

# Memorandum

**TO:** Chairman's Executive Committee

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

**DATE:** September 30, 2005

**RE: REGULATORY AUDIT REPORT – FORTISALBERTA INC.**

Attached is the audit report arising from the regulatory audit of FortisAlberta Inc. (Fortis) that we completed recently. Also attached is management's response to the audit report.

As noted in the report, we determined that Fortis had effective processes for controlling inter-affiliate transactions and the regulated customer billing process. In addition, transactions in these processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements. There were two significant observations arising from the audit, both of which dealt with improvements required to shared services agreements. These observations, together with management's responses, are outlined in Appendices 1 and 2 to the report.

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

If you have any comments about the attached, please give me a call at 7-2316.

*(original signed by)*

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Richard M. A. McCabe

Restricted Distribution:  
Bob Heggie, Utilities Branch  
James Harbilas, Vice President Operations, Finance & Chief Financial Officer,  
FortisAlberta Inc.



James Harbilas  
Chief Financial Officer

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September 30, 2005

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

Dear Mr. McCabe:

Re: Regulatory Audit of Inter-Affiliate Transactions and the Regulated Customer Billing Process for the 12-Month Period Ended December 31, 2004

Thank you for the opportunity to discuss your audit findings and observations during the closing meeting of this audit and for the opportunity to comment on the draft regulatory audit report. This letter provides our comments with respect to this audit and the draft final audit report. It is our understanding that this letter will be included with the final version of the audit report.

The management of FortisAlberta has reviewed the draft final audit report and we believe that the report is complete and accurately reflects the findings and observations as discussed at the closing meeting.

FortisAlberta would like to thank the Board and Board staff for accommodating the day-to-day operational commitments of FortisAlberta personnel during the audit period allowing for minimal disruption of normal business. The professionalism of your staff was appreciated.

If you have any further questions or concerns, I would be pleased to discuss them with you.

Sincerely,

**SIGNED BY JAMES HARBILAS**

on mailed original

James Harbilas C.A.  
Vice President Finance & Chief Financial Officer  
FortisAlberta



# FortisAlberta Inc.

## Regulatory Audit of Inter-Affiliate Transactions and the Regulated Customer Billing Process for the 12-Month Period Ended December 31, 2004

September 2005

**Audit Team:**

Richard McCabe  
Darcy Mazurkewich  
Nick Iannone

**ALBERTA ENERGY AND UTILITIES BOARD**  
Regulatory Audit Report #2005-005: FortisAlberta Inc.  
Regulatory Audit of Inter-Affiliate Transactions and  
the Regulated Customer Billing Process

September 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 two key activities of FortisAlberta Inc. (Fortis). The key activities that were the subject of this audit were the inter-affiliate transactions process and the regulated customer billing process.

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 Fortis 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 Fortis, as well as a review of Decisions arising from applications made to the EUB by Fortis during the two-year period ended December 31, 2004. During this period, Fortis and its predecessor company, Aquila Networks Canada (Alberta) Ltd. (Aquila), and in some cases, other related entities, were involved in a very significant number of applications before the EUB. These applications dealt with transmission cost deferral accounts, general rate applications, compliance filings, generic cost of capital, and the transfer of Aquila's interest to Fortis.

The Audit and Compliance group of the EUB's Utilities Branch carried out the assignment between August 3 and September 16, 2005. The closing meeting was held with management on September 16, 2005.

## Overview

Aquila Networks Canada (Alberta) Ltd. was incorporated under the laws of Alberta for the initial purpose of acquiring the distribution and retail operations of TransAlta Utilities Corporation, pursuant to an asset transfer agreement, which had an effective closing date of August 31, 2000. Effective January 1, 2001, Aquila disposed of its retail operations and related assets and began operating solely as an owner and operator of distribution assets. On May 31, 2004, all of the issued and outstanding shares of Aquila were acquired by a wholly-owned subsidiary of Fortis Inc. On June 1, 2004, the name of the distribution company was changed to FortisAlberta Inc.

Fortis owns and operates approximately 103,000 kilometres of distribution power lines in southern and central Alberta. Fortis provides electricity distribution services to more than 400,000 customers and its distribution system comprises about 60% of the low-voltage distribution system in Alberta. As a distribution company, Fortis does not invoice the customers

directly. Instead, it invoices the retail energy companies, who are responsible for the commodity portion of the monthly electricity bill to the customers, for the distribution and transmission portions of the monthly bills. In turn, Fortis is invoiced by the transmission administrator for the transmission services.

