

Memorandum

TO: Chairman's Executive Committee

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

DATE: July 27, 2007

RE: REGULATORY AUDIT REPORT – ATCO GAS

Please find attached the audit report arising from the recently completed regulatory audit of ATCO Gas, as well as management's response to the audit report.

The Audit Team determined that ATCO Gas had effective processes for controlling Deferral and Reserve Accounts, and Operations, Maintenance and General Expenditure processes. In addition, transactions reviewed for these processes were complete, accurate, properly supported, timely, and in accordance with applicable regulatory requirements in all material respects.

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

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



Darcy Mazurkewich

cc: Bob Heggie, Executive Manager, Utilities Branch
Brian Bale, Vice President, Controller, ATCO Gas.



July 26, 2007

Mr. Darcy Mazurkewich
Head, Audit and Compliance Group
Alberta Energy and Utilities Board
640 – 5th Avenue S.W.
Calgary, Alberta
T2P 3G4

Dear Mr. Mazurkewich:

RE: Deferral and Reserve Accounts and Operations, Maintenance and General Expenses for the Year Ended December 31st, 2006

We have reviewed the draft audit report of your findings and agree with the information and conclusions contained therein.

ATCO Gas is pleased that the audit findings confirm our strong commitment to ensuring our compliance with the regulatory process re: deferral and reserve accounts, and to maintaining high quality and effective financial and operational processes and internal controls while adhering with regulatory requirements.

We would like to thank you for accommodating our internal schedules and express our appreciation for the professionalism of the AEUB Audit Team throughout this process.

Sincerely,

A handwritten signature in black ink that reads "B.R. Bale".

Brian R. Bale
Vice-President, Controller

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ATCO Gas

Regulatory Audit of Deferral & Reserve Accounts and Operations, Maintenance and General Expenses for the Year Ended December 31, 2006

July 2007

Audit Team:

Darcy Mazurkewich
Nick Iannone
Joel Thompson

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2007-003: ATCO Gas
Regulatory Audit of Deferral & Reserve Accounts and Operations,
Maintenance & General Expenses

July 2007

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Background:

ATCO Gas, a division of ATCO Gas and Pipelines Ltd., is a member of the ATCO Group of Companies. ATCO Gas provides natural gas distribution services in Alberta to approximately 970,000 customers in nearly 300 communities. Its two service territories, ATCO Gas North, serving customers living in, and north of, the City of Red Deer, and ATCO Gas South, serving customers living south of the City of Red Deer, cover approximately 85% of the province. ATCO Gas owns and operates approximately 36,000 kilometres of pipeline throughout Alberta.

Objectives and Scope

The overall objective of the audit by the Utilities Branch of the Alberta Energy and Utilities Board (EUB) was to review ATCO Gas' financial and operational controls over two key activities: the development and operation of deferral and reserve accounts, and accounting for operations, maintenance and general (O&M) expenses.

The scope of the audit included a review of procedures used by ATCO Gas related to the provision of financial information necessary for compliance with the regulatory process. The audit procedures included the examination of samples of transactions of the key components of each of the selected activities for the year ended December 31, 2006. The audit also followed up on the findings of the previous EUB audit of ATCO Gas (Utility Audit Report 2005-007). The audit resulted in this report which expresses an opinion on the effectiveness of ATCO Gas' system of internal controls and procedures with respect to the key activities reviewed and whether ATCO Gas has managed the particular accounts concerned in conformance with regulatory requirements.

The Audit Team carried out the field assignment between April 23, 2007 and May 18, 2007 at ATCO Gas' Corporate Office in Edmonton. A meeting was held with ATCO Gas' Financial Management team on the final day of the assignment to discuss the results of the field work.

Deferral and Reserve Accounts

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 and reserve accounts are the main mechanisms that are used to provide this protection in that they are used to reconcile approved forecasts with actual amounts incurred by the utility. Resulting variances are either charged or refunded to customers accordingly after application to the EUB for approval for disposition.

The EUB's practice has been to evaluate the use of deferral and reserve accounts 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 or reserve account are the materiality of the amounts 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.

ATCO Gas has a number of deferral accounts and reserves, some of which like the hearing cost reserve and the reserve for injuries and damages, have been in existence for a number of years and are included in the list below. Also in the list below are new deferral accounts that were approved by the EUB in ATCO Gas' 2005-2007 General Rate Application No. 1400690 (resulting in Decision 2006-004).

As at December 31, 2006, the balances in ATCO Gas' deferral and reserve accounts amounted to <\$1.0> million, which is significantly different from the December 31, 2005 balance of \$12.7 million. This is primarily because the EUB's approvals of one-time adjustments totaling <\$14.5> million in EUB Decision 2006-004. The one-time adjustments represent a form of true-up to the respective deferral and reserve account. The recovery from or refund to customers is made via a rate rider rather than through the revenue requirement process.

The deferral and reserve accounts at December 31, 2006 (stated in millions) are:

- \$ (0.4) Deferred Hearing Cost Reserve
- \$ (0.1) Reserve for Injuries and Damages
- \$ (0.1) Deferred Bad Debt Expense
- \$ (0.6) Deferred Utilities Consumer Advocate Costs
- \$ 0.2 Deferred Variable Pay Program

The one-time adjustments occurring in 2006 and approved by the EUB related to the above deferral and reserve accounts (stated in millions) are:

- \$ 8.8 Deferred Hearing Cost Reserve
- \$ (0.8) Reserve for Injuries and Damages
- \$ 1.4 Deferred Bad Debt Expense
- \$ 0.5 Deferred Utilities Consumer Advocate
- \$ 4.6 Production Abandonment Costs

The 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 and reserve accounts.

