

Chapter 3

Section 3.07

Hydro One Inc.— Acquisition of Goods and Services

Background

As part of the reorganization of the former Ontario Hydro, Hydro One Inc. was created pursuant to the *Electricity Act, 1998* and incorporated under the *Business Corporations Act* on December 1, 1998. The principal business of Hydro One, which is wholly owned by the Province of Ontario, is the transmission and distribution of electricity to customers within Ontario.

Hydro One controls almost \$12 billion in total assets, which consist primarily of its transmission and distribution systems. The Corporation transmits electricity from generators through approximately 28,600 kilometres of high-voltage wires to Hydro One's distribution business, which distributes the electricity to Hydro One's customers through a network of 124,000 kilometres of low-voltage wires.

In 2005, Hydro One earned over \$4.4 billion dollars in revenue. Its costs totalled \$3.4 billion, \$2.1 billion of which was for the purchase of electricity to distribute to its customers. The remaining costs were for operations, maintenance, and administration (\$792 million) and for depreciation and amortization (\$487 million). Including the acquisition of capital assets and excluding employee sala-

ries and benefits, over \$800 million was spent by Hydro One on the procurement of goods and services in the 2005 calendar year.

Hydro One has contracted an outside service provider to perform the purchasing activity for the corporation, but local departments and individuals also do a significant amount of purchasing—\$163 million in 2005, or about 20% of total spending—using corporate charge cards.

Audit Objectives and Scope

This was the first value-for-money (VFM) audit conducted at Hydro One under the expanded mandate of the Office of the Auditor General of Ontario, which came into effect November 11, 2004. The expanded mandate allows us to conduct VFM audits of Crown-controlled corporations and subsidiaries of Crown-controlled corporations. We chose to examine procurement practices as a means of gaining a broad understanding of the overall expenditures and operations of Hydro One.

The objective of the audit was to assess whether the corporation had adequate systems and procedures in place to ensure that goods and services were acquired with due regard for value for money

and in compliance with corporate policies and sound business practices.

The scope of our audit included discussions with corporation staff, a review and analysis of documentation provided to us by the corporation, and research into the procurement practices and control of employee expenses in other public and private enterprises. The corporation's internal audit department had relatively recently conducted a number of audits on procurement, which we found very helpful in determining the scope and extent of our audit work in selected areas.

Our audit was performed in accordance with the standards for assurance engagements, encompassing value for money and compliance, established by the Canadian Institute of Chartered Accountants, and accordingly included such tests and other procedures as we considered necessary in the circumstances. The criteria used to conclude on our audit objective were discussed with, and agreed to, by Hydro One management and were related to systems, policies, and procedures that the corporation should have in place.

Summary

We found that Hydro One generally had adequate policies in place to help ensure that goods and services were acquired with due regard for value for money. However, systems and procedures were not adequate to ensure compliance with corporate policies. In 2004, Hydro One's internal audit department audited many aspects of the corporation's purchasing functions. For several key areas, internal audit concluded that internal controls needed to be improved, and we noted at the time of our audit that a number of internal control weaknesses remained to be addressed.

Some of our major concerns and observations were as follows:

- Hydro One's corporate policy encourages the establishment, through a competitive process, of blanket purchase orders (BPOs) for the procurement of goods or services directly from specified vendors for a stipulated period of time. However, the BPOs we examined were not always established through a competitive-procurement process, or there was inadequate documentation available to verify whether a competitive process was used. In addition, BPO suppliers increased their prices periodically without competition. For example, a BPO established in 1996 for a two-year term with an original value of \$120,000 had been revised 39 times, extended an additional eight years, and had been increased in value to \$6.7 million.
- Competitive selection of suppliers is required for all Hydro One purchases over \$6,000 unless a BPO arrangement has been made. We found that procedures needed to be improved to ensure that the required competitive process was followed in the acquisition of goods and services. In a number of the cases we tested, the required competitive-procurement process was not followed in the acquisition of general services, materials, or engineered equipment. In most of the exceptions noted, either acquisitions were made through an invitational, rather than a public, tender, or the required three quotes were not obtained.
- Hydro One's procurement policy allows goods or services to be purchased from a single vendor ("single-sourcing") if it is neither possible nor practical to obtain them through the normal competitive processes. However, most of the single-source purchases we examined were for materials, consulting services, and contract staff that could have been obtained from several different vendors. As well, the required documentation justifying the decision to

single-source was not on file for most of the single-source purchases we examined.

- For the contracts we tested, we found instances where the contract price did not agree to the submitted bid; the deliverables were not clearly described; and/or the contract price did not agree with the value on the purchase order. For example, one consultant bid \$2.7 million for a contract, and the contract was awarded for this amount, yet the purchase order was set at \$3 million. To enhance internal controls, such differences should be justified and clearly documented.
- In December 2001, Hydro One entered into a 10-year, \$1-billion agreement to outsource significant operations of the corporation. Under its master service agreement with its service provider, Hydro One can reduce the fees it pays the provider if benchmarking studies show that the provider is charging higher than fair market rates. Although a consultant's benchmarking report concluded that no adjustment to fees were required, the consultant examined only two of the six lines of business conducted by the service provider, and a more thorough review may have been warranted.
- During the 2005 calendar year, Hydro One purchased \$127 million worth of goods and services using corporate charge cards. We found that the documentation, such as charge-card slips that were submitted to support expenditures, was often insufficient to determine what was purchased. We also identified instances where employees had not detailed the use of cash advances received and charged to their corporate charge cards, yet the related monthly statements had been reviewed and approved.
- In 2005, Hydro One staff wrote almost 32,000 cheques on their charge-card accounts totaling \$41.2 million, with the largest charge-card

cheque being for just over \$300,000. These cheques were used to pay major vendors for services such as telephones, telecommunications, security, and utilities. In other organizations, such payments are generally processed through the finance department to ensure segregation of duties and other controls. We were informed that the issuance of charge-card cheques was to reduce the number of transactions processed by the outsourced finance department, since this department was paid on the basis of the number of transactions processed. However, since Hydro One pays interest on cheques and cash advances in excess of \$30 million, we questioned whether paying major vendors by cheque through the charge-card system actually results in any savings.

