

Memorandum

TO: Chairman's Executive Committee

FROM: Darcy Mazurkewich, Head, Utility Audit and Compliance Group

DATE: December 13, 2006

RE: **REGULATORY AUDIT REPORT –EPCOR ENERGY SERVICES**

Attached is the audit report arising from the recently completed regulatory audit of EPCOR Energy Inc. and EPCOR Energy Alberta Inc. collectively known as EPCOR Energy Services (EPCOR). Also attached is management's response to the audit report.

As noted in the report, we determined that EPCOR has effective processes for controlling the following activities: Operating and Maintenance costs; and Inter-Affiliate Transactions. In addition, transactions examined in these processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements.

In the final paragraph of the report, we noted that EPCOR management and staff fully cooperated with us throughout the audit assignment.

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

<Approved for distribution by>

Darcy Mazurkewich

cc: Bob Heggie, Executive Manager, Utilities Branch
Guy Bridgeman, Senior Vice President, EPCOR Energy Services

10065 Jasper Ave
Edmonton AB T5J 3B1
Canada



December 11, 2006

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

Attention: Mr. Darcy Mazurkewich
Head, Audit and Compliance Group

Dear Sir:

**Subject: EPCOR Energy Services
Regulatory Audit Report #2006-005
Regulatory Audit of Inter-Affiliate and
Operations and Maintenance Processes
For the Year Ended December 31, 2005**

EPCOR Energy Services appreciates 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 #2006-005.

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, operational processes and regulatory compliance standards within our inter-affiliate transactions, operations and maintenance processes.

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,

A handwritten signature in black ink, appearing to read 'Guy Bridgeman', is written over the word 'Sincerely'.

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



EPCOR Energy Inc. and EPCOR Energy Alberta Inc.

Regulatory Audit of Inter-Affiliate and
Operations and Maintenance Processes
For the Year Ended December 31, 2005

December 2006

Audit Team:

Darcy Mazurkewich
Nick Iannone
Joel Thompson

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2006-005: EPCOR Energy Inc. and EPCOR Energy Alberta Inc.
Regulatory Audit of Inter-Affiliate and
Operations and Maintenance Process

December 2006

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Objective and Scope

The overall objective of the Audit and Compliance Group of the Utilities Branch, Alberta Energy and Utilities Board (EUB) was to conduct a regulatory audit of the financial and operational controls exercised over two key activities of EPCOR Energy Inc. (EEI), and EPCOR Energy Alberta Inc. (EEAI), collectively referred to as EPCOR Energy Services (EES). The key activities that were the subject of this audit were the Inter-Affiliate and the Operations and Maintenance (O&M) processes.

The scope of the audit was limited to a review of the regulatory requirements related to these key activities. Audit procedures included the selection and examination of samples of transactions and review of the internal controls over the key components from each process for the year ended December 31, 2005. The audit resulted in this report expressing an opinion on the effectiveness of the internal controls and procedures with respect to these key activities. The audit also included a review of the conformity of business practices with respect to the regulatory requirements.

This audit was the second audit undertaken by the EUB on utility activities of EES, with the first having been conducted in May 2005 (see Audit Report 2005-003). The Audit was carried out between October 23, 2006 and November 10, 2006. A closing meeting was held with management on the final day of the audit.

Background

Edmonton Power Corporation was incorporated in 1995 and changed its name in 1996 to EPCOR Utilities Inc. (EPCOR). The City of Edmonton is the sole shareholder of EPCOR. Regulated energy services are provided by EEI, and EEAI, both of which are incorporated in Alberta and are wholly-owned subsidiaries of EPCOR.

EEI provides regulated rate tariff (RRT) electricity service to approximately 275,000 residential and small commercial customers within the EPCOR Distribution Inc. service area. In addition EEI provides call centre and billing and collection services to other EPCOR subsidiaries for water, competitive natural gas, and competitive electricity products. EEI also provides billing and collection services to the City of Edmonton Waste and Drainage Departments and to Alberta Energy Savings L.P. (a non-affiliate) that acquired most of EPCOR's competitive energy contracts in Alberta, effective November 1, 2004.

EEAI provides RRT electricity service to approximately 338,000 residential, farm, oil and gas, and small commercial customers in the FortisAlberta Inc. service area and the Town of Ponoka. EEAI also provides default supply electricity service to customers in these service areas and the City of Edmonton.

Prior to September 1, 2004, RRT services had been provided by EPCOR Energy Services Inc. (EESI) and EPCOR Energy Services Alberta Inc. (EESAI). Following EUB Decision 2004-074, the provision of RRT service was assigned by EESI and EESAI to EEI and EEAI, respectively.

Audit Coverage

Inter-Affiliate Process

In order to serve its RRT customers, EEI relies upon its staff and upon resources and services it receives from other affiliates. As EEAI does not have any employees, EEI provides EEAI with all services necessary for EEAI to serve its customers. In addition, EEI also provides services to other affiliates and non-affiliates.

Affiliate services received or provided by EEI are detailed in Service Level Agreements (SLAs) which define the relationship, the nature and terms of service(s) to be received or provided and the basis for compensation. The SLAs are the result of negotiations between affiliates and are based on the applicable 2005 Budgets which also formed the basis of the EES 2005-2006 Regulated Rate Tariff (RRT) Non-Energy Charge Application (numbers 1389878 (EEI) and 1389879 (EEAI)). These SLAs incorporate the requirements arising from EUB Decision 2003-040 (the Inter-Affiliate Code of Conduct) and Decision 2004-010 (the EPCOR Code of Conduct and Exemption Application).

