Memorandum

TO: Chairman's Executive Committee

FROM: Richard McCabe, Head, Utility Audit and Compliance Group

DATE: January 28, 2005

RE: REGULATORY AUDIT REPORT – DIRECT ENERGY REGULATORY SERVICES

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

This was the second regulatory audit of a utility conducted since the group was established. In addition, it was the first audit conducted under our recently developed three-year rotational audit plan. As such, it represents a significant milestone in the continuing development of the group.

As noted in the report, we determined that DERS had effective processes for acquiring natural gas on behalf of its regulated customers and for billing gas and electricity charges to its regulated customers. In addition, transactions in both processes were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements. There was one significant observation arising from the audit, regarding the use of peaking transactions. This observation, together with management's response, is outlined in Appendix 1 to the report.

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

If you have any comments about the attached, please give me a call at 7-2316.

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Richard M. A. McCabe

Restricted Distribution:
Bob Heggie, Utilities Branch
Lori Topp , Senior Vice President, Direct Energy Marketing Limited

Direct Energy
Regulated Services

January 24, 2005

Alberta Energy and Utilities Board
640 – 5th Avenue S.W.
Calgary, Alberta T2P 3G4

Attention: Richard M. A. McCabe, C.A., MBA
Head, Audit and Compliance Group
Utilities Branch

Dear Mr. McCabe:

Re: Direct Energy Regulated Services Regulatory Audit of The Gas Acquisition Process and The Billing Process 2004

Direct Energy Regulated Services (DERS) appreciates this opportunity to review and respond to the final draft regulatory audit report. We understand that this response will be appended to the Alberta Energy and Utilities Board (EUB or Board) Regulatory Audit of The Gas Acquisition Process and The Billing Process Report #2005-001.

The management of DERS has reviewed the final draft regulatory audit report and believes that 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 portray 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,

Lori Topp
Senior Vice President, Western Region
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EUB Alberta Energy and Utilities Board

Direct Energy Regulated Services

Regulatory Audit of The Gas Acquisition Process and The Billing Process

Report #2005-001
January 2005

Audit Team:

Richard McCabe
Darcy Mazurkewich
Balvir Dhillon
Karen McCambly

Objectives and Scope

The overall objective of the assignment was to conduct a regulatory audit of the financial and operational controls over two key activities of Direct Energy Regulated Services (DERS), a business unit of Direct Energy Marketing Limited. The key activities that were the subject of this audit were the Gas Acquisition process and the Regulated Billing process (for both gas and electric customers).

The audit included a review of the linkage between the operations of these activities, and the related financial information and the regulatory process. The audit covered sample transactions and reviews of the key components of each process for the 6-month period ended October 31, 2004, resulting 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 conform with regulatory requirements.

The Audit and Compliance group of the Alberta Energy and Utility Board's Utilities Branch carried out the assignment between November 22 and December 20, 2004, when the closing meeting was held with management.

Overview

DERS is a new regulated-service provider within the Alberta gas and electricity industries, having acquired the regulated retail functions of ATCO Electric Ltd. and ATCO Gas and Pipelines Ltd. (ATCO Gas) in May 2004. As a result, DERS is the largest regulated retailer within Alberta, with sales to approximately 875,000 gas customers and 180,000 electricity customers, sometimes exceeding $200 million per month.

The activities examined during the audit were selected following a review of financial information provided to the Board by DERS, as well as a review of Decisions arising from applications made to the Board by the ATCO companies and DERS during the two-year period ended December 31, 2004. These applications dealt with DERS's purchase of the ATCO companies' retail businesses, regulated rate tariffs, and Code of Conduct issues.

DERS was selected for the Audit and Compliance group's second audit mainly for two reasons. Firstly, there is a very high level of public interest in its activities, following its takeover of ATCO's regulated retail functions. Secondly, DERS is a very significant player in the utility marketplace due to the large volumes of energy purchased and equally large dollars billed to regulated rate customers. Although DERS has only been operating for a very short time, it was deemed appropriate to review the effectiveness of its controls over key processes now in order to assure the Board and stakeholders that there are either no major deficiencies or that they have been noted, and are being corrected.

Audit Coverage

Gas Acquisition Process

DERS acquires gas on a daily basis to meet the energy needs of its regulated customers. In addition, it conducts certain transactions to fulfill its obligations to ATCO to balance the operating volumes on its pipeline. To enable DERS to carry out these activities effectively, it has developed a number of operating and control procedures. These procedures include forecasting expected gas volume requirements, balancing supply acquisition from various sources, providing related information for review by the Board, confirming purchase transactions with third parties, and balancing volumes acquired and related costs to pipeline statements and invoices.

The amount of gas acquired by DERS on behalf of its regulated customers varies, based mainly on forecasted temperature and customer load. For the 2 months, June and September, examined in depth during the audit the total monthly volume of gas acquired was 6.6 PJ and 9.0 PJ respectively.