- In one case, a senior executive's secretary charged over \$50,000 to her charge card for goods and services, a significant portion of which was for the person to whom she reported. The senior executive then approved the purchases, whereas Hydro One's policies require that the executive's superior approve the expenses. This practice also exempts these expenditures from an annual review of senior executive expenses conducted by the Corporation's external auditor.

Detailed Audit Observations

PROCUREMENT OF GOODS AND SERVICES

Hydro One has good general policies for the acquisition of goods and services, such as its principle of acquiring materials and services without favouritism at the lowest overall cost. Also, according to Hydro One corporate policy, procurement decisions are to take into consideration supplier capability and past performance; all relevant factors affecting the life

cycle of the materials; the impact on the environment; and health and safety. Procurement decisions must also pass the ultimate scrutiny of sound business judgment. In addition to its general procurement principles, Hydro One has specific policies for the acquisition of general services, construction, materials, and engineered equipment.

The Supply Chain Management group within Hydro One is responsible for implementing, monitoring, and enforcing compliance with procurement policies and procedures. Procurement activity has been outsourced to an external service provider. The Supply Management Services department of that provider executes procurement on behalf of Hydro One, including such functions as ordering, receiving, and inspecting goods, as well as monitoring spending, verifying compliance with purchasing policy, and processing payments.

Needs Assessments and Justification for Purchases

Hydro One's purchasing guidelines require that a business case be prepared for all programs or projects that require the approval of a vice president. In general, these are valued at more than \$50,000, depending on the business department and the type of purchase. The guideline strongly recommends—but does not require—that business cases be prepared for expenditures under \$50,000. In the case of consulting services, which include contract staff or persons hired indirectly through temporary-help agencies, the rationale for hiring a consultant must be documented before the competitive process begins. The policy also states that all options for performing the work internally must be exhausted first.

Buyers from the Supply Management Services department of the outside service provider are provided with a checklist to use as a guide for each purchasing request, to determine if sufficient information has been provided before proceeding with

the purchase. However, through discussions with buyers, we found that documents justifying the purchase are not typically forwarded to the Supply Management Services department, so the buyer usually assumes that the person making the requisition has already prepared the proper justification document. Consequently, we followed up with persons making requisitions and found that for a number of the purchases we sampled, the need for the purchase was not documented or the documented justification was not adequate. Although Hydro One staff informed us that the needs had been documented for some of the exceptions we identified, the documentation could not be located.

We also found that justification of the need for contract staff was often not documented or the documented rationale was inadequate. In particular, the reasons provided often did not consider the availability of internal resources. Proper evaluation and documentation of staff requirements could help central management identify and meet training and hiring needs in a more cost-effective manner than engaging outside contracted services. In addition, for a few of the purchases we tested, the approval for justification was obtained after work commenced or after the effective date of the contract.

RECOMMENDATION 1

To help ensure that corporate needs are adequately assessed and that purchases are properly justified prior to acquisition, Hydro One should:

- follow the requirements for a documented business case for major purchases;
- verify that sufficient information has been provided to supply-management buyers; and
- adequately evaluate corporate needs, including consideration of alternatives and existing resources, prior to proceeding with the acquisition.

Blanket Purchase Orders

Hydro One's corporate policy encourages the establishment of blanket purchase orders (BPOs) for the procurement of goods or services directly from specified vendors. The expected benefits of BPOs are lower procurement costs, security of supply, and the managed inventory of more commonly used items. Such arrangements are to be for a stipulated period of time and are to be entered into through a competitive process with at least one new supplier being qualified to bid each time the BPO is competitively renewed.

At the time of our audit, Hydro One had established over 1,000 BPOs for materials, contract staff, and consulting services. According to information from Hydro One's database, these BPOs ranged in value up to \$250 million, and many were in effect for more than 10 years. Although BPOs typically have a stated maximum value, approximately one-quarter of the BPOs had no stated maximum. We were informed that purchases against these BPOs are usually low-dollar items purchased on corporate charge cards. In addition, over 700 BPOs had changes made to their original maximum values, effective terms, or both. Ten percent of the BPOs had had their original terms extended by at least five years and an equal number had had their maximum values increased by at least \$1 million.

We noted that several of the BPOs we examined either were not established through a competitive procurement process or did not have adequate documentation available to indicate that a competitive process had been used. In view of the hundreds of millions of dollars of business given through BPOs, we believe it is essential that documented competitive practices be followed if Hydro One is to demonstrate adherence to its procurement principle to acquire materials and services without favouritism at the lowest overall cost.

