

Memorandum

December 1, 2005

TO: Chairman's Executive Committee

FROM: Ed Gallagher, Audit and Compliance Group, Utilities Branch

**REGULATORY AUDIT REPORT
EPCOR DISTRIBUTION INC. AND EPCOR TRANSMISSION INC.**

Attached is the audit report arising from the regulatory audit of EPCOR Distribution Inc. (EDI) and EPCOR Transmission Inc. (ETI) that we completed recently. Also attached is management's response to the audit report.

As noted in the report, we determined that EDI and ETI had effective processes for controlling inter-affiliate transactions, capital projects and related capital expenditures. In addition, transactions with respect to these processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements. Management of EDI and ETI provided satisfactory responses to four observations arising from the audit, which were discussed during the course of the audit fieldwork. The observations were not sufficiently significant to warrant inclusion in the audit report.

As noted in the final paragraph, we received the full co-operation of management and staff of EDI and ETI throughout the course of the audit.

The audit was conducted jointly by staff of the Audit and Compliance Group and Grant Thornton LLP, Chartered Accountants. This was the first time that we took the opportunity to use a third party resource on a regulatory audit, and we can confirm that the arrangement contributed positively to the effectiveness of the audit process.

(original signed by)

Edward J. Gallagher

Attachments

pc Bob Heggie, Executive Manager, Utilities Branch
Guy Bridgeman, Senior Vice President, EPCOR Distribution and Transmission Inc.
Richard Taylor, Senior Consulting Manager, Grant Thornton LLP

10065 Jasper Ave
Edmonton AB T5J 3B1
Canada



December 1, 2005

Alberta Energy and Utilities Board
640-5th Avenue S.W.
Calgary, AB T2P 3G4

**Attention: Mr. Edward Gallagher
Audit and Compliance Group**

Dear Sir:

**Subject: EPCOR Distribution Inc. and EPCOR Transmission Inc.
Regulatory Audit Report #2005-006
Regulatory Audit of Inter-Affiliate Transactions,
and Capital Project and Cost Management Processes for the
12-Month Period Ended December 31, 2004**

EPCOR Distribution Inc. and EPCOR Transmission Inc. appreciate the opportunity to review and respond to the Regulatory Audit Report as conducted by the AEUB. We understand that this response will be appended to the above noted Audit Report #2005-006.

We have reviewed the Audit Report and are pleased with the results of the audit as it is a reflection of our commitment to the internal controls, effective operational processes and regulatory compliance standards within our inter-affiliate transactions, capital projects and cost management processes. We will be reviewing those areas discussed at the closing meeting to determine an appropriate course of action in an effort to continually provide customers with high service levels.

We would like to thank the AEUB for their accommodation of our internal schedules and deadlines and commend the members of the Audit Team for their professional manner and conduct throughout the audit process.

Should you have any questions or concerns, please feel free to contact me at (780) 412-7822.

Sincerely,

<original signed by Guy Bridgeman>

Guy Bridgeman
Senior Vice President
EPCOR Distribution Inc. and
EPCOR Transmission Inc.



EPCOR Distribution Inc. and EPCOR Transmission Inc.

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

November 2005

Audit Team:

EUB

- Ed Gallagher

Grant Thornton LLP

- Cherie Reeves
- Jacqui Dueck
- Ashley Penna

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2005-006: EPCOR Distribution Inc., and EPCOR Transmission Inc.
Regulatory Audit of Inter-Affiliate Transactions, and Capital Project and
Cost Management Processes

November 2005

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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 EPCOR Distribution Inc. (EDI) and EPCOR Transmission Inc. (ETI). 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 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 as to whether or not the activities conform with regulatory requirements.

This audit was carried out at EDI and ETI as part of a three-year regulatory audit plan. The plan has been developed to audit key activities of utilities regulated by the Alberta Energy and Utilities Board (the Board or EUB), 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 EDI and ETI, as well as a review of Decisions arising from applications made to the Board by EDI and ETI during 2003 and 2004. These applications dealt with regulated rate tariffs, and Code of Conduct issues.

The Audit and Compliance group of the Board's Utilities Branch carried out the assignment between October 11, 2005 and November 4, 2005, when the closing meeting was held with management.

Overview

EDI and ETI, together with EPCOR Water Services Inc. (EWSI), comprise EPCOR Utilities' Infrastructure Division. EDI and ETI were incorporated in the Province of Alberta on October 2, 1998 and are wholly owned by EPCOR Utilities Inc. (EPCOR). Effective January 1, 1999, all of the assets and liabilities of the distribution and transmission operations of EPCOR were transferred to EDI and ETI at book value.

ETI owns and operates high voltage substations and transmission lines, which form part of the Alberta provincial power grid. ETI transmits energy through 72 to 240kV aerial and underground lines from generating plants or the transmission grid to the City of Edmonton, surrounding communities and to large industrial plants throughout its service area.

EDI owns and operates the facilities that provide electricity distribution services to customers within the City of Edmonton, through distribution substations, transmission substations, high voltage facilities, distribution feeders and primary distribution lines. In 2004, EPCOR distributed

approximately 12% of the existing provincial energy consumption to approximately 268,700 residential and 32,400 commercial consumers in the City of Edmonton.

EDI and ETI collect a provincially-regulated distribution tariff and transmission tariff, respectively, for the provision of their services. The revenue raised from these tariffs is intended to allow EDI and ETI to recover their prudent and reasonably incurred costs in addition to providing an opportunity to earn an approved forecast rate of return on their investments in their distribution and transmission infrastructures. Under the *Electric Utilities Act*, regulation of EDI transferred from Edmonton City Council to the Board, effective January 1, 2004.

