

ELECTRONIC DISTRIBUTION

Memorandum

TO: Chairman's Executive Committee
FROM: Darcy Mazurkewich, Utility Audit and Compliance Group
DATE: December 21, 2005

RE: REGULATORY AUDIT REPORT – ATCO ELECTRIC

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

As noted in the report, we determined that ATCO Electric had effective processes for controlling the 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. There were several 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 to warrant being included in the audit report.

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

If you have any comments about the attached, please call me at 297-7365.

<Approved for distribution by>

Darcy Mazurkewich

Bob Heggie, Executive Manager, Utilities Branch
S.F. (Sett) Policicchio, President, ATCO Electric



December 16, 2005

Audit and Compliance Group – Utilities Branch
Alberta Energy and Utilities Board
640 – 5 Avenue SW
Calgary, AB T2P 3G4

Dear Mr. Mazurkewich:

RE: ATCO Electric Regulatory Audit Report

ATCO Electric would like to thank you for the opportunity to discuss your audit findings and observations during the closing meeting of the regulatory audit and for this opportunity to comment on the draft regulatory audit report. It is our understanding that this letter will be attached to the final version of the audit report.

ATCO Electric has reviewed the draft regulatory audit report and agrees with the information contained in the report. ATCO Electric is very pleased with the findings and overall conclusion of the audit. ATCO Electric believes that this is a direct result of our ongoing commitment to fully comply with all regulatory decisions and directives in a timely manner and to ensure effective systems of financial and operational controls are in place throughout the organization.

ATCO Electric would like to thank you for the recognition given to our management and staff and for accommodating our internal schedules and deadlines. ATCO Electric would also like to commend the audit team for its professionalism and conduct throughout the audit assignment.

Yours truly,

Original signed by Mr. Policicchio

S. F. (Sett) Policicchio
President



ATCO Electric

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

December 2005

Audit Team:

Darcy Mazurkewich
Nick Iannone
Lorena Ziegler

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2005-008: ATCO Electric
Regulatory Audit of Capital Project and Cost Management Processes and
Inter-affiliate Transactions

December 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 ATCO Electric. The key activities that were the subject of this audit were the capital project management process, cost management process, and inter-affiliate 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 Electric 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 Electric, as well as a review of Decisions arising from applications made to the EUB by ATCO Electric during the two-year period ended December 31, 2004. These applications dealt with deferral accounts and reserves, exchange fees, general rate applications, compliance filings, generic cost of capital, and Affiliate Code of Conduct issues.

The Audit and Compliance group of the EUB's Utilities Branch carried out the assignment between November 8th and December 2nd 2005, when the closing meeting was held with management.

Overview

ATCO Electric Ltd. is a member of the ATCO Group of Companies. ATCO Electric serves more than 182,000 customers in northern and east-central Alberta – resource rich areas of the province where electricity is an essential component of industrial development. The company has nearly 80 years experience in serving this territory. ATCO Electric is headquartered in Edmonton and has 37 service offices throughout its service area in Alberta. ATCO Electric delivers power to homes, farms and businesses, in cities, towns, Native reserves and Metis settlements – more than 200 communities in all.

Audit Coverage

Inter-Affiliate Operating Transactions

All transactions with affiliates are governed by the ATCO Group Inter-Affiliate Code of Conduct (Code) appended to Decision 2003-040, the Inter-Affiliate Code of Conduct Decision. The

purpose of the Code, which became effective September 1, 2003, is to establish standards and conditions for interaction between ATCO Electric and its affiliates. ATCO Electric has developed Master Services Agreements (“MSA”) or Master Services Contract (“MSC”) with each affiliate, designed to define the relationship between the entities that are parties to the agreements. All services with affiliates that the MSA/MSC applies to can be brought under that MSA/MSC by way of a schedule(s) to that MSA/MSC. These agreements have been modified, where necessary, as a result of the requirements arising from the EUB Decision 2003-040. For the period ending December 31, 2004, ATCO Electric had 70 active service agreements.

During 2004, ATCO Electric paid approximately \$36 million to affiliates for operational type services and approximately \$10 million for capital related services. Operational services received by ATCO Electric included billing and customer services, information technology services, executive management and administrative services, corporate aircraft services, rent and the use of the trademark license. Capital related services included purchase of equipment, computer systems development and the treatment and testing of poles.

ATCO Electric recovered approximately \$6 million from affiliates for services that it had provided to them during 2004. The cost recoveries for services provided by ATCO Electric included financial management and administrative services, electrical sales, royalty fees, operational services and rental recoveries.

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 EUB.

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 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.
- EUB 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 authorized; and were in accordance with regulatory requirements.
- A review of the data provided was performed against information filed in the 2004 Compliance Report and the 2005 – 2006 ATCO Electric GRA application, #1399997.

The audit conclusion was that ATCO Electric has an effective process for controlling inter-affiliate operating transactions, and that inter-affiliate operating transactions were complete and

accurate, properly authorized and supported, were priced appropriately, and were in accordance with regulatory requirements.

Capital Project Management Process

ATCO Electric incurred capital expenditures of approximately \$214 million in 2004. Which is significant as that amount is roughly 15% of ATCO Electric's Property, Plant and Equipment balance. It is anticipated that the capital project management activities of ATCO Electric will continue to be significant, given the combined need to replace aging assets and to upgrade or add assets to meet high customer growth. ATCO Electric's capital expenditures can be broken down into the following four categories.

- Transmission Projects
- Distribution Projects
- Isolated Generation Projects
- General Property Plant and Equipment

In a given year, ATCO Electric manages between 4,000 to 5,000 projects, including capital growth, maintenance and support projects. During the audit period ATCO Electric managed projects with a diverse range of sizes. Greater than 50% of the projects active in 2004 were distribution projects averaging less than \$10,000. In contrast to those projects, the largest active project was construction of the Dover to Whitefish transmission line, which was a multi-year project completed in 2004. It had a total capital cost of \$98.7 million and 2004 expenditures in excess of \$60.5 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.
- EUB Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A reconciliation of the data provided was performed against relevant capital schedules filed in the 2005 – 2006 ATCO Electric GRA application, #1399997.
- 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 Electric'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 audit conclusion was that ATCO Electric has an effective process to manage its capital projects, as the capital projects tested were properly approved, assigned a manager, accurately reported, closed in a timely fashion, and complied 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 authorized; 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 AFUDC was calculated and applied correctly.

The audit conclusion was that ATCO Electric has an effective process for controlling capital cost transactions, and that capital expenditures were complete, accurate, properly authorized, 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 Electric were effective and the related transactions were in accordance with regulatory requirements. Some minor exceptions of non-material amounts were noted. These items were brought to the attention of management along with suggestions to help improve the effectiveness of the related procedures. Management provided their responses to these items, including an appropriate timetable for dealing with the matters noted. These items 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 ATCO Electric. Nevertheless, they made time to provide the audit team with explanations and answers to our queries. We thank the management and staff of ATCO Electric very much for their valuable help and cooperation during the audit.