BPO suppliers were also being allowed to increase their prices periodically without competitive pricing reviews or price negotiations. For exam-

ple, a BPO established in 1996 for the supply of assorted parts originally had a two-year term and a value of \$120,000. It had been revised 39 times, extended an additional eight years, and increased in value to \$6.7 million. We reviewed prices paid for recent purchases and found that Hydro One was paying current prices quoted by the vendor. To continually revise a BPO over a long period of time is equivalent to purchasing from a single vendor, which is contrary to Hydro One's policy of acquiring, where practical, competitive proposals or tenders for its purchases to maintain the integrity and transparency of the procurement process.

RECOMMENDATION 2

To ensure that goods and services are acquired at the lowest overall cost, Hydro One should:

- establish blanket-purchase-order agreements through a competitive process unless a sound documented rationale for sole-sourcing has been approved;
- review existing long-standing blanket purchase orders to determine if they should be re-tendered;
- ensure that the prices being paid are those set out in the blanket-purchase-order agreements; and
- develop procedures regarding significant modifications to the terms and conditions of blanket purchase orders.

Competitive Selection

Corporate policy requires the competitive selection of suppliers for all Hydro One purchases over \$6,000 unless a BPO arrangement has been made. The competitive process used depends on the type of goods or services being acquired and the estimated cost of the purchase. In general, lower-valued procurements require three written quotes from selected vendors, while purchases of greater

value require a more open tendering process. We reviewed a sample of purchases and found that controls were not adequate to ensure compliance with procurement policies. For example:

- Three written quotes must be obtained for all purchases valued from \$6,000 to \$15,000. These purchases are typically acquired locally by departments using corporate charge cards. For the sample tested, 20% did not obtain any quotes, and for an additional 20% there was no supporting documentation to confirm management's assertion that the required quotes had been obtained.
- For consulting services, including contract staff, the required competitive-procurement process was not followed in 40% of the cases sampled, with most of the exceptions being sole-sourced. In addition, we found cases in which the justification for selecting the vendor was not adequately documented. For example, a vendor that bid over \$400,000 for a consulting contract was chosen even though that vendor did not have the lowest qualified bid. We were informed that the vendor was selected based on the results of an interview; however, the evaluation of the interview process and results were not documented.
- When acquiring general services, materials or engineered equipment, the required competitive procurement process is to request written quotations using a bidders list for purchases up to \$50,000; conduct a private request for tender for purchases between \$50,000 and \$1 million; and conduct a public tender for purchases greater than \$1 million. For these purchases, the required competitive procurement method was not followed in several of the cases tested. In most of the exceptions, either the acquisitions were made through a private or invitational, rather than a public, tender or the required three quotes were not obtained.

In September 2004, Hydro One's internal audit department identified similar issues of non-compliance with competitive procurement policies; yet, as of the time of our audit, our work indicated that these weaknesses had not yet been corrected.

RECOMMENDATION 3

To help ensure that it is getting value for money and that purchases are acquired through an open, fair and competitive process, Hydro One should follow established procurement policies and guidelines, and adequately document decisions made in the selection of vendors.

Single Sourcing

Hydro One's procurement policy allows single sourcing, which is the purchase of goods and services from vendors without a competitive process, up to a value of \$6,000. If the value of the procurement exceeds that amount, single sourcing of goods and services is allowed only if it is neither possible nor practical to obtain the required goods or services through the normal competitive processes. In such circumstances, the reason for single sourcing must be documented and approved by Hydro One's internal Supply Chain Management group before a vendor is approached.

Corporate policy outlines potential single sourcing as situations in which the supplier may be the only one in the market, may hold legal rights to the required goods, or may be the original supplier of equipment and the buyer wishes to avoid expensive modifications to adapt goods of a different design. However, the single-source purchases we examined were for materials, consulting services, and contract staff that could have been obtained from several different vendors. As well, most of the single-source purchases we examined, which ranged from \$6,200 to \$4.3 million, did not

have the required documentation justifying and/or approving them.

We also noted purchases in which only some goods or services were acquired through a tender and the rest were single-sourced. For example, after a tendering process, a contract was established with a consulting firm to conduct a benchmarking study on outsourced IT services. Before the finalization of the contract, Hydro One also single-sourced additional work from the same firm: a benchmarking study for customer service operations for a total of \$583,000. Adequate justification for single sourcing had not been documented.

In September 2004, Hydro One's internal audit group concluded that single-source procurement was not always being justified by a business case and approved prior to the awarding of the business. Based on our work, improvements are still needed in this area.

RECOMMENDATION 4

To ensure that single sourcing is used only when it is not possible or practical to go through the normal competitive process, Hydro One should implement oversight procedures to ensure that adequate justification for single sourcing is documented and properly approved before the business is awarded.

Managing and Controlling the Purchases of Goods and Services

When an organization makes significant purchases of goods and services, all parties involved normally sign documents to specify the deliverables to be provided, formally define their respective responsibilities, outline contract terms, and set pricing. Such documents could include formal contracts, signed purchase orders, and vendor bid submissions. For some of the purchases we tested, either

there were no formal contracts outlining purchasing arrangements or there was no evidence of other signed documents indicating that both parties agreed with the terms, pricing, and deliverables outlined in the purchase order.

Where formal contracts existed, we found instances where the contract price did not agree with the submitted bid; the deliverables were not clearly described; and/or the contract price did not agree with the price on the purchase order. For example, one consultant bid \$2.7 million on a contract, and the contract was awarded for this amount, yet the purchase order was set at \$3 million. To enhance internal controls, any differences between bid submissions, deliverables, contract price, and/or purchase orders should be justified and adequately documented.

