

Chapter 4

Section 4.07

Hydro One Inc.—Acquisition of Goods and Services

Follow-up on VFM Section 3.07, *2006 Annual Report*

Background

Hydro One Inc. was created following the reorganization of Ontario Hydro, pursuant to the *Electricity Act, 1998*, and incorporated under the *Business Corporations Act* on December 1, 1998. Wholly owned by the province of Ontario, Hydro One has as its principal business the transmission and distribution of electricity to customers in Ontario.

In 2007, Hydro One controlled \$12.8 billion in total assets (\$12 billion in 2005), consisting primarily of its transmission and distribution systems. It earned \$4.7 billion in revenue (\$4.4 billion in 2005), while its total costs were \$3.8 billion (\$3.4 billion in 2005). These costs included \$2.2 billion (\$2.1 billion in 2005) for the purchase of electricity to distribute to its customers, \$995 million (\$792 million in 2005) for operations, maintenance, and administration, and \$521 million (\$487 million in 2005) for depreciation and amortization.

Our 2006 audit focused on Hydro One's spending on goods and services, including its acquisition of capital assets but excluding employee salaries and benefits. This spending totalled more than \$800 million in the 2005 calendar year. Once a purchase decision has been made by Hydro One staff, an outside service provider performs the

purchasing activities on Hydro One's behalf. In-house departments and individuals also do a significant amount of buying (using corporate charge cards)—\$163 million in 2005, or about 20% of total spending.

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, its systems and procedures were not adequate to ensure compliance with corporate policies. In 2004, Hydro One's internal audit department examined many aspects of the corporation's purchasing functions and concluded that, in several key areas, internal controls needed to be improved. 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 had not always been established through a competitive procurement process, or had no documentation available to verify that a competitive process had been used. In

addition, in a number of cases we tested, BPO suppliers were being allowed to increase 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 increased in value to \$6.7 million.

- Competitive selection of suppliers is required for all Hydro One purchases over \$6,000 where no BPO arrangement exists. We found that procedures needed to be improved to ensure that the required competitive process was followed in the acquisition of goods and services.
- Hydro One’s procurement policy allows goods and 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, many of the single-source purchases for materials, consulting services, and contract staff that we examined could have been obtained from several different vendors, and there was no supporting documentation on file justifying the single-source decisions.
- 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 the service provider, Hydro One can reduce the fees it pays the provider if benchmarking studies show that the provider is charging more than fair market rates. Although a consultant’s benchmarking report concluded that no adjustment to the fees was required, the consultant had examined only two of six lines of business conducted by the service provider.
- During the 2005 calendar year, Hydro One purchased \$127 million worth of goods and services using corporate charge cards. We found instances where the documentation, such as charge-card slips, submitted in support of expenditures was often insufficient to

determine what was purchased. We also identified instances where monthly statements had been reviewed and approved even though employees had not provided details about the use of cash advances received and charged to their corporate charge cards.

- A senior executive’s secretary charged over \$50,000 to her charge card, of which a significant portion was on behalf of that executive. The senior executive approved the transactions, whereas Hydro One’s policies required that executives’ superiors approve executive credit-card expenses.

We made a number of recommendations for improvement and received commitments from Hydro One that it would take action to respond to the issues we raised.

Current Status of Recommendations

Information we obtained from Hydro One suggests substantial progress was made in addressing all of the recommendations in our *2006 Annual Report*. As well, Hydro One has initiated internal compliance reviews in most areas to ensure that all staff are complying with its strengthened procedures. The current status of action taken on each of our recommendations is as follows.

PROCUREMENT OF GOODS AND SERVICES

Needs Assessment and Justification for Purchases

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.

Current Status

Hydro One informed us that it reinforced the requirement to produce a documented business case for major purchases. One memorandum was sent to all Hydro One staff regarding revisions to procurement policies and procedures. Another, to all line managers, reiterated the requirement to have on file a documented business case for all major purchases, and emphasized the requirement for proper objective evidence to show that a purchase was properly justified and approved.

Hydro One initiated a quarterly internal compliance audit to test whether a sample of purchase-order files contain the necessary documentation. We were informed that, commencing in April 2008, the frequency of compliance audits was temporarily increased to monthly from quarterly, providing management with more current information to encourage speedier implementation of any necessary remedial action. The purchase-file checklist was revised to include all relevant purchase-justification documents. Results of compliance audits are summarized in compliance scorecards and presented for review to the Vice President of Supply Chain Services, the Executive Vice President and Chief Financial Officer, and Outsourced Supply Services Management, who then address any non-compliance issues. We were also informed that these compliance results are discussed regularly with Hydro One's President at executive meetings.

