Terasen

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Re: Response to Request for Public Comment – Reporting on Internal Control over Financial Reporting and Certification of Disclosure in Issuers' Annual and Interim Filings

This letter is being respectfully submitted in response to the Commission's invitation for written submissions regarding the following:

- Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* (the Proposed Internal Control Instrument);
- Companion Policy 52-111CP (the Proposed Internal Control Policy and together with the Proposed Internal Control Instrument, the Proposed Internal Control Materials);
- Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* (the Revised Certification Instrument);
- Forms 52-109F1, 52-109FVT1, 52-109FM1, 52-109F1R, 52-109F1R – AIF, 52-109F2, 52-109FT2, 52-109FM2 and 52-109F2R (together, the Revised Certification Forms); and,
- Companion Policy 52-109CP (the Revised Certification Policy and together with the Revised Certification Instrument and the Revised Certification Forms, the Revised Certification Materials).

Terasen is a leading provider of energy transportation and utility infrastructure management services, with two strong base businesses – natural gas distribution and petroleum transportation – and an emerging business in water and utility services. Terasen Inc. is headquartered in Vancouver, British Columbia, and its shares trade on the Toronto Stock Exchange (symbol: TER). As an OSC registrant, Terasen Inc. is subject to certification requirements as outlined in Multilateral Instruments 52-109 and 52-111. As a result of public debt / equity issuance, separate certifications are also required for two of Terasen Inc.'s subsidiaries – Terasen Gas Inc. and Terasen Pipelines (Trans Mountain) Inc. Certification responsibilities are taken very seriously at Terasen, with full support of management and the board of directors.

As I am also a Director of another public company that has already filed and complied with SOX 404, I believe I have additional practical experience that has influenced some of my comments in this letter.

Certification requirements have been introduced by the Canadian Securities Administrators ("CSA") in an effort to improve the quality and reliability of reporting issuers' annual and interim disclosures. The CSA believes that this, in turn, will help to maintain and enhance investor confidence in the integrity of Canadian capital markets. Terasen commends the CSA for the spirit and intent at the core of Multilateral Instruments 52-109 and 52-111.

It is recognized at Terasen that beyond regulatory compliance, certification compliance efforts create potential for improvements to business processes, improved accountability of process owners, and enhancement of linkages with Enterprise Risk Management ("ERM").

The certification process introduced at Terasen has increased the level of discipline and rigor around disclosure processes, providing senior management and the board of directors a heightened degree of comfort regarding continuous disclosure processes. It is expected that, specific to disclosure processes and controls, the certification process will provide opportunity to realize efficiencies going forward.

As part of certification compliance efforts, entity level control environment assessments have been conducted for Terasen Inc. and each of its major lines of business. The Internal Control – Integrated Framework, published in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), has been adopted to assess the general entity level control environment. The Control Objectives for Information and related Technology ("COBIT") framework has been adopted to assess the information technology control environment. Management appreciates the value recognized from these entity level control environment assessments. However, considering the depth and complexity of these assessments, it is questionable whether the cost of undertaking comprehensive annual updates would outweigh the benefits. It is recommended that the CSA allow for, and external auditors support, less frequent updates to these assessments unless there is material change in the business environment.

Regarding testing of the entity level control environment, there will certainly be pragmatic limitations. For example, how would an auditor – whether internal or external – be able to practically assess the ethical stance of senior management and/or the board of directors? Appropriate consideration will need to be given to these testing limitations.

With respect to certification requirements specific to internal control over financial reporting, Terasen welcomes the one-year deferral as announced by the OSC on April 1, 2005. There is strong argument that further deferral is warranted in light of US SOX 404 implementation experience. Terasen would welcome extended deferral as it would provide opportunity to more effectively deal with human and capital resource constraints associated with certification compliance efforts and the refinement of US guidelines for auditor attestation. It is believed that extended deferral would also provide opportunity to more effectively manage ultimate auditor attestation costs.

