

Memorandum

June 22, 2009

TO: Willie Grieve, Chair, Alberta Utilities Commission

FROM: Darcy Mazurkewich, Manager Audit and Compliance

REGULATORY AUDIT OF DIRECT ENERGY REGULATED SERVICES

Please find attached the audit report resulting from the recently completed Regulatory Audit of Direct Energy Regulated Services (DERS) as well as management's response to the audit report.

The Audit Team determined that DERS has effective controls and processes, has demonstrated regulatory compliance, and provided accurate information to the Commission for regulatory purposes.

As noted in the report, DERS management and staff provided us with their full cooperation throughout the audit.

If you have concerns about the attached, please call me at 403.592.4429.



Darcy Mazurkewich
Manager, Audit and Compliance
Utilities Division

**CC: Gary Newcombe, Vice President, Government & Regulatory Affairs Canada,
Direct Energy Marketing Limited
Bob Heggie, Chief Executive, Alberta Utilities Commission**

June 18, 2009

Mr. Darcy Mazurkewich
Manager, Audit and Compliance
Alberta Utilities Commission
Fifth Avenue Place
4th Floor, 425 – 1 Street, SW
CALGARY, Alberta
T2P 3L8

Dear Mr. Mazurkewich:

Re: Alberta Utilities Commission Regulatory Audit of Direct Energy Regulated Services' (DERS') Natural Gas Acquisition Process, O&M Expenses, and Gas Code of Conduct Compliance

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 Utilities Commission (AUC) Regulatory Audit of the DRT natural gas procurement process, O&M expenses, and Gas Code of Conduct Compliance.

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 you and your team 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,

<Original signed by Gary Newcombe>

Gary D. Newcombe
Vice President, Government & Regulatory Affairs Canada
Direct Energy Marketing Limited



AUC

Alberta Utilities Commission

Direct Energy Regulated Services

Regulatory Audit of Activities Including the
Gas Procurement Process,
Operations, Maintenance & General Expenses, and
Gas Code of Conduct Compliance
for the Year Ended December 31, 2008

June 2009

Audit Group:

- Nick Iannone
- Joel Thompson
- Darcy Mazurkewich



ALBERTA UTILITIES COMMISSION

Regulatory Audit Report #2009-001: Direct Energy Regulated Services
Regulatory Audit of Activities Including the
Gas Procurement Process,
Operations, Maintenance & General Expenses, and
Gas Code of Conduct Compliance
for the Year Ended December 31, 2008

June 2009

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Overview

Direct Energy Regulated Services (DERS) is a regulated business unit of Direct Energy Marketing Limited (DEML) which is a wholly owned Canadian subsidiary of Centrica plc, a provider of energy in the United Kingdom and North America. DEML's head office is in Toronto.

In May 2004, DERS acquired the regulated retail functions of ATCO Electric and ATCO Gas. As a result of the acquisition DERS became the largest regulated retailer in Alberta, as it began to provide Regulated Rate Tariff (RRT, electricity, or power) services and Default Rate Tariff (DRT or natural gas) services to customers in the ATCO Electric Ltd. and ATCO Gas service territories.

In 2008, DERS averaged 712,000 DRT customers and 159,000 RRT customers. DERS reported combined DRT and RRT revenues of \$1,818 million which includes transmission and distribution flow through charges.

Objectives and Scope

The Audit and Compliance Group (Audit Group) of the Alberta Utilities Commission (Commission or AUC) performed this audit.

The objective was to provide the Commission an opinion on the effectiveness of the controls and processes, regulatory compliance, and accuracy of information provided to the Commission by DERS.

The scope of the audit included three key activities of DERS for the year ended December 31, 2008. The key activities were the Gas Procurement process, the combined Operations, Maintenance and General Expense process for the DRT and RRT services, and the Gas Code of Conduct compliance.

To attain the objective, the Audit Group developed and applied an audit plan. Based on the results of applying the procedures in the audit plan, the Audit Group can express an opinion.¹ The audit procedures applied are outlined in greater detail in the following sections of this report.

The audit work and this report adhere to professional standards, but may differ in certain respects with Generally Accepted Auditing Standards (GAAS) since it is a regulatory audit specifically intended to provide assurance to the Commission.

The Audit Group performed the audit fieldwork between April 20, 2009 and May 19, 2009. The closing discussions were held with management on June 5, 2009, at DERS' Calgary office.

¹ The Commission is not bound by the findings of the Audit Group with respect to any future hearings or proceedings in which an issue is raised and which was the subject of a prior audit.

Gas Procurement Process

As a regulated service provider within the Alberta gas and electricity industry, DERS' acquires gas on a daily basis to meet the forecasted energy needs of its DRT customers. DERS procurement portfolio of daily, monthly, life of reserves and peaking energy requirements are acquired at current market prices. In addition, DERS conducts certain transactions to fulfill its responsibility for the distribution system load balancing function on the ATCO Pipeline system. In Order [U2008-290](#),² the AUC approved ATCO Gas' Retailer Service. The implementation of the Retailer Service included the transition of load balancing from DERS to ATCO Gas. Effective October 1, 2008, DERS discontinued the daily balancing on the ATCO Pipelines system.