We also found problems similar to those noted for blanket purchase orders where changes were made to existing contractual arrangements. We identified a number of cases in which the overall value of a contract or purchase order had increased from its original value over the term of the contract. In several of such cases that we reviewed, the justification for the increase was not documented. There were also several cases where either the change was not properly approved or there was no documentation showing that proper approvals had been obtained.

Hydro One's corporate policies and procedures require a buyer to determine if sufficient information has been provided before proceeding with a purchase request, and to maintain all relevant information in a purchase-order file. However, for a majority of the files we reviewed, relevant information was not on file. Missing documentation included tendering documents, evaluations, bids received, signed contracts, business cases, and approvals. In 2004, an internal audit on the acquisition of consulting services concluded that purchase-order files were generally incomplete. Our

work indicated that progress still needs to be made in this area.

Hydro One's policy requires that the work of consultants and contract staff be evaluated upon completion of the assignment. Post-performance evaluations were not conducted for many of the consultant- and contract-staff engagements we tested. There was also no central registry to maintain information on vendors' performance for future reference by all departments throughout the corporation.

RECOMMENDATION 5

To properly manage and control the procurement of goods and services, Hydro One should:

- ensure that it has signed contracts or other documentation that define the responsibilities of both parties, including the price and specific deliverables to be provided;
- ensure that purchase orders and contracts accurately reflect the agreed-upon terms and conditions under which the contract was awarded;
- ensure that any changes to the original contract terms and conditions are adequately justified, appropriately approved, and properly documented;
- identify the minimum documentation that is essential for each purchase and put in place a monitoring process to ensure that purchasing files are consistently maintained with all required information; and
- evaluate all vendors upon completion of work, as required, and examine the costs and benefits of setting up a central depository of information about vendors' performance for use throughout the corporation.

Procurement and Payment Approval

In accordance with Hydro One's corporate policy, all procurement activities should be made in compliance with the corporation's authority register, which outlines the signing-authority limits of different management positions. Authority to requisition goods and services resides with line staff within the corporation. Purchasing authority in excess of \$15,000 has been delegated to the outside service provider's Supply Management Services department. Both requisitioning and purchasing authority must be obtained prior to issuance of the purchase order or awarding of business to vendors.

We found that Hydro One's signing authority register caused confusion that resulted in the inappropriate authorization of purchases. Signing-authority limits are set according to position, but our discussions indicated that because there is little consistency in job titles in various parts of the organization, it was often unclear to staff what an individual's authority limit should be. In addition, the authority limits specified in the accounts-payable system occasionally did not agree with the established register. Hydro One's internal audit department reported similar findings in September 2004 in its report on Controls over Signing Authorities. During our audit, we were informed that a new authority register was being developed that may address the concerns that have been identified.

For a number of the purchases tested, we found that either the acquisition did not have the proper requisitioning or purchasing authority or no approval documents could be provided to show whether proper approvals had been obtained. We also noted that payments were made without the proper level of approval for several of the purchases tested.

For the purchases we tested, we noted instances where Hydro One either did not take advantage of early payment discounts or incurred penalties for late payments.

RECOMMENDATION 6

To help ensure that purchases of goods and services are properly authorized and that the appropriate amounts are paid, Hydro One should:

- complete the development of its authority register to clarify signing authority requirements;
- reinforce the requirement that Supply Management Services staff have all required approvals on hand before proceeding with the purchase; and
- make payments on a timely basis to avoid late charges and take advantage of early payment discounts.

Management of Outsourcing Agreement

In December 2001, Hydro One entered into a 10-year, \$1-billion agreement to outsource significant operations of the corporation, namely, six lines of business: customer-service operations, supply-management services (procurement staff), human resources, information technology, finance (accounts payable and receivable), and settlements (management of payments for and reports on purchased power).

We reviewed various aspects of the management of the outsourcing agreement and noted the following:

- Under the master service agreement, Hydro One can perform benchmarking studies to assess the reasonableness of costs in the last calendar quarter of the third, sixth, and ninth years of the agreement. Two of the six outsourced lines of business were benchmarked after the third year. We were informed that these two lines of business accounted for approximately 60% of the total base service fees under the master ser-

vice agreement. According to the agreement, if the service provider's fees are found to be higher than fair market rates, they can be reduced. A consultant was engaged by Hydro One and the service provider to complete the benchmarking study, and the consultant found that, for the lines of business reviewed, the service provider's fees were at the midpoint of comparable fees in the marketplace. We were informed that the consultant reviewed only two lines of business because consultants with sufficient baseline data and expertise were not available for the other four lines of business. Nevertheless, given the magnitude of the outsourcing contract, a more thorough review may have been warranted.

- Hydro One is entitled to service credits when certain service failures, such as computer-service interruption, occur. Performance indicators have been established for each outsourced line of business, which are to be used to gauge when a service failure has occurred. We reviewed the most serious service failures since inception of the contract and noted that, although Hydro One recovered \$100,000 in out-of-pocket expenditures from the service provider, it had not calculated the potential value of forgone service credits or fully pursued the financial remedies it was entitled to. Using the service-credit formula, we estimated that Hydro One had not pursued over \$300,000 in financial remedies.
- Hydro One is not reconciling monthly summary billing reports from the service provider to the amounts recorded in the general ledger and paid to the vendor. The amount expensed through the general ledger for 2005 was \$13 million higher than the amount shown on the monthly summary reports and \$24 million higher than in 2004. Since senior management advised us that they use these summaries to track the costs of the contract to

compare against the budget, we would have expected these differences to be reconciled. Reconciling these reports from the service provider on a monthly basis would provide Hydro One with the assurance that both the expenses recorded in its accounts and the amounts reported by the service provider are accurate.