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 and reserve accounts were identified.
- Business process documents were reviewed and discussed with management to determine whether related procedures and controls were adequate.
- Continuity schedules were reviewed and analyzed for completeness and accuracy.
- The accounts were analyzed and reconciled to ATCO Gas management reports, financial statements and the annual operation and financial information filed with the EUB (Applications No. 1461727 and No. 1512338).

- Relevant EUB Decisions and Utility Cost Orders were reviewed and the related regulatory requirements and directives were identified and built into the audit tests.
- A sample of deferral and reserve account transactions for the audit period was selected, and tests were carried out to verify that the selected items were:
 - complete, properly supported and accurate,
 - recorded in the correct account and time period,
 - properly authorized, and
 - in accordance with regulatory requirements and directives.
- A review of the methodology and information used to derive the rate riders for the Deferred Company Owned Storage Account (DCOSA) and the Deferred Company Owned Production Account (DCOPA).

The resulting conclusion was that ATCO Gas has an effective process for controlling the transactions related to the deferral and reserve accounts, that such transactions were complete and accurate, properly authorized and supported, and that the deferral accounts and reserves were maintained in accordance with regulatory requirements and directives.

Operations, Maintenance and General Expenses

During 2006 ATCO Gas incurred O&M expenses of approximately \$257.5 million for the North and South service territories combined, which is up approximately 5.0% over the previous year. These expenses include a wide variety of costs which are necessary for the normal daily functioning of ATCO Gas' business. Included are expenses such as salaries, wages and benefits, contract labour, consultants' services, telecommunications, IT services, customer billing, corporate office costs, transmission, distribution, vehicle costs, odorant costs, general operating supplies and building and communications charges.

The total O&M expenses for the North and South service territories combined for 2006 can be classified into the following major categories (stated in millions).

- \$ 0.8 Production & Gathering
- \$ 0.4 Gas Management
- \$ 4.3 Underground Storage
- \$62.9 Transmission
- \$59.1 Distribution
- \$ 7.3 General
- \$ 4.9 Sales & Transportation Promotion
- \$39.6 Customer Accounting
- \$67.8 Administration & General
- \$10.4 One Time Recovery

Taking into consideration the EUB approved forecast and business requirements, the annual O&M target amounts are proposed and established by management through the Business Plan function. The annual Business Plan is established in September for the following year. In January of the current year the Business Plan is implemented as the forecast and is used to manage the Business according to the target objectives of the forecast.

During the current year the O&M transaction costs are incurred through the normal operations of the business and are reported and controlled through a system of management internal controls such as numbered transaction documents (e.g., Purchase Requisitions & Purchase Orders), expenditure authorization limits and transaction review and approval procedures, etc.

The O&M transactions are reported in the monthly reporting package which includes some reports that compare the actual expenses to the forecast amounts. The monthly results and variances are analyzed and discussed by management and they may make adjustments (if necessary) on the basis of the results and/or other relevant internal or external factors which impact the forecast or results. This quarterly reporting package is produced by the Operations and Finance groups. Management meetings are held where the operating results are analyzed, discussed, and adjustments are made, if necessary.

The following are the significant audit procedures undertaken.

- Relevant EUB Decisions and Orders were reviewed and the related regulatory requirements and directives were identified and built into the audit tests.
- The documented procedures and control matrices prepared for C-SOX Bill 198 outlining controls around the O&M transactions were reviewed and the results of the testing of the controls were reviewed and discussed with management.
- Risk control measures such as the authorization matrix for expenditure transactions, the reporting processes for areas such as Procurement, Accounts Payable, and Payroll which flow transactions into O&M were reviewed. These documents were prepared to comply with the regulatory requirements of C-Sox Bill 198 and outline the control processes of the reporting systems. The functioning of these controls and the results of prior audit assessments by the ATCO Gas Internal Audit Team were reviewed and discussed with management.
- The comparison of actual expenses recorded in the General Ledger to amounts in the approved EUB Forecast and Budget was checked for any unusual items and also to verify whether the O&M expenses were managed to the levels set by the budget.
- The indirect labour and overhead charge transactions, which were included in the audit sample were reviewed and checked for accuracy and completeness. Also the allocation method used for distributing these charges to the projects and cost centers was checked for accuracy.
- The accounts were analyzed and reconciled to ATCO Gas management reports, financial statements and the annual operation and financial information that is filed with the EUB. (Application No. 1512338).
- The key components, procedures, control points issues and risks associated with the O&M expenses were identified and reviewed to determine whether related procedures and controls were adequate and tests were conducted to determine their effectiveness.
- A sample of O&M transactions was selected from the transaction file provided by ATCO Gas Management 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 regulatory requirements.

The resulting conclusion was that ATCO Gas has effective processes for controlling its O&M expenses, and that the transactions selected were complete, accurate, properly authorized, supported, and in compliance with regulatory requirements.

Follow Up from Last Audit

During the last regulatory audit of ATCO Gas, the Audit Team made minor observations to which Management had responded to and committed to take specific action. During this audit, the EUB Audit Team met with representatives from Management to review whether those actions were taken and to assess the results of those actions.

Management provided evidence that they had taken the necessary steps and completed the committed action plans for the observations made in the previous audit.

The resulting conclusion was that ATCO Gas has appropriately addressed the observations raised in the last audit.

Principal Audit Findings and Overall Conclusion

Overall, the Audit Team found that the financial and operational controls over the selected activities of ATCO Gas were effective and that the transactions reviewed for compliance were in accordance with regulatory requirements in all material respects.

The Audit Team would like to express its appreciation to the management and staff for the cooperation and assistance given to us during the course of our audit.