To effectively carry out the procurement and load balancing activities, DERS has a number of operating and control procedures that it follows. These procedures include:

- maintaining separate books and staff for its DRT activities,
- establishing contractual relationships with all counterparties,
- forecasting gas volume requirements by service territory,
- balancing supply acquisition from various sources,
- confirming purchase transactions with counterparties,
- balancing volumes acquired and related costs to pipeline statements and invoices,
- adherence to limits as outlined in DERS' financial risk management policy, and
- providing related information to the Commission for review and approval.

To calculate the monthly Gas Cost Flow Through Rate (GCFR), DERS continues to use the flow through pricing model that was approved by the Alberta Energy and Utilities Board in Decisions [2001-75](#)³ and [2002-035](#).⁴ DERS also maintains a deferred gas account which includes the costs of gas procurement and the related costs of imbalances, excess sales and other adjustments.

The daily amount of gas that DERS acquires on behalf of its DRT customers varies mainly due to forecasted temperature and customer load. A one degree change in temperature can affect forecasted volumes by approximately 25,000 GJ's. For the months of January and November, examined during the audit, the total monthly volume of gas acquired was 26.1 PJs and 13.9 PJs respectively. During 2008, DERS acquired approximately 151.0 PJs of gas at a cost of \$1.1 billion on behalf of its average customer base of 712,000.

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, gas procurement transactions during the period.

² Order U2008-290, ATCO Gas Retailer Service and Gas Utilities Act – Phase II, Part B Process, Modules 3 & 5 (Application 1575607) (Released September 12, 2008)

³ Decision 2001-75, Methodology For Managing Gas Supply Portfolios And Determining Gas Cost Recovery Rates (Methodology) Proceeding and Gas Rate Unbundling (Unbundling) Proceeding (Applications 2001040 and 2001093) (Released October 30, 2001)

⁴ Decision 2002-035, ATCO Gas North GCRR Methodology and Gas Rate Unbundling – Compliance Filing (Applications 1257378 and 1257516) (Released March 21, 2002)

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

- AUC Decisions and Orders were reviewed and the related regulatory requirements were built into the audit tests.
- The key components, processes, control points, issues, and risks associated with the gas volume forecasting process were identified. The basis for the forecast was reviewed and the daily volume forecasts were recalculated for a number of days and verified to the gas forecasts used by DERS.
- GasEDI⁵ contracts and other contractual relationships with counterparties were reviewed.
- The sources from which gas for DRT customers was acquired were reviewed to determine whether gas was being acquired from third party or related entities, and whether gas was being acquired on provisions consistent with standard industry terms and conditions.
- The procedures used for preparing the monthly GCFR filings were reviewed and the November 2008 filing was analyzed in detail. The significant items in the filing were verified with supporting documentation, and it was determined whether the filing was in compliance with regulatory requirements.
- A sample of gas procurement transactions for the period was selected, and tests were carried out to verify that the selected items were complete and accurate, were recorded in the correct period, were properly recorded as regulated transactions, had been properly authorized, and were in accordance with regulatory requirements.
- The procedures used to conduct gas volume reconciliations were reviewed and evaluated for effectiveness. Gas volumes acquired for November 2008 were reconciled to pipeline statements and to counterparties' invoices.

The audit conclusion was that the process used by DERS for acquiring gas on behalf of its DRT customers for 2008 was effective, and that gas procurement transactions were complete and accurate, properly authorized and supported, priced appropriately, and in accordance with regulatory requirements.

Operations, Maintenance and General Expenses

In 2008 DERS reported \$71.6 million of Operations, Maintenance and General (OM&G) expenses. These 2008 OM&G expenses can be classified into four broad categories as follows.

- | | |
|------------------|--|
| • \$46.7 million | Billing and customer care (primarily ATCO I-Tek costs) |
| • \$11.5 million | Other operating expenses |
| • \$ 5.1 million | Salaries and wages |
| • \$ 8.3 million | Administrative and general |

The first two categories are primarily made up of direct charges incurred by DERS. The latter two categories are primarily made up of indirect charges (for example corporate allocations). DERS describes its multi step allocation process in its 2009 to 2011 DRT and RRT rate application 1600749.⁶

⁵ GasEDI, the EDI stands for Electronic Data Interchange. The full name is "GasEDI Base Contract for the Short-Term Sale and Purchase of Natural Gas" and it is a standardized physical delivery contract intended to govern multiple gas purchases, sales and exchanges anywhere in Canada or the US.

