

Delivering value during times of change

To achieve high performance, chief audit executives must seize opportunities and meet increasing demands

December 2010

*Utilities and Power
Generation Industry*

At a glance

Our most recent survey of utility company internal audit teams reveals a growing emphasis on risk assessment.

Construction, energy trading, environmental issues and regulatory compliance are areas to be included in today's internal audit plan.

Effective assessment of utility company risks requires a process that is linked to management's strategic objectives and business requirements.

Introduction

Internal audit organizations are directing their focus and skills to help utilities and power companies face new and complex risks brought about by sweeping change. As a result, many utility company internal audit teams are laying the groundwork for redefining a higher value scope of work.

Change ushers in risk for today's utilities and power companies

The utilities and power generation industry is in the spotlight as companies, governments, and consumers face risks posed by commodity price volatility, security and privacy, environmental impacts, and critical infrastructure needs to modernize and meet regulatory requirements for reliability while maintaining a reasonable cost to customers.

Meanwhile, as the global economy struggles to stabilize, chief executive officers are focused on balancing risk with new growth opportunities and the enhancement of information technology (IT). For internal audit (IA) organizations, it's an environment clouded with uncertainty but ripe with profound opportunities to grow in stature by building strong alliances with management and the audit committee.

Because risk increases during times of sweeping change, power and utility company leaders are increasingly relying

on their IA departments to apprise them of risk and to help them make sure strategic business decisions are executed effectively. Most corporations acknowledge that an internal audit function, with the visibility and a mandate that cuts across the entire organization, has the necessary vantage point to help the company address the significant challenges and risks it faces. And utility companies are no exception. Most of their chief audit executives (CAE) are proactively taking steps to further coordinate various risk and compliance functions to provide more holistic risk assurance.

Results from PwC's Utilities 2010 CAE Survey—our fifth annual report that assimilates and analyzes data from utilities across North America—support what we heard at our roundtable event in October 2010 in Houston. Today's utility company IA leaders view energy trading and risk management, construction, environmental issues,

regulatory compliance and asset management, IT, maintenance, and safety as areas of risk that should be included in their audit plans.

Other risk areas included in internal audit plans are automated metering infrastructure (AMI)/smart grid; government grant compliance; green house gas regulations and reporting; and the convergence of US generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS).

Faced with these complex and diverse challenges, IA departments are pressured as never before to deliver value to their stakeholders. It's not surprising that CAEs continue to reduce their Sarbanes-Oxley financial reporting compliance efforts and concentrate more of their resources on operational and strategic concerns.

Utilities and power companies face new risks

Nearly all respondents to our most recent CAE survey said they cover construction or other major capital improvement projects. Additionally, 88% of respondents said their companies have significant ongoing or planned construction or other major capital projects in the works, and more than half of these projects are subject to reasonableness review by a regulatory agency. At PwC, we have seen a rise in the number of construction and major capital improvement internal audit projects. As the average age of the utility infrastructure increases and utility assets approach their useful life, companies must decide whether the asset will be upgraded or replaced. New projects may also be pending as companies consider how they will meet renewable energy and environmental standards. As a result, utilities are moving forward with significant capital investments in generation, transmission and distribution infrastructure, and related core information technology (IT) systems.

Also top of mind among utility IA groups is the risk associated with the implementation of AMI and smart grid initiatives within their organizations.

Of the 39% of respondents who said their companies are implementing an AMI or smart grid solution, most said it would result in changes to their IT and security environments. Nearly half of the respondents (47%) said the implementations had caused them to update their risk assessment to cope with significant control and operational issues. And 45% of respondents said their companies were awarded a government grant to help defray the cost of the smart grid system, adding that they believe government grant compliance requirements are more restrictive than their current policies and procedures, constituting additional risk.

Among companies with trading operations, the risk mentioned most frequently was energy risk management and trading, with 96% of IA groups saying that is an area they cover. This overwhelming response to our survey question makes sense in light of utility company exposure to wholesale price volatility and the increasing uncertainty of competitive markets. Further, external oversight bodies are requiring more rigorous financial disclosure and

demonstration of robust corporate governance policies and practices in the area of energy trading. While most internal audit groups cover key areas such as financial controls, compliance with energy risk policies and segregation of duties, survey results showed that fewer IA organizations cover the more complex risk areas such as energy trading and risk management systems and quantitative risk measures.