During 2005, EES paid \$522.5 million to their affiliates for the various services that they received. Included in this amount is \$492.3 million of energy and tariff related services payable to EPCOR Merchant & Capital L.P. (EMC) and EPCOR Distribution Inc. (EDI). Payments for non-energy related services amounted to \$30.2 million. The affiliates concerned, a brief description of the major services provided, and the respective amounts paid are summarized below:

EPCOR - \$22.3 million (total)

- \$8.8 million for corporate services (includes all departmental services, space rental, Board of Directors costs, mailroom and facility operations)
- \$6.7 million for short and long term financing
- \$4.3 million for corporate assets usage
- \$2.4 for million IT shared services

EMC - \$5.0 million (total)

- \$3.2 million for guarantee fees
- \$1.6 million for RRT procurement & load validation and settlement

EDI - \$1.9 million (total)

- \$1.4 million for service requests (i.e. meter read)
- \$0.4 million for administration and accounting services

City of Edmonton - \$1.0 million (total)

- \$1.0 million for cash processing and postage

During 2005, EEI recovered \$18.9 million for services that it provided to its affiliates. Recoveries of non-energy related services were \$16.2 million. This included fee for service recoveries of \$1.0 million from EMC, \$2.8 million from EDI for access to EEI systems of records, \$7.3 million from the City of Edmonton Waste and Drainage Departments and \$5.1 million from EPCOR Water Services Inc. for billing and customer related services.

A main focus of the audit work in this section was to test the effectiveness of the internal controls and procedures related to the transactions carried out in accordance with the SLAs. In addition, the completeness and accuracy of, and support for, these inter-affiliate operating transactions were tested for the year ended December 31, 2005.

The following is a summary of the significant audit procedures undertaken.

- EUB Decisions and other related regulatory requirements were identified, reviewed and built into the audit tests.
- Financial information regarding Directive 014 requirements (Application numbers 1478147 (EEAI) and 1478148 (EEI) were reviewed and built into the audit test.
- The key components, procedures, control points, issues, and risks associated with the inter-affiliate transactions process were identified, and reviewed to determine whether related procedures and controls were adequate, and tested 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.
- SLAs were reviewed to determine whether they covered all of the services that were provided and whether they had been properly approved.
- SLAs supporting services to and from EEI and various affiliates were cross-referenced to Table 8 of the EES 2005-2006 RRT Non Energy Charge Application.
- A sample of inter-affiliate transactions was selected, and tests were 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.

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

Operations and Maintenance Processes

During 2005, EES incurred \$94.0 million of O&M expenditures, of which \$41.1 million were allocated to the provision of RRT services. The actual expenditures recorded were managed based on EES's budgeted expenditures, which also formed the basis of its 2005 – 2006 RRT Non-Energy Charge Application.

For operational efficiencies EPCOR manages and operates EEI and EEAI as a single entity, where possible. This single entity model is reflected in their accounting practices. When an expenditure is specific to either EEI or EEAI the cost is recorded against that particular entity. For the majority of expenditures the costs are recorded in a pooled activity account and are later allocated for reporting purposes through the use of a retail cost model (RCM). During the 2005 – 2006 RRT Non Energy Charge Application process the RCM was vetted. It was amended as

directed by the EUB and subsequently approved in Order U2006-213 when the revenue requirement for EES was approved.

A main focus of the audit work in this section was to test the effectiveness of the internal controls and procedures related to the transactions carried out in accordance with the O&M expenditure process. In addition, the audit tested the completeness and accuracy of, and support for, the O&M transactions during the year ended December 31, 2005.

EES's use of a single entity accounting model and of the RCM required detailed transactional level testing based on the \$94.0 million of expenditures. The detailed testing was followed by a review of the RCM, and EES's application of it to the 2005 actual expenditures.

The following is a summary of the significant audit procedures undertaken.

- EUB Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests.
- Financial information regarding Directive 014 requirements (Application numbers 1478147 (EEAI) and 1478148 (EEI) was reviewed and built into the audit test).
- The key components, procedures, control points issues and risks associated with the operations and maintenance transaction processes were identified and reviewed to identify whether related procedures and controls were adequate and tests were conducted to determine their effectiveness in practice.
- The procedures followed for authorizing, recording and processing the O&M transactions selected for the business cycle were reviewed in detail.
- A sample of O&M transactions for the year ending December 31, 2005 was selected and tests were carried out to verify that the selected items were
 - complete, properly supported and accurate,
 - recorded in the correct entity and time period,
 - properly authorized, and
 - in accordance with with regulatory requirements.

The resulting conclusion was that EES has effective processes for controlling the regulated O&M processes and related transactions, and that the transactions selected were complete and accurate, properly authorized and supported, and were in accordance with regulatory requirements.

Principal Audit Findings and Conclusion

Overall, the financial and operational controls over the selected key activities of EES were found to be effective. The related transactions were checked for compliance to the EUB Decisions and Regulations and were found to be in accordance with regulatory requirements.

We would like to thank the management and staff of EES for the cooperation and assistance given during the audit, by taking the time to provide the audit team with explanations and answers to our questions and queries.