The corporate policy on consultants and the corporate procedure for retention of consultants have been revised to include requirements to:

- evaluate and document the rationale for hiring contract staff before a contract is awarded; and

- exhaust all options to have the work performed internally before retaining contract help.

Blanket Purchase Orders

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.

Current Status

We were informed that Hydro One reinforced the requirement that all blanket purchase orders (BPOs) be established using a competitive process unless single sourcing has been properly approved. Memoranda have been sent to all Hydro One staff highlighting changes in the procurement procedures. One of these memoranda states that goods and services should be procured through an auditable and competitive process open to qualified vendors, unless circumstances dictate consideration of single sourcing. The procurement procedure includes specific guidelines as to when single sourcing may be considered.

Hydro One also indicated that, in 2006, it put in place a new BPO renewal plan to track and monitor BPOs expiring any time up to December 2007. Procurement managers analyzed and determined whether each BPO should be renewed, extended, or allowed to expire and/or be retendered. Team leads were then required to follow the plan with monthly

updates. We understand that this new BPO renewal plan is being maintained on an ongoing basis and reviewed on a monthly basis with Hydro One Supply Chain Services.

A memorandum was issued to all Hydro One staff reinforcing line-manager responsibility to ensure that the corporate procurement policy is followed for all purchases. This policy requires that the pricing of BPO agreements be monitored to ensure that all invoices and price changes are in accordance with established terms. Quarterly (and, temporarily, monthly) internal-compliance audits monitor adherence to the policy. In addition, any significant changes to the BPO terms and conditions require appropriate approvals. The procedure further states that adding an item to a BPO without competition requires approval equivalent to that for a single-source agreement.

Competitive Selection

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.

Current Status

Hydro One advised us that a memorandum was issued to all its employees emphasizing that management expects compliance with all policies and procedures. A separate communication was issued to explain that it is the responsibility of line managers to ensure that the corporate procurement policy and organizational authority registers are followed for all purchases. This communication also highlighted the expectation that goods and services should be procured through an auditable and competitive process unless business circumstances dictate the use of an alternative process. Documentation of the competitive process is to be retained by

the buyer for all purchases in excess of \$15,000 and consulting work in excess of \$50,000.

Single Sourcing

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 purchase is made.

Current Status

We were informed that Hydro One employees received clarification regarding the requirements for single-source purchases. A memorandum was also issued that outlined the changes made to the procurement procedures. According to the amendments, single-source approval must be sought from the Manager of Supply Chain Management for purchases of goods and services with an estimated value of more than \$15,000, or consulting services worth more than \$50,000. We were also informed that Hydro One has developed a process to ensure that adequate justification and appropriate approvals for single sourcing are documented in accordance with the policy. The single-source-procurement approval form includes a section for justification of the single-source purchase and, to help ensure compliance, requires the signatures of the requisitioning line of business and one of the following: Supply Chain Management, the Executive Vice President and Chief Financial Officer, President and Chief Executive Officer, or Executive Committee, as specified by the applicable organizational-authority register or the executive-authority register.

Managing and Controlling the Purchases of Goods and Services

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.

Current Status

Hydro One advised us that, subsequent to our audit in 2006, it commenced a review to ensure the completeness of documentation as required by the revised procurement procedure. According to the revised procurement procedure, purchase-order and supporting contract files must accurately document the agreed-upon terms and conditions under which the contract was awarded. Any changes to the original contract terms and conditions must be adequately justified, appropriately approved, and properly documented. Hydro One now maintains a purchase-order file-documentation checklist outlining the documentation requirement for each purchase-order file.

To monitor compliance with procurement requirements, Hydro One implemented a process in May 2006 to review all purchase-order files prior to closing the file. In addition, quarterly (and, temporarily, monthly) sample compliance tests (compliance audits) are performed to help ensure

that all purchase-order files contain the necessary documentation. We reviewed the most recent quarterly compliance report, issued in March 2008, and noted that over 80% compliance was achieved for the documentation attributes tested by Hydro One's internal compliance team. The audit report made a number of recommendations for further improvement. It should be noted that the monthly audit report issued in June 2008 found 96% compliance for the five key documentation attributes reported to the Board of Directors:

- appropriate authorizations for purchase orders;
- requirements met for single sourcing;
- vendor-selection justification completed and approved;
- evidence that advertised vendor selection was completed and approved; and
- bid evaluations completed and documented.