- The service provider was guaranteed information technology (IT) work each year beyond that related to the base fees in the agreement. From the start of the contract on March 1, 2002, to December 31, 2005, \$53 million in additional IT project work was guaranteed. For Hydro One's remaining IT requirements, the service provider was involved in identifying potential projects, conducting needs assessments, identifying deliverables, determining required resources, and estimating project costs. Corporate policy requires that Hydro One must ensure that no supplier has an unfair advantage over its competitors through pre-tender discussions intended to develop the scope of the procurement. At the time of our audit, the service provider had been awarded \$61 million in IT work over and above the amount guaranteed under the outsourcing agreement. The additional project work should have gone through an open, fair, and competitive procurement process; yet only \$12 million worth was competitively tendered. The other \$49 million was single-sourced. We acknowledge that the experience and the expertise of the service provider may put it in the best position to deliver additional IT services. However, by not holding open competitions for such a significant amount of additional project work, Hydro One has not adhered to the intent of its policy of awarding business without favouritism and with assurance that the business is

being awarded at the lowest overall cost in a fair, open, and competitive manner.

RECOMMENDATION 7

To help ensure that it is receiving the best value for the \$1 billion it is spending on its 10-year outsourcing agreement, Hydro One should:

- consider benchmarking all outsourced lines of business in future benchmarking studies;
- collect service credits it is entitled to;
- reconcile summary reports from the service provider with the amounts recorded as expenses in the general ledger on a monthly basis; and
- tender significant information technology projects in accordance with corporate policy.

CORPORATE-CARD PURCHASES

During the calendar year 2005, Hydro One purchased \$163 million worth of goods and services using two different charge-card programs: corporate charge cards (\$127 million) and fleet cards (\$36 million). Corporate charge cards are intended to be used for employee business expenses and local procurement of items costing less than \$15,000.

Corporate policy states that the charge card is a payment mechanism only and that, regardless of the type of procurement method used or the method of payment, all purchasing activities must comply with Hydro One's policies and procedures, which provide mandatory requirements and guidelines for decision-making with respect to procurement.

Business units may also set up corporate charge cards for other types of spending. In 2005, over 322,000 purchases were made with 5,100 corporate charge cards, each of which is assigned to a specific employee. The fleet card is used to purchase fuel and pay maintenance and repair costs for corporate-owned and leased vehicles. A unique

card is issued for each vehicle. In 2005, there were 5,500 fleet cards.

Some corporate charge cards give the holder special privileges, such as the ability to obtain cash advances or to write cheques. Cash advances are to be used for out-of-pocket expenses, such as for parking, mileage reimbursement, and purchases at fast-food restaurants. The employee would then file business expense receipts in support of the cash advance taken.

At the time of our audit, 47% of the corporate cardholders' accounts had cash advance privileges and 25% allowed for the writing of cheques. Corporate-card transactions processed in the year can be broken down as illustrated in Figure 1.

Administration of Corporate Charge Cards

To obtain a corporate charge card, an employee must complete an application form for management approval and sign a document agreeing to comply with the terms and conditions that govern the use of the corporate card. Our testing of a sample of charge cards issued in 2005 revealed that, overall, charge cards were issued in accordance with company policy. However, we did note a number of issues related to the administration of charge cards:

- Twenty-seven local charge-card co-ordinators are the only persons with the authority to contact the bank on an ongoing basis regarding administrative issues for the corporate-card program. These issues include setting up cardholder accounts, cancelling cards, and changing credit limits or address information. We noted that proper documentation, signed by the department manager, to initially set up local charge-card co-ordinators with the bank was not completed in 50% of the cases tested, and, in most instances, instructions to set up local charge-card co-ordinators came directly from the individuals themselves rather than their superiors.

Figure 1: Hydro One Corporate Charge-card Transactions in 2005

Source of data: Hydro One

Type of Transaction	# (000 s)	Amount (\$ million)	% of Total
vendor purchases	278	82	64
charge-card cheques	32	41	33
cash advances	12	4	3
Total	322	127	100

- Hydro One's policy regarding the cancellation of corporate charge-card accounts requires that the reason for cancelling an account be documented, as well as whether the card was recovered and destroyed. Only half of the sample we tested had documented a reason why the account needed to be cancelled, and only half indicated whether the card had been recovered and destroyed. In addition, as of January 2006, 148 cards had been inactive for more than 12 months; almost 100 of these had been inactive for more than two years. Some cards had not been used for over five years. One-third of the inactive cards had monthly credit limits of at least \$10,000. Corporate charge cards issued to individuals but intended for specific projects were not being cancelled upon an employee's termination, and cards were not being promptly cancelled for persons on long-term disability.
- Each corporate charge card is set with a monthly credit limit and cash advance limit. We tested increases made to charge-card limits in 2005 for a sample of cardholders and found that, overall, changes were justified and properly approved. However, corporate policy requires that monthly limits be established that are consistent with the requirements and responsibilities of the applicant's position and the intended use of the charge card. We found that for both credit and cash-advance privileges, the limits were often set significantly

higher than actual usage. For example, in one case, an employee's corporate-charge-card limit was \$2 million per month. Overall, 40% of cardholders spent less in a year than their monthly limit, indicating that their limits may be excessive.