Audit Coverage

Inter-Affiliate Operating Transactions

For 2004, ETI provided operations management, maintenance, repair, engineering, system control and general plant services to affiliated subsidiaries of EPCOR, in return for which it received \$3.1 million. In addition, ETI received operational and inventory management, administration, maintenance, repair, utilities, facility and general plant, and executive and business support services from EPCOR and affiliated subsidiaries, in return for which it paid \$4.9 million. ETI also paid \$6.2 million in interest costs to EPCOR.

For 2004, EDI provided operational and inventory management, administration, maintenance, repair, meter reading, security lighting services, system support, facility and general plant, and executive support services to affiliated subsidiaries of EPCOR, in return for which it received \$10.4 million. In addition, EDI received UIS access services, executive and business support services from EPCOR and affiliated subsidiaries, in return for which it paid \$11.0 million. EDI also paid \$9.2 million in interest costs to EPCOR.

EDI and ETI have developed a number of inter-affiliate service agreements 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), and Decision 2004-010 (the EPCOR Utilities Inc. Code of Conduct and Exemption Application Decision).

EDI and ETI have two types of inter-affiliate transactions – capital and operating transactions. The capital and operating transactions, and the related audit work and conclusions, are discussed in this section.

EDI and ETI have several agreements with EPCOR, EPCOR Energy Services Inc. (EESI), EPCOR Generation Inc. (EGI), EPCOR Technologies Inc (ETech) and EWSI. The agreements deal with various services such as accounting, business development, regulatory, operational, administrative services, management, repair services, etc. The charges are based on an annual fixed fee, the actual labour, materials and other expenses related to a particular job or the use of assets owned by EDI and ETI.

EDI also entered into an agreement with EPCOR for a promissory note agreement for \$35 million. The original agreement was effective December 31, 2004, with a term to December 31, 2024. The interest rate is 6.07% payable semi-annually on June 30th and December 31st, with the first repayment on June 30, 2005.

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.

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, if applicable.
- 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 service agreements and regulatory requirements.

The audit conclusion was that EDI and ETI have effective processes 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.

The Project Management Process

The levels of capital expenditure incurred by EDI and ETI in 2004 were consistent with 2003 levels.

The amounts of proposed capital expenditures sought by EDI for 2004 were approved by the Board in Decision 2004-067 issued on August 13, 2004. The 2004 capital expenditure forecast of ETI was approved in Decision 2004-018 (the EPCOR Transmission Inc. 2003-2004 Transmission Facility Owner Tariff and Negotiated Settlement Decision) issued on February 26, 2004.

EDI expended \$29.7 million in capital additions in 2004, comprising \$25.8 million in projects related to customer metering, and aerial and underground distribution systems and services, \$1.2 million in expenditure on work at the service centers, security lighting, tools and instruments, \$1.1 million on information systems projects and \$1.6 million on vehicles.

ETI expended approximately \$11.5 million, comprising \$5.2 million in projects related to aerial and underground transmission systems, and \$6.3 million in work at substations.

In Decision 2004-067, the Board directed EDI to:

- consider the capitalization policies of other Alberta utilities in the policies recommended in the next General Tariff Application (GTA);
- provide at the next GTA, appropriate business policies for capital expenditures in excess of \$500,000; and
- file at the next GTA, a comprehensive business case justifying actual 2004 costs for the RDS project.

It was noted that EDI has filed documentation in response to these directions for review and consideration by the Board in the 2005 GTA.

The Board also directed EDI to:

- reduce the forecast for the RDS project from \$5.7 million to \$2.9 million;
- remove the forecast of \$1.1 million with respect to the MDM project from 2004 capital additions, and file an appropriate business case supporting any future proposal for funding on this project; and
- reduce the forecast for vehicle additions from \$6 million to \$2.9 million

It was noted that EDI incurred no significant expenditure on the MDM project, which it is understood will not be moving forward, and that actual 2004 rate base additions for vehicles were approximately the amount approved by the Board, included in additions to plant and construction work in progress. Expenditure for 2004 on the RDS project was included in construction work in progress.

With respect to the capital project management process, the audit objective was to determine the effectiveness of the procedures and controls over the 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 in the audit period was selected, and tests carried out to verify that the selected items were properly approved based on the signing authority matrix, prior to initiating activity or incurring commitments or expenditures.
- Tests were also 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, and the use of project reviews.
- The procedures used for initiating changes to approved capital projects were evaluated and examined to determine if the changes were reviewed and approved at an appropriate level.

As indicated below in the final section of this report, some observations were noted and discussed with management. Nevertheless, the audit conclusion was that EDI and ETI have

effective processes to manage their capital projects and that capital projects are being handled in compliance with regulatory decisions.

The Cost Management Process

The 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 carried out to verify that the selected items were complete, properly supported and accurate, recorded in the correct entity and in the correct time period; properly authorized; and in accordance with regulatory requirements.
- Tests were carried out to ensure that AFUDC ceased to be calculated on completed projects and that the appropriate depreciation charge had been set up and expensed.

The audit conclusion was that EDI and ETI have effective processes for controlling capital cost transactions, and that capital expenditures were complete, accurate, properly authorized, supported, and in accordance with regulatory requirements.

Principal Audit Findings and Overall Conclusion

Overall, the financial and operational controls over the selected key activities of EDI and ETI were effective and the related transactions in accordance with regulatory requirements. Some exceptions were noted in a small number of transactions that were not of a material amount, which were brought to the attention of management. The observations included suggestions to management to help improve the effectiveness of the related procedures. Management provided responses to the observations, including an appropriate timetable for dealing with the matters noted. These exceptions and related observations however, were not considered of sufficient significance to warrant inclusion in this report.

The audit fieldwork was carried out at a busy time for management and staff in EDI and ETI. 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 EDI and ETI for their very valuable help and co-operation during the audit.