance with regulatory requirements.

Capital Project Management Process

ATCO Pipelines incurred significant capital expenditures in 2003 and 2004. ATCO Pipelines spent \$47.9 million on capital expenditures in 2004, roughly 9% of its Property, Plant and Equipment balance. It is anticipated that ATCO Pipelines' capital project management activities will continue to be significant, given the need to address high consumer and oil sands demand for natural gas by replacing or upgrading aged assets, and constructing new assets.

The EUB approved the majority of the forecast capital expenditures sought by ATCO Pipelines for 2003 and 2004. However, the EUB directed ATCO Pipelines to provide greater details and more quantitative analysis of its capital expenditures in future applications so that the reasonability of the forecast expenditures can be more fully assessed.

In a given year, ATCO Pipelines manages up to 600 capital growth, maintenance and support projects. During the audit period, the majority of projects ranged from \$10,000 to \$100,000, with about 20 projects having a budget in excess of \$500,000. The two largest projects in 2004 had budgets of about \$5.5 million. These projects were the Unaccounted For Gas - North project (approved in Decision 2003-100) and the SCADA Load Balancing project (approved in Decision 2004-078).

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.
- EUB 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 ATCO Pipelines' 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 sample of change orders was examined to determine if they were reviewed and approved appropriately.

The audit conclusion was that ATCO Pipelines 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

A main focus of the audit work in this section was to test the effectiveness of the controls and procedures related to capital expenditure transactions, including the completeness, accuracy of, and support for, these transactions during the 12-month period to December 31, 2004.

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 capital expenditure transactions were identified.
- EUB 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, that AFUDC ceased to be calculated and that the appropriate depreciation charge had been set up and expensed to the project, in a timely manner.

The audit conclusion was that ATCO Pipelines has an effective process for controlling capital cost transactions, and that capital expenditures were complete, accurate, properly authorised, supported, and were in accordance with regulatory requirements.

Principal Audit Findings and Overall Conclusion

Overall, the financial and operational controls over the selected key activities of ATCO Pipelines 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.

The audit fieldwork was carried out at a very busy time for management and staff in ATCO Pipelines. 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 ATCO Pipelines for their very valuable help and cooperation during the audit.