RECOMMENDATION 8

To improve administration and control over the corporate-charge-card program, Hydro One should:

- ensure that proper documentation and approvals are obtained for setting up local charge-card co-ordinators;
- follow up on and, if necessary, cancel inactive charge cards and active cards that are assigned to terminated and inactive employees; and
- review current credit and cash-advance limits placed on corporate charge cards to ensure that the limits are reasonable given the individual's responsibilities and the intended use of the card.

Review of Monthly Statements

On a monthly basis, cardholders are required to submit their charge-card statements with supporting documentation to their superior for review and approval. Supervisory staff are responsible for scrutinizing the statements and the accompanying support to ensure that charges incurred are for legitimate business expenditures. A supervisor may be the only party aside from the purchaser to review the transactions, making supervisory review a critical internal control for ensuring that purchases are made for business-related purposes in compliance with policy.

- We reviewed the monthly charge-card statements for a sample of cardholders and found that over 75% of the statements tested had

not been reviewed and approved within 28 days as required by corporate policy. We noted statements that had not been reviewed and approved for up to nine months after the statement date.

- The monthly statements submitted to supervisors are to include a reconciliation of cash advances on the charge card with cash used. If the entire advance is not spent on business expenditures, the remainder is to be carried forward and applied to future business expenses. During our testing, we noted that Hydro One staff often did not use standard cash-use reports or complete the form correctly, making it unclear whether the employee owed money to the company or vice versa. We identified employees in our sample who had not accounted for cash advances taken on their charge cards, and yet their cash-use reports had been reviewed and approved. For example, one employee had not detailed the expenditure of \$2,200 in cash advances over a six-month period in 2005. Subsequent follow-up revealed that these advances were for legitimate business purposes. Nevertheless, given that almost half of all cards allow cash advances and given the higher risk associated with such transactions, a thorough and timely review and approval process is crucial.
- We found that supervisors did not adequately scrutinize corporate charge-card expenditures. For the sample we tested, there were a number of instances in which proper supporting documentation was not submitted to substantiate purchases, or the documentation submitted was incomplete, and yet the statements had been approved. For example, some cardholders did not submit receipts for all expenditures or submitted inadequate receipts, such as signed charge-card slips that did not itemize purchases. Without such information, supervisors may not be able to determine whether

all charges were appropriate and incurred for business purposes.

- Hydro One’s charge-card policy also requires that all expenses be supported by a detailed explanation as to the nature and business purpose of the expense. For hospitality expenses, this would include the names of participants and the purpose of the event. We found that many of the cardholders tested who were claiming business meals did not disclose with whom they had had these meals or the organization the individuals were representing; therefore, a reviewer would not be able to determine with certainty if the expenses charged were legitimate business expenses.

In 2004, Hydro One’s internal audit group reported on the lack of receipts and inadequate documentation to support charge-card purchases and made recommendations for corrective action. Our observations suggest that improvements are still necessary to ensure compliance with corporate-card policies and procedures.

RECOMMENDATION 9

To effectively manage the use of corporate charge cards and to ensure that all expenditures are incurred for business purposes, Hydro One should implement procedures to ensure that:

- cardholders submit original detailed receipts with their charge-card statements for review and approval;
- necessary explanations and other supporting information are provided to verify the business nature of expenses incurred;
- cash-advance expenditures are detailed and accompanied by supporting documentation to facilitate management review and approval; and
- monthly charge-card statements are reviewed for adequacy of supporting receipts and approved on a timely basis.

Monitoring Corporate Charge Cards

On a monthly basis, Hydro One management is required to review summary-level departmental control reports to ensure that all cardholders are valid employees; that statements have been submitted for approval each month; that credit limits reflect the current needs of cardholders; and that expenditures have been charged to the appropriate project and/or general ledger account. Timely monitoring and corrective action is important because the use of the corporate charge cards has made it difficult to apply the traditional financial controls, such as segregation of duties, since one person can requisition, purchase, and receive goods and services. However, we found that these monthly reports were not being adequately reviewed and, therefore, corrective action was not being taken on a timely basis. Only one of the departments we reviewed had monthly reports that were properly approved and dated. For the other departments, some reports had no evidence of review and had not been signed or dated. In fact, some staff told us they did not know the reports were supposed to be signed and dated.

Each corporate charge card is designed to automatically record purchases against a particular general ledger account and/or project. This eliminates the need to do journal entries to reallocate the charges. However, a large number of charge-card purchases were booked to miscellaneous accounts that do not adequately describe the nature of the expense. For example, all of the expenses charged to one project, totalling \$4.1 million, were categorized as “miscellaneous.” In 2005, over \$18 million was booked to an account called “business expenses procurement card.” Hydro One staff informed us that even though expenditures charged to projects can be broken down to more specific expenditure types, the data cannot be analyzed across projects. In other words, Hydro One cannot determine the total amount it spent in 2005 for categories such as

travel, meals, and conferences. Without this detail, such corporate-wide expenditures cannot be monitored over time for reasonableness.

Hydro One's Employee Listing Report highlights cardholders with invalid or missing employee ID numbers. These discrepancies are forwarded to local charge-card coordinators on a monthly basis for follow-up and correction. Timely correction of discrepancies helps to ensure that all cards are valid and assigned to *bona fide* employees. However, we noted that one-third of the discrepancies identified in the January 2006 report had not been corrected by the end of March 2006.

RECOMMENDATION 10

To effectively monitor corporate charge-card usage, Hydro One should implement procedures to ensure that:

- management reviews and signs off on monthly charge-card departmental summary-level and exception reports to ensure that any items requiring follow-up are identified and addressed in a timely manner; and
- purchases made through corporate charge cards are fully allocated to projects and general ledger accounts so that project costs and expense accounts can be monitored over time for reasonableness.

