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Memorandum

TO: Chairman's Executive Committee

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

DATE: May 11, 2006

RE: REGULATORY AUDIT REPORT – NOVA GAS TRANSMISSION LTD.

Attached is the audit report arising from the regulatory audit of NOVA Gas Transmission Ltd. that we recently completed. Also attached is management's response to the audit report.

As noted in the report, we determined that NOVA Gas Transmission Ltd. has effective processes for controlling the inter-affiliate transactions, capital projects and related capital expenditures. In addition, the transactions tested with respect to these processes were complete, accurate, properly authorized and supported, timely, and in accordance with applicable regulatory requirements. There were some 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 NOVA Gas Transmission Ltd. 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

cc: Bob Heggie, Executive Manager, Utilities Branch
Lee Hobbs, Controller, NOVA Gas Transmission Ltd.



May 5, 2006

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

Attention: Darcy Mazurkewich

Dear Mr. Mazurkewich

**RE: Nova Gas Transmission (NGTL)
Regulatory Audit of the Capital Project and Cost Management Process and
Inter-Affiliate Transactions**

NGTL has reviewed the draft audit report of your findings and agrees with the information and opinions stated therein. TransCanada is pleased that the audit opinions are reflective of its strong commitment to internal processes and controls.

TransCanada would also like to express its gratitude to the audit team for its professionalism in conducting the audit process while, at the same time, accommodating TransCanada's commitments to its internal work schedules and deadlines.

Should you have any questions or concerns, please contact me at (403) 920-2754.

Yours very truly,

Original signed by
Lee Hobbs
Controller
Nova Gas Transmission Ltd.



NOVA Gas Transmission Ltd.

Regulatory Audit of the Inter-Affiliate Transactions
and Capital Project and Cost Management Processes
for the 12-Month Period Ended December 31, 2005

April 2006

Audit Team:

Darcy Mazurkewich
Nick Iannone
Lorena Ziegler

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2006-002: NOVA Gas Transmission Ltd.
Regulatory Audit of Inter-affiliate Transactions and
Capital Project and Cost Management Processes

April 2006

Published by

Alberta Energy and Utilities Board
640 – 5 Avenue SW
Calgary, Alberta
T2P 3G4

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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 NOVA Gas Transmission Ltd. (NGTL). The key activities that were the subject of this audit were the inter-affiliate transactions, capital project management process, and capital cost management 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 procedures and controls over the key components of each process for the 12-month period ended December 31, 2005. 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 NGTL 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 NGTL, as well as a review of Decisions arising from applications made to the EUB by NGTL during the two-year period ended December 31, 2005. These applications dealt primarily with general rate applications issues, Affiliate Code of Conduct issues and revenue requirement issues.

The Audit and Compliance group of the EUB's Utilities Branch carried out the assignment between March 13th 2006 and April 7th 2006. The closing meeting was held with management on April 11, 2006.

Overview

NGTL, a wholly-owned subsidiary of TransCanada PipeLines Limited (TCPL), owns and operates an Alberta-wide natural gas transportation system ("the Alberta System"). The Alberta System collects and transports natural gas for use in Alberta and delivery to provincial boundary points for connection with TCPL's Canadian Mainline, BC System, the Foothills System and other pipelines for export to Eastern Canada and to the United States. The Alberta System at 23,339 km in length and with throughput volumes of 3,999 Bcf in 2005 is one of the largest carriers of natural gas in North America. In 2005, the Alberta System operating under the 2005-2007 Revenue Requirement Settlement had revenues of \$1.2 billion. The Alberta System is regulated by the EUB primarily under the provisions of the *Gas Utilities Act (Alberta)* (GUA) and the *Pipeline Act (Alberta)*. Under the GUA, the rates, tolls and other charges, and terms and conditions of service are subject to the approval of the EUB. In addition, major facilities are approved by the EUB before construction begins.

Audit Coverage

Inter-Affiliate Operating Transactions

TCPL is an integrated energy company with operations in two principal business segments: gas transmission and services, and power generation and marketing. The business operations of TCPL are performed in functional areas that provide integrated services to the various lines of business throughout the organization. Under this structure, NGTL does not have any employees. Rather, TCPL employees are assigned to provide the services required to operate NGTL. The costs of providing these services are allocated to NGTL in accordance with TCPL's Operating Cost Allocation policy. This policy is based on the principle of direct charging costs to lines of business where possible and allocating the remaining costs using appropriate allocation drivers. The Operating Cost Allocation policy was reviewed but not tested during this audit. Operating agreements where TransCanada as Operator is responsible for all the administration and operating services necessary to operate NGTL and its Affiliates will be subjected to a more extensive review during a future audit of NGTL's operations and maintenance transactions and processes.

This audit focused on agreements other than those mentioned above, namely agreements for the provision of transportation services, financial arrangements, gas balancing services and the purchase of electricity.

During 2005, NGTL paid approximately \$129 million to its parent and other related companies for services that it received. This amount included \$49 million for interest payments made to TCPL, \$69 million for gas transportation services provided by Foothills Pipe Lines (Alta.) Ltd., \$2 million for electricity purchased from TransCanada Energy Ltd., and \$9 million for gas transportation services provided by TransCanada Pipeline Ventures Limited Partnership (Ventures). Ventures is wholly-owned by NGTL, 99.99 % directly and the remaining 0.01 % through a wholly-owned subsidiary, TransCanada Pipeline Ventures Ltd.

During 2005, NGTL received \$1 million for gas balancing services that it had provided to TCPL.

The main objective 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 for the 12-month period ending December 31, 2005, 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.
- 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.

The audit conclusion was that NGTL has effective processes for controlling inter-affiliate operating transactions, and that inter-affiliate operating transactions were complete, accurate, properly authorized and supported, were priced appropriately, and were in accordance with regulatory requirements.

Capital Project Management Process

NGTL invested \$75 million on capital expenditures in 2005, which equaled the amount forecast by NGTL in its 2004 Annual Plan. The \$75 million was a relatively minor amount of expenditure in comparison to NGTL's Plant, Property and Equipment balance which exceeds \$4 billion. However, it is notable that in the 2005 Annual Plan which NGTL filed with the Applications Branch of the EUB, NGTL has forecasted 2006 capital expenditures to be \$165 million, which is over double the 2005 amount.

In 2005, NGTL managed approximately 400 projects, the large majority of which were for Capacity Capital (system growth projects). The remaining projects were for capital maintenance and general plant additions. The latter includes information technology, tools, buildings and leasehold improvements projects. During the audit period, roughly 75% of the projects were under \$100,000 in size, with a very small number of projects having expenditures in excess of \$1 million in 2005.

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 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 NGTL's Authorities and Spending Limits policy, 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 NGTL 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 Capital 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 for the 12-month period ending December 31, 2005.

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 the completed projects were transferred from construction work in progress to the appropriate in-service accounts in a timely manner and that AFUDC ceased to be applied as of the in-service date.

The audit conclusion was that NGTL has an effective process for controlling capital expenditure 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 NGTL were found to be effective and the related transactions examined 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 NGTL. Nevertheless, they made time to provide the audit team with explanations and answers to our queries. We thank the management and staff of NGTL for their valuable help and cooperation during the audit.