In the area of governance, risk, and compliance (GRC) and enterprise risk management, 62% of respondents said their organizations embrace a GRC program. Governance activities performed by internal audit to support the organization's board and audit committee included:

- Review and assess IT governance, 75%
- Conduct investigations, 75%
- Provide the board with an assessment of primary enterprise risks, 68%
- Test operating effectiveness of codes of conduct and related policies, 65%
- Provide the board with an assessment of risk mitigation effectiveness, 62%
- Provide input into assessment or appointment of external audit firm, 54%
- Provide executive compensation compliance with time and expense policies, 51%

In the related area of the North American Electric Reliability Corporation (NERC) reliability standards, nearly all IA groups with electric operations assess compliance with those standards. Additionally, evaluation of compliance systems and readiness assessments were covered by the majority of respondents. In a change from last year's survey, the number of respondents who said they map reliability standards to operational processes and controls increased significantly during 2010.

In the area of sustainability and corporate responsibility, 51% of respondents said they issue a corporate sustainability report, but only 12% of IA functions provide coverage of the assertions within the report. Looking forward, the majority of respondents said they would provide coverage of the assertions in future years.

The convergence of US GAAP with IFRS is also capturing the attention of IA leaders. Forty-five percent of the respondents to the CAE survey said their companies have already completed or are in the process of performing an IFRS impact analysis. An additional 50% said they plan to conduct an IFRS impact analysis in the future. Many survey respondents stated they plan to review new controls and policy, process, and system changes.

Focusing on technology

To reduce costs and improve efficiency, utility companies are increasingly turning to technology and expect that their IA team will provide assurance for costly transformation projects. Many utility companies have implemented or are planning to implement an enterprise resource planning (ERP) system or asset management system, and plenty of others are gearing up to upgrade or implement Customer Care and Billing Systems (CC&B) to support AMI and smart grid projects. As a result, management and audit committees are calling for IA teams to be more savvy about the technology involved. Utilities are also implementing systems and using technology tools to generate huge volumes of data that, when analyzed correctly, can help identify where higher risks exist within the organization. Management wants its IA team to play a role in identifying risks as utilities go through significant business transformations resulting from the implementation of technology solutions. In line with increasing risks associated with these transformational IT initiatives, the percentage of IT audits included in survey respondents' audit plans is at an all time high.

Redefining internal audit

According to the CAE survey results and comments made during the roundtable event, internal audit effectiveness depends on a risk assessment process that is in line with management's strategic objectives and the risk assurance functions throughout the organization.

As the utility industry continues to evolve, IA teams need an effective strategic planning process to make sure internal audit priorities are in sync with a company's emerging risks and changing stakeholder expectations.

For example, utility company IA teams are starting to collaborate with personnel across the organization to create risk assurance maps. The maps highlight where risk assurance coverage is adequate and identifies opportunities to avoid duplication of efforts or to fill gaps.

With this information, IA teams can inform the board and the audit committee on who provides risk assurance coverage and where change is needed.

The first step towards redefining an IA team and putting it on the path to high performance is to define a vision and build the business case to support it. Next, IA leaders must scrutinize all aspects of their scope, people, processes, and technologies, and challenge whether they have the right internal audit strategy and capabilities in place.

Finally, to benefit from change and overcome its inherent risks requires a plan. Organizations that break down their vision and goals into initiatives that can be tackled logically and systematically are the ones most likely to succeed in driving value.

About our survey: The objective of our fifth annual survey was to capture and understand chief audit executives' perspectives on the primary issues facing the utilities and power generation industry. We conducted the survey during August 2010 and received responses from 46 companies representing a diverse group of utilities:

78%

of respondents have
electric operations

80%

of respondents have
gas operations

78%

of respondents have
non-regulated
operations

9%

of respondents have
other operations

***For a deeper discussion about these issues or to obtain our
Utilities 2010 CAE survey results, contact:***

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