Use of Corporate Charge Cards

According to Hydro One corporate policy, cardholders can issue cheques against their charge-card accounts to reimburse subordinates for their business expenses, where individuals have not been issued a corporate charge card of their own, and to pay vendors that do not accept credit. In 2005, 1,300 staff wrote a total of 31,800 cheques totalling \$41.2 million, with the largest charge-card cheque being for just over \$300,000.

If payments are made by cheques written against charge-card accounts, the name of the payee does not

appear on the charge-card statement or in the corporate charge-card database. Therefore, Hydro One has no record of payments to such vendors unless the payee information is manually entered into the system after the cancelled cheques are returned to the corporation. For 2005 transactions, Hydro One staff started to manually input payee detail information into the system for analysis—but as of May 2006, the inputting had not been completed.

Many of the corporate charge-card cheques were for over \$15,000 and were used to pay major vendors for services such as telephones, telecommunications, security, utilities, and vehicle leases. In other organizations, such payments are generally processed through the finance department, to ensure segregation of duties and other internal controls. In 2005, Hydro One processed 530 purchases that exceeded the \$15,000 limit, for a total of \$33.5 million. These purchases were either charged to the cards directly or paid with cheques written against the charge cards. We noted that some of these payments were made to consultants even though corporate policy states that consultants are not to be paid with corporate charge cards.

Hydro One management informed us that using charge cards helps to reduce reliance on the outsourced finance department, eliminate late payment fees, and reduce costs under an outsourcing agreement in which the Corporation pays the service provider according to the volume of invoices processed.

We analyzed charge card usage to determine if it was cost-effective. We found that, if the combined value of cash advances and cheques exceeds \$30 million annually, Hydro One incurs interest charges on the excess amount from the date of the transaction to the payment date. Our estimate suggests that, in 2005, Hydro One did not achieve any savings by using charge-card cheques rather than paying vendors through the accounts payable system under the terms of its outsourcing agreement. By comparison, the government of Ontario also uses charge cards but limits the cards use to small-dollar

transactions, with large-dollar charges being paid through the regular accounts payable system.

RECOMMENDATION 11

To ensure that corporate charge cards are used only for the purposes intended, namely employee business expenses and local purchases less than \$15,000, Hydro One should:

- minimize the use of charge-card cheques; and
- use the finance department to process large payments to major vendors.

Business Expenses and Employee Recognition

Hydro One policy states that employee business expenses should be “reasonable under the circumstances.” Although there were no guidelines regarding purchases for staff recognition and appreciation, we noted that it was common practice at Hydro One to purchase gifts for such purposes. Gifts purchased were in the form of gift certificates, flowers, bottles of wine, recreational activities, dinner theatres, and music CDs. There was often no documentation for gift purchases to indicate who was being recognized or for what reason. We acknowledge that, from time to time, purchases for staff recognition and appreciation may be well justified. However, given the diverse nature of the items purchased and the wide-ranging amounts spent, we believe there is need for corporate guidance in this area.

We found examples in which employee business expenses such as accommodation and meals did not seem to be reasonable in the circumstances. We also noted several cases where excessive mileage was claimed, usually due to not claiming the lesser of the distance from home or office to the work site as required by corporate policy.

We also noted items charged to corporate charge cards that we would have expected to be questioned as part of the review-and-approval process. For example, two senior executives charged medical examinations to their corporate charge cards instead of submitting them to the corporate insurance plan for reimbursement. One employee was using his corporate charge card to pay for physiotherapy that should have been covered by the company’s health insurance plan. Another employee charged \$900 to replace personal items, such as music CDs, that were lost when a company vehicle was stolen.

In one situation, expenses were being charged to a subordinate’s charge card and then approved by the person for whom the purchases were intended. In this case, a senior executive’s secretary charged over \$50,000 to her charge card for goods and services, a significant portion of which was for the person to whom she reported. These items should have been approved by her superior’s boss and, in accordance with policy, should have been subject to the annual review of all senior executive expenses conducted by the corporation’s external auditor. Each year the external auditor carries out specific procedures on charge-card statements and supporting documentation for senior executives and reports to the board of directors. Although the auditor has reported some non-compliance with corporate-card policy on the issues of documentation and authorization requirements, the auditor does not provide assurance that the charges were reasonable, that they were incurred for business purposes, or that the expenditures reviewed for the individuals were complete.

RECOMMENDATION 12

To help ensure that business expenses and employee recognition expenditures are in accordance with corporate policy and are reasonable under the circumstances, Hydro One should:

- develop guidelines to establish corporate expectations regarding the reasonableness of expenditures under various circumstances;
- reinforce the obligation for management to thoroughly review expense claims prior to approval; and
- implement a more comprehensive process to periodically review expense claims for compliance with corporate policy.

Monitoring of Fleet Charge Cards

On June 15, 2004, Hydro One signed an agreement with a service provider for the provision of fleet-management services, including the tracking of vehicle maintenance and repairs and fuel costs. The service provider pays third-party mechanics for repairs and maintenance on company-owned and leased vehicles, and then bills Hydro One for these costs. The service provider maintains a database with the service history for each vehicle. Information is entered into the service provider's system and is accessible to Hydro One via an online connection.