## **Audit Coverage**

### **Inter-Affiliate Transactions**

Fortis has received or provided a number of services from or to its parent and other related companies. During 2004, Fortis paid over \$2 million to related parties for operating services that it received. The costs that were charged to Fortis for the services that it received included costs for executive management services, information technology services, and parent company direct charges. In addition, during 2004, Fortis paid about \$8.8 million in interest charges to related companies for short- and long-term financing, all of which was repaid at the time of the transfer of the utility business from Aquila to Fortis.

Fortis also recovered more than \$7 million from affiliates for operating services that it had provided to them during 2004. The cost recoveries by Fortis for the services that it provided consisted of costs related to the provision of information technology services, meter shop services, costs of shared and directly assigned employees, and charges related to the joint use of assets.

One of the main objectives of the audit work in this section was to test the effectiveness of the controls and procedures related to inter-affiliate transactions. The other main objectives were to test the completeness and accuracy of, and support for, inter-affiliate 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 operating transactions were identified.
- The items that were identified 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 authorised; and were in accordance with regulatory requirements.

The audit conclusion was that, with the exception of the items noted in Appendices 1 and 2, Fortis has an effective process for controlling inter-affiliate transactions, and that inter-affiliate transactions were complete and accurate, properly authorised and supported, were priced appropriately, and were in accordance with regulatory requirements.

### **The Regulated Customer Billing Process**

Fortis, as a distribution company, is responsible for preparing and issuing a bill for all electricity delivery services that it provides to each customer site. These bills are issued to electricity retailers, which in turn bill both the delivery and commodity charges to the end-customer. In the twelve-month period ended December 31, 2004, Fortis billed on average just over 400,000 customer sites each month, with total transmission and distribution revenue of approximately \$384 million.

Billing at Fortis is done on a cycle basis. All customer sites are assigned to one of 20 cycles and bills are issued monthly for all customer sites within each cycle. Irrigation sites are an exception, as they are only billed twice a year. In 2004, the detailed billing transactions for each customer site that were generated during each of the billing cycles were bundled by retailer into monthly electronic files for distribution to the retailer. As a result, retailers may have billed the related charges to their customers four or more weeks after the amount of the bill was calculated by Fortis. As of July 2005, Fortis, in response to provincial regulations, shifted to a daily process of sending the electronic bill transaction files to retailers.

One of the main objectives of the audit work in this section was to test the effectiveness of the controls and procedures related to the three core billing processes, namely, the site management process, the meter data management process, and the tariff billing process. The other main objectives were to test the completeness and accuracy of, and support for, samples of billing outputs and inputs during the 12-month period to December 31, 2004.

Site management procedures reviewed included the sub-processes of creating the site data and maintaining the site records for energize status, changes of rates, contract changes, and retailer of record. Meter data management procedures reviewed included the sub-processes of collecting meter reads and validating those reads. Tariff billing procedures reviewed involved the sub-processes to prepare tariff bill charges, and invoice the related charges.

Audit scope was limited to the review and testing of tariff billing charges for the 12-month period ended December 31, 2004. No testing was done regarding the processes and transactions related to non-tariff charges or any charges for pre- or post-2004 usage.

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 regulated customer billing process were identified.
- The items that were identified were reviewed to determine whether related procedures and controls were adequate and tests were conducted to determine completeness, ownership, and timeliness.
- Alberta Regulations, EUB Decisions, and EUB Directives were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of tariff bill transactions was selected from all twelve months in the period. Tests were carried out to verify that the selected items were complete, properly

supported, accurate; were recorded in the correct time period, and were in accordance with regulatory requirements.

- A sample of transactions (e.g. de-energize completions) used as inputs to the customer billing process was selected, and tests were carried out to verify that the billing transactions generated and issued to retailers were consistent with the input information.

The audit conclusion was that Fortis has an effective process for controlling the regulated customer billing process, and that regulated customer billing transactions were complete, accurate, properly supported, generated on a timely basis, and were in accordance with regulatory requirements. Some minor observations were noted and brought to the attention of management, who provided a response, including an appropriate timetable for dealing with the matters noted. Suggestions were also made to management to help improve the effectiveness of the related procedures.

### **Principal Audit Findings and Overall Conclusion**

Appendices 1 and 2 contain details, including management's response, of two observations arising from the audit work that were considered to be significant enough that they warranted disclosure in this report. In addition, 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. Some suggestions were also made to management to help improve the effectiveness of the related procedures.

Despite the exceptions noted, overall, the financial and operational controls over the selected key activities of Fortis were effective and the related transactions were in accordance with regulatory requirements.