⁶ AUC Application 1600749/EPIS ID 149 – Direct Energy Regulated Services 2009-2011 Default Rate Tariff and Regulated Rate Tariff Application

Of note is DERS' indication in its application that in 2008, 90 positions accounted for 33.57 Full Time Equivalents (FTEs) based on a deemed time allocation for each position ranging from 0.03 to 1.00 FTE. DERS' policy requires that only those positions which are fully dedicated to DERS business be charged directly to the DERS business unit. For the partially allocated positions, only the portion of the individual's salary matching their deemed allocation, plus a benefit loading, is charged to the DERS business unit.

Because the value of the ATCO I-Tek charges to DERS for billing and customer care services is being reviewed through a proceeding commonly referred to as the DERS Collaborative Benchmark Study, the Audit Group restricted the testing of any I-Tek charges sampled to a review of the accuracy of the recording of those charges by DERS.

The main focus of the audit work in this section was to determine whether the DRT and RRT OM&G expenditures were accurately reported and complied with regulatory requirements. For example, to ensure that the expenditures were reported in a valid account classification, variances were properly explained and disallowed expenditures and non-regulatory transactions were excluded.

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

- Reviewed relevant AUC Decisions and Orders with the related regulatory requirements and directives identified and built into the audit tests.
- Reconciled expenses recorded in the DERS RRT and DRT accounts to the Rule 005 filings.
- Where applicable reconciled actual expenses recorded to actual values provided in DERS 2009 to 2011 DRT and RRT rate application.⁷
- A sample of OM&G transactions was selected and tests were carried out to verify that the selected items were:
 - complete, properly supported and accurate,
 - recorded in the correct entity and time period,
 - properly authorized, and
 - in accordance with regulatory requirements.

The resulting conclusion was that DERS' DRT and RRT OM&G expenditures were accurately reported and complied with regulatory requirements.

Gas Code of Conduct Regulation Activities

As a result of ATCO Gas & Pipelines Ltd. and ATCO Electric Ltd, appointing DERS to perform the regulated retail functions for their distribution customers, DERS is a default supply provider under the Gas Code of Conduct Regulation (GCCR).

DERS, as required by the GCCR, has a Commission approved Compliance Plan (Plan) that details the policies, measures and monitoring mechanisms in place to ensure DERS compliance with the GCCR.

⁷ AUC Application 1600749/EPS ID 149 – Direct Energy Regulated Services 2009-2011 Default Rate Tariff and Regulated Rate Tariff Application

Briefly, the main purpose of the Plan is to provide standard industry guidelines and metrics for entities to follow. These metrics focus on areas such as:

- ensuring equality of treatment of customers and retailers,
- establishing confidentiality standards for customer information, and
- setting standards to prevent the utilities from giving unfair competitive advantages to affiliates and also to provide standards for the maintenance of separate records, accounts and reporting in the normal course of business.

DEML staff is responsible for carrying out the compliance measures that are required by the DERS Compliance Plan (Plan). It outlines the obligations and responsibilities of DEMML personnel who are responsible to ensure that the requirements of the Plan are satisfied.

Employees and agents or contractors who support the regulated services are required to comply with the requirements of the GCCR and Plan in the following areas:

- equality of treatment of customers,
- confidentiality of customer information,
- equality of treatment of retailers,
- business practices of the DRT provider,
- prevention of any unfair competitive advantages to affiliates of the DRT provider,
- maintenance of separate records and accounts,
- compliance Plan and compliance reporting, and
- compliance audits.

The audit work for this section was comprised of a selection from the above areas of the Plan and focused on the GCCR activities that were performed during 2008.

The following steps represent the significant audit procedures performed.

- Reviewed the GCCR, Plan and relevant Commission Decisions to facilitate development of audit procedures for testing of DERS's compliance.
- Reviewed the minutes of and related reports submitted to the Compliance Plan Committee at the quarterly meetings for evidence that actions specified in the measures of the Plan were completed in a timely manner.
- Reviewed some of the tests that were conducted in some areas by the regulatory staff of DERS as required by the Plan.
- Selected samples of employees from lists for testing of compliance with the Plan to certificates and confidentiality agreements signed by employees, officers and directors to verify completeness, accuracy, and timeliness.
- Reviewed with management, the internal procedures DERS has in place to enable them to sign certificates and send notifications to employees, as required by the Plan.
- Reviewed and examined the control procedures used to ensure customer confidentiality.
- Determined that the annual compliance report is supported by the documentation reviewed in the other procedures.

The Audit Group found that DERS followed the measures in its Plan and the related policies and procedures in all material respects. Therefore, our conclusion is that DERS has demonstrated compliance with the GCCR.

Conclusion

Based on the scope of the audit and the audit procedures set out above, the Audit Group is of the opinion that in all material respects DERS has effective controls and processes, has demonstrated regulatory compliance, and provided accurate information to the Commission for regulatory purposes.

The Audit Group appreciates the cooperation and assistance provided by the management and staff of DERS during the course of the audit.