

Memorandum

TO: Chairman's Executive Committee
FROM: Darcy Mazurkewich, Head, Utility Audit and Compliance Group
DATE: November 24, 2006

RE: REGULATORY AUDIT REPORT –DIRECT ENERGY REGULATED SERVICES

Attached is the audit report arising from the recently completed regulatory audit of Direct Energy Regulated Services (DERS). Also attached is management's response to the audit report.

As noted in the report, we determined that DERS had effective processes for controlling the Electricity Acquisition, Inter-Affiliate and Deferral Accounts activities. In addition, transactions examined in these processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements. There were a few minor observations arising from the audit, which were discussed and cleared with management. These observations were not of sufficient significance to warrant inclusion in the audit report.

As noted in the final paragraph, we received the full cooperation of DERS management and staff throughout the audit assignment.

If you have any comments about the attached, please give me a call at 297-7365.

<Approved for distribution by>

Darcy Mazurkewich

cc: Bob Heggie, Executive Manager, Utilities Branch
Gary Newcombe, Vice President Government & Regulatory Affairs, Canada West, DERS
Cam Barton, Vice President & General Manager, DERS

November 7, 2006

Alberta Energy and Utilities Board
Utilities Branch
Attn: Darcy Mazurkewich
Head, Audit and Compliance Group
640 5 Avenue SW
Calgary, AB
T2P 3G4

Re: **Direct Energy Regulated Services Regulatory Audit of the RRT electricity acquisition process, inter-affiliate transactions deferral accounts and reserves**

Dear Darcy:

Direct Energy Regulated Services (DERS) appreciates this opportunity to review and respond to the final draft regulatory audit report. We understand this response will be appended to the Alberta Energy and Utilities Board (EUB or Board) Regulatory Audit of the RRT electricity acquisition process, inter-affiliate transactions deferral accounts and reserves.

The management of DERS reviewed the final draft regulatory audit report and believes the report to be complete and accurately reflective of the findings communicated to DERS both during the audit and at the closing meeting. DERS is of the view that the audit findings confirm our highest commitment to financial and operational processes and controls and accurately portrays our regulatory compliance standards.

I would like to thank the Board for their accommodation of our internal schedules and deadlines, and would commend the members of the Audit Team for their professionalism and conduct throughout the audit process.

Should you have questions or comments, please contact me directly.

Yours truly,



Cam Barton
Vice President & General Manager DERS
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Direct Energy Regulated Services
is a business unit of Direct Energy Marketing Limited

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Direct Energy Regulated Services

Regulatory Audit of the RRT Electricity Acquisition Process,
Inter-Affiliate Transactions, and Deferral Accounts and Reserves
for the 12-Month Period Ended December 31, 2005

November 2006

Audit Team:

Darcy Mazurkewich
Nick Iannone
Joel Thompson

ALBERTA ENERGY AND UTILITIES BOARD

Regulatory Audit Report #2006-004: Direct Energy Regulated Services
Regulatory Audit of the RRT Electricity Acquisition Process,
Inter-Affiliate Transactions, and Deferral Accounts and Reserves

October 2006

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Objectives and Scope

The overall objective of the assignment was to conduct a regulatory audit of the financial and operational controls over three key activities of Direct Energy Regulated Services (DERS), the regulated Alberta business unit of Direct Energy Marketing Limited (DEML). The key activities that were the subject of this audit were the RRT Electricity Acquisition Process, the Inter-Affiliate Transactions and the Deferral Accounts Process (for both gas and electricity customers).

The audit included a review of the regulatory requirements related to the operations of these activities. The audit covered sample transactions and reviews of the key components of each process for the period ending December 31, 2005 and resulted in the expression of an opinion on the effectiveness of the controls and processes with respect to these key activities as well as an indication of whether the activities conformed with regulatory requirements.

It is worthwhile to note that on March 14th, 2006 the Market Surveillance Administrator (MSA) issued a report entitled "Review of Electricity Procurement for Regulated Rate Tariff Customers in Alberta". The MSA conducted a review of the RRT electricity procurement process in Alberta to assess whether the process enables the participants to conduct themselves in a manner consistent with the fair, efficient and openly competitive operation of the market. The objective of the MSA review differs from the Board's audit objective to determine if in 2005 DERS effectively managed the RRT electricity acquisition process and complied with regulatory requirements. Consequently, the Board perceives the MSA review as complimentary to the Board's audit.

This is the second audit of DERS, with the first having been conducted in late 2004 (see audit report 2005-001).

The Audit and Compliance Group of the Alberta Energy and Utility Board's (the Board), Utilities Branch carried out the assignment between September 11 2006 and September 29, 2006. The closing meeting was held with management on October 03, 2006.