Each month, Hydro One receives two statements from the service provider: one for fuel costs and one for vehicle-maintenance costs. The state-

ments provide the total dollar amount charged to each fleet card. Each of the 5,500 fleet cards, which are used to pay for maintenance, repairs, and fuel for corporate-owned and leased vehicles, represents one vehicle. The fleet manager is responsible for reviewing and approving the statements prior to payment. In order to verify the accuracy of the amounts being billed each month, the fleet manager informed us that he spot-checks 15 to 20 items from the monthly statements by conducting a high-level review of fuel and maintenance charges, discussing the request for repair with the staff who authorized it, and viewing the vehicle's service history. However, there was no record of which items were spot-checked or what verification was actually done, and the small sample selected may not be sufficient to verify the accuracy of the \$3 million spent monthly using fleet cards.

RECOMMENDATION 13

In order to ensure that it is being billed the correct amount for authorized repairs, service maintenance, and fuel costs, Hydro One should:

- consider a more rigorous verification of the monthly fleet-card billings; and
- retain adequate documentation associated with the verification of monthly billings.

HYDRO ONE INC. RESPONSE

We appreciate the recommendations made in the Auditor General's report and the recognition that our policies are adequate to ensure that goods and services were acquired with due regard for value for money. The recommendations are generally reasonable and for the most part in accordance with existing Hydro One policies. Management has been in the process of implementing various policies and procedures to strengthen controls and address previous internal audit findings. These actions address many of the concerns and recommendations identified.

Recommendation 1

Management recognizes that the purchase-order files may not include all supporting documentation, although the information was generally available elsewhere within the corporation. A process was implemented in May 2006 to review all purchase-order files (including all 2006 files and 2005 major vendor files) for completeness.

Recommendation 2

A process for renewing and reducing the extension of blanket purchase orders was under way

in May 2006 to ensure the commodity is taken to market in a rational manner that does not jeopardize our source of continuing supply. The remaining aspects of the recommendation are part of the renewal process.

Recommendation 3

We agree with the recommendation and have strengthened policies to ensure the application of the competitive process in all situations. Although current policy was not followed in the examples provided, the process was consistent with the policy or practice in place at the time of purchase.

Recommendation 4

Management agrees.

Recommendation 5

In addition to the review of purchase files noted under Recommendation 1 above, management will also consider whether, in our circumstances, any benefit would be obtained from preparing a vendor evaluation and, if so, consider the benefits and costs of maintaining a central repository for the evaluations.

Recommendation 6

As discussed under Recommendation 1 above, a process was implemented in May 2006 to review all purchasing files for completeness.

The new authority register is in the final stages of implementation. It will also enable the automation of our approval controls.

To eliminate the few instances where payments have not been timely, management will re-emphasize the importance of making payments on time to avoid late-payment penalties and to obtain any early-payment discounts.

Recommendation 7

Due to the lack of comparables, management was able to benchmark only two lines of businesses. Our expectation is that, as outsourcing

grows, we may be able to find comparables for the remaining businesses.

Since the service provider exhibited outstanding efforts in correcting the issue raised in the audit, management exercised its business judgment to forgo the credits in this particular instance. Management recovered from the service provider all incremental costs incurred as a result of this issue.

A detailed review of the contract is completed monthly. A governance structure has been implemented around the contract such that management is comfortable that effective controls are in place.

The legacy information-technology systems are highly customized in-house systems. It was anticipated from the outset that a high volume of project work would be done by the service provider, since the required knowledge workers would reside there. The service provider's project rate card compares favourably with other tier 1 service providers, based on recent competitively bid projects. As the corporation moves to a standardized architecture, we will rely less on the service provider. This process is under way.

Recommendation 8

A process has been implemented requiring all local charge-card co-ordinators to be approved by the corporate charge-card co-ordinator.

Management agrees that all cards for terminated employees should be cancelled on a timely basis. On a monthly basis, a control report identifying any charge cards assigned to an inactive employee number is reviewed. Current procedures require that supervisors regularly confirm the ongoing need for inactive cards. A process will be introduced to cancel inactive cards once they expire.

Management agrees that credit and cash-advance limits should be reviewed on a regular

basis. We will reinstitute a sample compliance audit and periodically review the continuing need for all high-dollar limits.

Recommendations 9 and 10

Management will re-emphasize to employees the importance of complying with the procedures. To assess compliance, management will reinstitute sample compliance audits, which were temporarily suspended in 2005. The results of these audits will be reviewed with the appropriate divisional Vice-President.

In the future, management will require that both the cash advance and matching expense be shown on the summary cash-use report to facilitate review by the supervisor. Supporting documentation will continue to be attached.

Current policy requires that all expense claims have adequate documentation, and management will reinforce this requirement.

Recommendation 11

Management agrees that the use of corporate charge-card cheques should be limited to either exceptional circumstances or reimbursement of employee business expenses where

the employee has not been issued a Hydro One credit card. An email was issued by our Chief Financial Officer in April 2006 to emphasize the appropriate use of corporate credit-card cheques.

Current procedure specifically identifies the acceptable use of corporate charge cards. To strengthen controls, management will introduce an ongoing sample audit program for expenditures over \$6,000 to review, assess, and report compliance with this procedure.

Recommendation 12

Management agrees that expenditures should be reviewed for reasonableness. Current procedures, including the local purchasing policies and procedures, require such a review. Management will reinforce the obligation of supervisors to thoroughly review expense claims prior to approval.

Recommendation 13

Management agrees and will expand the size of the sample from the monthly statements that is spot-checked to 100 items and will retain the documentation.