The procedure for retention of consultants has been revised to provide the purchaser with a template form to evaluate the performance of a vendor. An evaluation co-ordinator is to review reports for all completed and outstanding evaluations on a weekly basis and follow up on overdue evaluations on a monthly basis to ensure that they are completed. The completed form is to be sent to Supply Chain Management, which acts as an interim central repository. A database for tracking performance evaluations for consultants and contractors was developed and, as of October 2007, contractor and consultant engagements were included in the database. The completed evaluations are stored in the database and will become available to other requisitioners for future reference.

Procurement and Payment Approval

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.

Current Status

Hydro One informed us that a new authority register has been developed and completed to clarify signing-authority requirements. Organizational-authority registers provide specific instructions on the level of authority for each procurement type, classified mainly by dollar value. Training sessions were also provided to staff regarding the organizational-authority registers. All staff that request, order, or approve transactions related to the purchase of goods and services, projects, or programs were to attend the sessions.

Hydro One also revised its policy to clarify signing-authority requirements in cases where more than one employee is involved. Now the most senior person associated with the expenditure must have it approved by his or her superior. Hydro One indicated it sent a memorandum to all employees reinforcing the requirement for compliance with the revised procurement policy and procedure, and further emphasizing that compliance will be monitored through quarterly compliance audits.

Hydro One also advised us it sent all employees a communication stressing the importance of making payments on time or early to obtain early-payment discounts, and of avoiding late-payment penalties. In May 2007, and again in March 2008, Hydro One performed reviews of a sample of invoices for late charges and found that they were not significant and did not justify a permanent change to the system to track them. However, we were informed that an annual review similar to the ones previously conducted will be performed to ensure that late-payment charges do not escalate.

Management of Outsourcing Agreement

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.

Current Status

In November 2007, Hydro One engaged a consulting company to benchmark all six lines of business performed by its outsourced service provider. The purpose of the engagement was to provide Hydro One with an independent assessment of the extent to which the services from the outsourced service provider were being delivered at a price no greater than fair market value as defined by the service agreement between Hydro One and the service provider. Staff are working with the consultant to deliver a detailed report to company management that would also be used to make any necessary pricing adjustments in accordance with the terms of the outsourcing agreement.

We were informed that Hydro One closely monitored service-level failures by the supply management services department of the outside service provider and did obtain certain service credits for 2007. At the time of our follow-up, it was exercising its legal entitlements to obtain service credits to which it is entitled.

Hydro One also indicated that a process has been implemented to reconcile the summary reports to the general ledger on a monthly basis. Differences between the monthly summary report and general ledger are analyzed and explained in the reconciliation.

Hydro One indicated that there must be competitive bids for all information-technology

projects, except in cases where advance approval was granted to buy from a single source. We were also advised that Hydro One has communicated and will enforce the requirement that single-sourced information-technology projects awarded to the outsourced service provider must be fully compliant with its single-source policies. Also, for the outsourced service provider, Hydro One developed a detailed five-stage contracting process that the requisitioner and contract management must follow and which provides details about how each party should be performing, and what each should be doing, at every stage of the contracting process. The five stages are:

- determining technical requirements;
- bid solicitation;
- bid evaluation;
- service delivery; and
- post-contract evaluation.

CORPORATE-CARD PURCHASES

Administration of Corporate Charge Cards

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.

Current Status

We were informed that a process has been implemented requiring all local charge-card co-ordinators to be approved by the corporate charge-card co-ordinator. The corporate co-ordinator forwards the authorized forms to the corporate-charge-card administrator, who ensures that proper documenta-

tion and approval has been obtained before the local co-ordinator is set up in the system.

Hydro One introduced a process to review—and cancel, if necessary—inactive cards and active cards assigned to inactive or terminated employees. Hydro One's administrative procedure requires the bank to cancel any card where there has been no financial or account activity for one year. We were informed by Hydro One that as of February 2008, these cancelled cards cannot be reactivated, and cancelled cards that expire cannot be reissued. We were informed that each month, Hydro One downloads employee-listing information from the bank and validates it against its own human-resources database. Any inconsistency is brought to the attention of the local charge-card co-ordinator for corrective action. The corporate-charge-card co-ordinator monitors this report on a monthly basis and follows up on recurring instances as appropriate.

In 2007, Hydro One initiated a process to generate a quarterly report for each line of business that analyses charge-card spending patterns for the previous 12 months. The reports examine the difference between credit limits and actual spending, and are provided to the management of each line of business for review. Any necessary adjustments to credit limits are sent to the local charge-card co-ordinator for processing.