Overview

DERS is the regulated business unit of DEML, a wholly owned Canadian subsidiary of Centrica plc, a leading provider of energy in the United Kingdom and North America. DERS is a service provider within both the gas and electricity industries and is regulated by the Board. In May 2004, DERS acquired the retail functions of ATCO Electric and ATCO Gas. As a result of the acquisition, this makes DERS the largest regulated retailer within Alberta, with sales to over 842,000 gas customers and over 164,000 electricity customers. Combined revenues including transmission and distribution exceeded \$2.249 billion of which electricity accounted for \$247.2 million.

During 2005, the Board issued two decisions in response to applications filed by DERS. One application dealt with Customer Care Service and the other with a request for a negotiated settlement on Default Rate Tariffs and Regulated Rate Tariffs.

Audit Coverage

RRT Electricity Acquisition Process

DERS purchases electricity for its RRT customers under The Settlement Agreement approved by the Board in Decision 2004-037 (April 30, 2004). Included in the Settlement Agreement is the Energy Price Setting Plan (EPSP) which outlines the acquisition process, the timelines of the procurement rounds, and the determination of energy portfolio prices for DERS electricity supply. In addition to the electricity supply cost, the Settlement Agreement provides for the recovery of both negotiated and flow-through costs for non-energy costs, other energy costs and return margin associated with DERS procurement activities.

For 2005, DERS acquired almost 2 million megawatt hours of electricity on behalf of its RRT customers, at a cost of about \$120 million (excluding transmission and distribution).

An integral part of the acquisition process is the preparation of the forecast. In 2005 the Forecast was prepared using input data from other areas such as site enrollment and wholesale settlement. Also factored in are assumptions for growth and attrition. This information was used to arrive at the usage factor (demand) which was part of the generation of the quarterly forecast.

The forecast for each quarter was prepared six weeks prior to the start of the quarter, along with the corresponding portfolio. The portfolio was created based on the forecast data by the Portfolio Manager, about one day later. The six week advance time was to allow for the forecast and portfolio to be circulated to the Independent Advisor and Consultation Parties for review and approval. The electricity acquisition amounts are based on the forecast demand.

A main focus of the audit was to test the effectiveness of the controls and procedures related to the activities noted above. In addition, the audit tested the completeness and accuracy of, and support for, electricity acquisition transactions during the period, including whether they were based on a processes approved by the Board.

The following is a summary of the significant procedures tested and the audit work done.

- The key components, procedures, control points, issues, and risks associated with the RRT electricity procurement process were identified.
- These items were reviewed to determine whether related procedures and controls were adequate and tests were conducted to determine their effectiveness.
- The sources from which electricity for regulated customers was acquired were reviewed to determine whether electricity was being acquired in accordance with the EPSP.
- The procedures used for preparing the quarterly energy charge filings with the Board were evaluated and the filing for one quarter was reviewed in detail. The significant items in the filings were verified with supporting documentation, and it was determined whether the filings were in compliance with regulatory requirements.
- Board Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of electricity procurement transactions for the twelve-month period was selected, and tests were carried out to verify that the selected items were complete, properly supported and accurate; were acquired at a price agreed to in accordance with the EPSP. The transactions were also tested to ensure that they were recorded in the

correct entity and time period; had been properly authorized; and were in accordance with regulatory requirements.

- The procedures used to conduct electricity volume reconciliations were determined and evaluated for effectiveness.

The audit conclusion was that the process used by DERS for acquiring electricity on behalf of its Regulated Rate Tariff customers for 2005 was effective, and that electricity acquisition transactions were complete and accurate, properly authorized and supported, were priced appropriately, and were in accordance with regulatory requirements.

Inter-Affiliate Transactions

DERS as the regulated Alberta business unit of DEML has five general categories of inter-affiliate transactions with other non-regulated business units of DEML. DERS does not have any employees. Rather, DEML employees are assigned to provide the services required to operate DERS. The costs of providing these services are allocated to DERS in accordance with the Cost Efficiency and Allocation Agreement between DERS and DEML. This agreement is based on the principle of direct charging salaries and commodity costs to either the power or gas business lines where possible. Indirect costs, primarily corporate allocations, are distributed using appropriate allocation drivers based either on the applied for costs or those costs approved by the Board.

The five inter-affiliate cost categories include corporate allocations, direct salaries, electricity (power) costs, gas costs, and management fees. The last category includes costs directly related to the procurement of power or gas. This audit section focused on the corporate allocations and salaries, since the electricity costs and management fees were tested in the electricity acquisition section of the audit, and the gas costs were previously tested in audit 2005-001.

During 2005, DERS paid approximately \$4.7 million to DEML for salaries and corporate allocations that it received. In addition, DERS incurred approximately \$1,627 million of inter-affiliate charges for gas and power commodity related costs.