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

Auditee: <b>FortisAlberta Inc.</b> Audit Time Period: <b>January - December 2004</b>	Done By: Richard McCabe Management Response By: Response Date:
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## Appendix 1 - Shared Services Agreements

### Observations:

It was noted that services were being provided by Fortis Inc., the parent company, to FortisAlberta and by FortisAlberta to certain affiliates and vice versa, although formal, approved agreements outlining the terms and conditions under which such services would be provided had not been put in place. For example, during the period from June 1 to December 31, 2004, services costing about \$190,000 had been provided to FortisAlberta by its parent, Fortis Inc., while FortisAlberta had provided services costing about \$1 million to Newfoundland Power, an affiliate.

It was also noted that there was a formal, approved shared services agreement between FortisAlberta and FortisBC, an affiliate, which included standard provisions, such as the services to be provided, the related costs, invoicing and payment terms, termination provisions and a dispute resolution mechanism. However, the agreement did not contain notice provisions, outlining the name of contacts in the event of any queries regarding the agreement or the need to revise the agreement.

### Impacts:

There are risks associated with carrying out services on behalf of affiliates, particularly when there are no formal, approved service agreements in place to govern the rights and responsibilities of each party. For example, services may be provided without adequate compensation, there may be inappropriate delays in making payment, such that one entity finances the operations of the other, or revenues or expenses could be recorded in the wrong legal entity.

In addition, the absence of a notice provision may lead to delays in dealing with queries related to the operation of the agreement or in amending the agreement, if necessary.

### Recommendations:

It is recommended that management negotiate with affiliates to which it supplies services, or from which it receives services, and implement comprehensive shared services agreements that outline clearly the rights and responsibilities of each party to the agreements.

It is also recommended that management amend the existing shared services agreement with FortisBC to include a notice provision.

### Management Response:

Management will negotiate with its affiliates that it supplies services to, or receives services from, to implement a Services Agreement, but only where such services are material. Management will also work with FortisBC to amend the Shared Services Agreement to include a notice provision.

Auditee: <b>FortisAlberta Inc.</b> Audit Time Period: <b>January - December 2004</b>	Done By: Richard McCabe Management Response By: Response Date:
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### **Appendix 1 - Shared Services Agreements (continued)**

**Estimated Completion Date:**

We expect to have this completed by January 1, 2006.

Auditee: <b>FortisAlberta Inc.</b> Audit Time Period: <b>January - December 2004</b>	Done By: Richard McCabe Management Response By: Response Date:
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## Appendix 2 - Electrical Meter Verification Agreement

### Observations:

It was noted that FortisAlberta had two agreements with its affiliate, FortisBC. The first agreement is a comprehensive shared services agreement, which covers a significant number of services to be provided by FortisAlberta to its affiliate, including meter management services. However, there is also an agreement between these affiliates called the Electrical Meter Verification Agreement, which indicates in more detail the services to be provided for meter management purposes.

It appears that these two agreements cover the same items. It is noted that management has indicated that the latter agreement is the one that they are using to govern the relationship between the affiliates for the provision of meter management services.

It was noted that the Electrical Meter Verification Agreement has adequate invoicing provisions, but does not indicate when the associated payments are to be made. In addition, the agreement does not have a provision regarding how disputes will be resolved.

It was also noted that there was an inconsistency in the termination provisions for the two agreements. In the Shared Services Agreement, the termination provision is 30 days, while the provision for the Electrical Meter Verification Agreement is 90 days.

### Impacts:

The existence of two agreements with the same affiliate, governing the same services, but with different provisions, provides a potential for confusion to arise regarding the operation or the administration of the agreements.

The absence of a provision to resolve disputes may mean that if disputes occur, they are not resolved promptly or effectively.

### Recommendations:

It is recommended that management determine the appropriate agreement to be used for the provision of meter management services to FortisBC and amend or terminate the other agreement.

It is also recommended that, if the Electrical Meter Verification Agreement is selected, the agreement be strengthened by including a dispute resolution provision, and a provision outlining adequate payment terms, including an appropriate interest penalty in the event that payments are not made on time.

### Management Response:

Management has determined that the appropriate agreement regarding the provision of meter management services to FortisBC is the comprehensive Shared Services Agreement so that all

Auditee: <b>FortisAlberta Inc.</b> Audit Time Period: <b>January - December 2004</b>	Done By: Richard McCabe Management Response By: Response Date:
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### **Appendix 2 - Electrical Meter Verification Agreement (continued)**

shared services are governed by the same agreement. The Electrical Meter Verification Agreement will be terminated. This may necessitate changes to the Shared Services Agreement. We will work with FortisBC to accomplish this.

#### **Estimated Completion Date:**

We expect to have this completed by January 1, 2006.