Similar to pragmatic limitations discussed above regarding testing of the entity level control environment, there are also limitations with respect to the assessment of effectiveness of internal control over financial reporting. There is general acknowledgment by those with related training and background that internal controls, no matter how well designed and operated, can only provide reasonable assurance of achieving an entity's control objectives. The likelihood of achievement is affected by limitations inherent in internal controls. These include the realities that human judgement in decision making can be faulty and that breakdown in internal controls can occur because of human failures such as simple errors or mistakes. Additionally, controls, whether manual or automated, can be circumvented by the collusion of two or more people or inappropriate management override of internal controls. To suggest that management and/or auditors could objectively arrive at a binary pass/fail conclusion about the effectiveness of a reporting issuers' system of internal control over financial reporting (i.e. is or is not "effective") would be a fallacy. However, it may be practical to provide an objective assessment as to reasonable assurance of operating effectiveness of key internal controls if there is clear focus on a risk-based approach to documentation, assessment, and testing of internal controls. In other words, only those internal controls considered to be primary in nature should warrant documentation, assessment, and testing. Assessment and testing of internal control over financial reporting would then be more appropriately focused on acceptability of residual risk status as opposed to inferring an absolute state of effectiveness.

My comments, I believe, are substantiated by rating agency perspectives and real-world facts. In a Special Comment – entitled Section 404 Reports on Internal Control: Impact on Ratings Will Depend on Nature of Material Weaknesses Reported – released by Moody's Investors Service ("Moody's") in October 2004, the rating agency indicated that:

> *"While a conclusion that internal controls are ineffective is certainly not good news, we believe that any reaction will need to take into consideration the nature of the material weaknesses because many of them will not rise to the level of serious concern from an analytical perspective.*
>
> *We are less concerned about material weaknesses that relate to controls over specific account balances or transaction-level processes. We refer to these material weaknesses as "Category A" material weaknesses. In most cases, we believe that the auditor can effectively "audit around" these material weaknesses by performing additional substantive procedures in*

> *the area where the material weakness exists. We expect to give companies reporting Category A material weaknesses the benefit of the doubt and not take an related rating action, assuming management takes corrective action to address the material weakness in a timely manner.*
>
> *Other material weaknesses relate to company-level controls such as the control environment or the financial reporting process. These material weaknesses, which we refer to as "Category B" material weaknesses, may result in us bringing a company to rating committee to determine whether a rating action is necessary. We are concerned about these material weaknesses because we question the ability of the auditor to effectively "audit around" problems that have a pervasive effect on a company's financial reporting. Also, Category B material weaknesses call into question not only management's ability to prepare accurate financial report but also its ability to control the business."*

At a recent conference, Moody's presented an analysis of material weaknesses reported in year one SOX Compliance. Moody's concern was more focused on the control environment, not transaction-level internal controls. In fact, of over 2,000 companies rated by them, other than delinquent filers, only 93 (representing 4%) companies reported material weaknesses in SOX 404 reports for 2004. The 63 companies that reported Category A material weaknesses did not experience impact on their ratings by Moody's. Of the 30 companies that reported Category B material weaknesses, rating actions (i.e. review for downgrade) were initiated against only 3 companies. Considering the ultimate goal of certification requirements to maintain and enhance investor confidence in the integrity of Canadian capital markets, this situation suggests that the costs of compliance are not commensurate with resulting benefits. Perhaps it could be argued that even one downgrade is too many. This may be true and is why I am recommending that the scope and timing of the auditor's attestation be modified to be reduced to a risk-based approach and cycle approach to testing to reduce the cost but yet provide that check and balance to management's evaluation. Such a recommendation is clearly not in accordance with SOX 404, but I believe it is appropriate. A company that wishes to be SOX compliant could simply extend the scope of the auditor's engagement.

I believe such an approach would be marked improvement from what I have personally seen in my capacity as a Director of a SOX 404 reporter.

Moreover, a balanced, risk-based approach to certification compliance efforts would undoubtedly enable reporting issuers to strike an appropriate balance between costs of compliance and benefits to stakeholders.

Similarly, it may be appropriate to consider modifying the scope of auditors work to cycle through the internal controls over a three-year period. Although it is reduced scope, I believe it still provides the appropriate check and balance to the management evaluation of internal controls. The cycle approach need not be systematic to ensure the element of choice remains with the auditor.

However, ultimately, I believe the internal control attestation should be built into the financial statement audit opinion. In the past (the 1970's) auditors, as a matter of course, did some work and relied on internal controls. Audit Plans should be mandated to evaluate and test internal controls in key risk areas with less substantive testing for such related accounts assuming the controls are in place.

I understand some firms are moving back to this approach but, realistically, without being mandated to do so, I see the opportunity for significant duplicate effort and overly cautious assessment of risk and incurred costs.

I thank the OSC for this opportunity to share my thoughts and would be happy to discuss these ideas further with you.

Sincerely,

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