The main objective of the audit work in this section was to test the effectiveness of the controls and procedures related to the transactions carried out in accordance with these agreements. In addition, the audit examined the completeness and accuracy of, and support for these inter-affiliate operating transactions for the 12-month period ending December 31, 2005, including a review of applicable regulatory requirements.

The following is a summary of the significant procedures tested and the audit work done.

- The key components, procedures, control points, issues, and risks associated with inter-affiliate operating transactions were identified.
- These items were reviewed to determine whether related procedures and controls were adequate and tests were conducted to determine their effectiveness in practice.
- A review was performed to determine whether management had adequate procedures to identify services that had been provided and whether the related costs were charged to the correct entity and business line.

- The inter-affiliate service agreement was reviewed to determine whether it covered all of the services that were provided and whether it had been properly approved.
- Board Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of inter-affiliate transactions for the period was selected, and tests were carried out to verify that the selected items were complete, properly supported and accurate; were recorded in the correct entity and business line, were recorded in the correct time period; had been properly authorized; and were in accordance with regulatory requirements.

The audit conclusion was that DERS has effective processes for controlling inter-affiliate operating transactions, and that inter-affiliate operating transactions were complete, accurate, done in a timely manner, properly authorized and supported, and were in accordance with regulatory requirements.

Deferral Accounts and Reserves

The Board's normal practice in setting rates for the provision of utility services is to use prospective ratemaking, wherever possible. However, in certain cases, the level of risk, arising from uncertainty associated with forecasting revenues or costs, borne by one or more parties in the regulatory process may be such that it is more advisable to use a mechanism that protects both utilities and ratepayers from the potential impact of inaccurate forecasts. Deferral accounts and reserves are the main mechanisms that are used to provide this protection.

The Board's practice has been to evaluate the use of deferral accounts or reserves on a case-by-case basis. As noted above, these mechanisms provide protection from uncertainty. However, there may also be negative impacts which may arise from their use, including rate fluctuations and intergenerational inequity.

The typical criteria used in determining whether or not to approve the use of a deferral account or reserve are the materiality of the amount involved, the level of uncertainty regarding the accuracy of a forecast of the associated revenues or costs, the ability to control the factors affecting the forecast, and the resulting level of risk borne by the utility and the ratepayers.

DERS has only a few deferral accounts and reserves established on its balance sheet. The primary deferral account is the Deferred Gas Account (DGA). The DGA is used to record and reconcile natural gas purchases, and related gas commodity costs, and gas cost recoveries made through the gas cost flow-through rate. The DGA was only partially tested during this audit since a more thorough examination of the DGA was undertaken in 2004 as part of the EUB's gas acquisition process audit.

It is notable that for DERS' 2004, 2005, and 2006 Default Rate Tariff and Regulated Rate Tariff applications, the Board approved a number of non-energy cost categories for deferral treatment. These costs are accounted for in DERS' income statement. Each year after the actual results are available, DERS applies to the Board to either recover or reimburse the balances of these deferred costs. Since these costs are primarily operating and maintenance costs, testing of them will be deferred until the Board audits DERS' operating and maintenance costs.

The remaining deferral account is the hearing cost reserve, which was examined in this audit.

The audit work in this section was to test the effectiveness of the controls and procedures related to the development and operation of the deferral accounts and reserves. In addition, the audit tested the completeness and accuracy of, and support for, a sample of transactions related to the deferral accounts and reserves during the year ending December 31, 2005.

The following is a summary of the significant procedures tested and the audit work done.

- The key components, procedures, control points, issues, and risks associated with the deferral accounts and reserves were identified.
- These items were reviewed to determine whether related procedures and controls were adequate and tests were conducted to determine their effectiveness in practice.
- Board Decisions were reviewed and the related regulatory requirements were identified and built into the audit tests in this section.
- A sample of deferral accounts and reserves transactions for the twelve-month period was selected, and tests were carried out to verify that the selected items were complete, properly supported and accurate; were recorded in the correct entity and in the correct time period; had been properly authorized; and were in accordance with regulatory requirements.

The audit conclusion is that DERS has an effective process for controlling the transactions related to the deferral accounts and reserves, and that such transactions were complete and accurate, properly authorized and supported, and that the deferral accounts and reserves were in accordance with regulatory requirements.

Principal Audit Findings and Overall Conclusion

Based on its examination, the Utility Audit and Compliance Group concludes that the financial and operational controls over the selected key activities of DERS were found to be effective and the related transactions examined were in accordance with regulatory requirements. Some minor issues and exceptions were noted. These items were brought to the attention of management along with suggestions to help improve the effectiveness of the related procedures. Management provided their responses to these items, including an appropriate timetable for dealing with the matters noted. These items were not considered of sufficient significance to warrant inclusion in this report.

DERS staff made the necessary time to provide the audit team with documents, explanations and answers to our queries. We thank the management and staff of DERS for their valuable help and cooperation during the audit.