Review of Monthly Statements

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.*

Current Status

Current policy requires all expense claims to be adequately documented. Management has reinforced this requirement in a communication to all employees that emphasized the importance of complying with the corporate charge-card policy. The memorandum also reiterated that all expense claims must be adequately justified and include complete supporting documentation, and that summary cash-use reports must show both the cash advance and matching expenses to facilitate review by the supervisor.

More specifically, all expenditures on the charge-card statement must be supported by a receipt or invoice. In addition, all cash withdrawals must be supported by a cash-use form and all cheques must be supported with a copy of the cheque, along with original related documentation.

The memorandum also outlined the obligation of supervisors to review thoroughly all expense claims prior to approval to ensure that they meet all procedural requirements and that they relate to valid and reasonable business expenses. New policy changes require that all charge-card statements must be approved within 60 days of the statement date.

Monitoring Corporate Charge Cards

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.*

Current Status

We were informed that Hydro One implemented a process in which the corporate-charge-card coordinator follows up on any discrepancies appearing on the employee listing report for two consecutive months, and retains the explanations regarding any exceptions. On a monthly basis, supervisors are required to review and approve the current month's report and advise the local charge-card coordinator of any errors, or of changes required.

We have also been advised that management has emphasized to employees the importance of allocating credit-card charges to either a project or the appropriate general-ledger account. Further, quarterly spending reports have been generated for management review for each line of business, providing total credit-card expenditures for a given quarter by type of expenditure.

To assess compliance, Hydro One reinstated the compliance audits that had previously been suspended. These compliance audits will be performed quarterly—although at the time of our follow-up review they were being done on a monthly basis—with findings reported to the vice president of the applicable line of business as well as the Executive Vice President and Chief Financial Officer and the President and Chief Executive Officer for review.

Use of Corporate Charge Cards

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.*

Current Status

Hydro One indicated that an email was issued by the Chief Financial Officer in April 2006 to all employees regarding the use of corporate charge cards. Hydro One has reinforced the policy that charge-card cheque-writing should be limited to either exceptional circumstances or to reimbursement of business expenses of an employee who does not have a Hydro One credit card. In the rare circumstances that a vendor has not been set up to accept credit cards, invoices with accompanying approvals can be sent to accounts payable for payment processing. However, if a payment is required immediately, charge-card cheques can be used but supporting documentation must be included in the monthly expense report. Further, we were advised that an audit process was introduced to review all cheques over \$15,000 for compliance with corporate policy.

Business Expenses and Employee Recognition

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.*

Current Status

Hydro One developed guidelines regarding acceptable and unacceptable expenditures under various circumstances. The guidelines also outline the

responsibilities of employees, supervisors, and the Hydro One accounts-payable department. Hydro One indicated that these guidelines have been implemented, communicated to employees, and will be enforced.

Hydro One also sent a communication to employees regarding business expenses and the management and use of corporate charge cards. This communication reinforces the obligations of supervisors to thoroughly review expense claims to ensure compliance with all procedural requirements and to ensure that all expenses are valid, reasonable in the circumstances, and business-related.

Hydro One also reinstated a previously suspended sample testing process regarding compliance with procurement policies and procedures for single sourcing, the use of consultants, employee business expenses, and the management and use of corporate charge cards. These audits, done every month on a temporary basis, will eventually move to a quarterly schedule. The results are communicated to the divisional vice president for action where required, and to the Executive Vice President and Chief Financial Officer (CFO) and the President and Chief Executive Officer (CEO) for review.

Hydro One implemented a process to monitor the documentation and authorization requirements for expenses incurred by the Chair of the Board, the CEO, the CFO, and the General Counsel by engaging an external auditor to examine compliance. Hydro One revised the policy on employee business expenses to include in the review the expense reports of the administrative assistants reporting to senior executives. The revised policy also requires that the executive's superior approve the expenses of the executive's administrative assistant.

Monitoring of Fleet Charge Card

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.*

Current Status

We were advised that sample verification of monthly fleet-card billings has been increased to 100 transactions. Fleet staff are also required to request 25 invoices from vendors directly to ensure billing accuracy. Further, fleet management performs random checks of various transactions

on a weekly basis to ensure that the Hydro One employee who approved the transaction has the appropriate level of authority.

According to Hydro One, to help ensure compliance, the fleet-asset manager reviews and signs off on each transaction verified by fleet staff. He or she also signs off on the cover sheet for the month as evidence of his or her review. The manager of fleet operations also signs off on these processes on a quarterly basis.