During the hearing concerning the possible transfer of responsibilities from the ATCO companies, DERS had indicated to the Board that it would use a pooling process for gas acquisitions, i.e. both regulated and unregulated gas would be acquired in one pool and then allocated as used. Subsequently, it decided not to use a pooling process and to keep the two gas pools separately. It has established separate “books” to control each type of gas acquisition and separate teams of staff to handle the related transactions.

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 acquisition transactions during the period, including whether they were based on a valuation approved by the Board.

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

- The key components, processes, control points, issues, and risks associated with the gas volume forecasting process were identified. The basis for the forecast was evaluated and the daily volume forecasts were recalculated for a number of days and traced to the gas management system used by DERS.
- The sources from which gas for regulated 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 “normal” commercial terms and conditions.
- The procedures used for preparing the monthly Gas Cost Flow-through Rate filings were evaluated and the December 2004 filings were reviewed 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 acquisition 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 authorised, and were in accordance with regulatory requirements.
- The procedures used to conduct gas volume reconciliations were determined and evaluated for effectiveness.

The audit conclusion was that the process used by DERS for acquiring natural gas on behalf of its regulated customers for 2004 was effective, and that gas acquisition transactions were complete and accurate, properly authorised and supported, were priced appropriately, and were in accordance with regulatory requirements.

Gas and Electricity Billing Process

DERS has 20 bill cycles in a month. In each bill cycle, roughly 44,000 gas and 9,000 electric bill statements are generated. The combined daily gas and electric bill amounts range from a low of $2 million during the lower demand summer season to a high of $10 million during the peak demand winter months.

DERS has sub-contracted the production of its gas and electric bills to ATCO I-Tek (I-Tek). Between them DERS and I-Tek have a number of complex processes to enable them to produce this large volume of billings effectively, some of which are defined by Alberta industry standards (e.g. the Settlement System Code of Alberta). In addition to the acquisition costs of the basic commodities, i.e. gas and electricity, DERS also processes a significant number of other transactions, such as the distribution charges that it receives from ATCO Gas and ATCO Electric, companies which are responsible for distributing the commodities to DERS' customers. These transactions are used in the calculation of the bill statements for customers generated out of the customer information system (CIS), which is owned and operated by I-Tek.

DERS and I-Tek also have in place controls to ensure that processes are working and that bills are being generated accurately. One example is a daily review of randomly selected invoices to detect inconsistencies or errors.

The audit testing focused on five areas:
- A detailed test of selected "raw data" transactions to verify that the final bill statements issued to customers were consistent with the original transaction. The audit tested samples of such transactions from two days in October 2004. The bill statements or the customer account records for the sites of the selected transactions were examined to verify that the bill periods, usage amounts, bill amounts, and account status were accurate.
- A detailed test of customer bill statements to confirm that they were accurate, based on raw data and regulatory requirements. The audit examined a sample of gas and electricity bill statements from two bill cycles in November 2004, to verify that the bill periods, usage amounts, and bill amounts were accurate. These items were also tested for compliance with applicable billing regulations.

- A review of the billing input validation controls to verify their existence, effectiveness to detect invalid data, and ability to recover from invalid data.
- A volumetric test of raw data transactions to billed values to verify the existence and effectiveness of the volumetric control reports, used to ensure that the billed dollars and volumes agree with the inputs.
- A review of the existence and effectiveness of the financial controls used to ensure that the billed dollars are properly recorded in the DERS general ledger and the Gas Cost Flow-through Recovery filing.

The audit conclusion was that the billing processes for regulated gas and electricity customers of DERS for 2004 were effective, and that billing transaction inputs and outputs were complete and accurate, properly supported, timely, and in accordance with applicable regulatory requirements.

Principal Audit Findings and Overall Conclusion

Appendix 1 contains details, including management's response, of one observation arising from the audit work that was considered to be sufficiently significant that it warranted disclosure in this report.

Nevertheless, overall, the financial and operational controls over the selected key activities of DERS were strong and the related transactions were in accordance with regulatory requirements. Some minor errors were noted in a small number of transactions; however, each of these items had already been discovered and corrected by management in a timely manner. Some suggestions were also made to management to help improve the effectiveness of the related procedures.

The audit fieldwork was carried out at a busy time for management and staff in DERS. Nevertheless, they found the time to provide the audit team with explanations and answers to our queries. We would very much like to thank the management and staff of DERS for their valuable help and cooperation during the audit.

Auditee: Direct Energy Regulated Services Audit Time Period: May – October 2004	Prepared: Richard McCabe Management Response: Gary Newcombe Response Date: January 10, 2005

Appendix 1 - Use of Peaking Transactions

Observation:
It was noted that, in the month of June 2004, there were peaking purchase deals on 23 out of the 30 days in the month. The transactions ranged in size from 5,000 GJ to 100,000 GJ. The average size of the transactions was just over 28,000 GJ. All but two of the transactions were for less than 50,000 GJ.

It was also noted that, in the month of September 2004, there were peaking purchase deals on every day in the month. The transactions ranged in size from 6,000 GJ to 200,000 GJ. The average size of the transactions was just over 62,000 GJ. Half of the transactions were for less than 50,000 GJ.

Management has indicated that peaking purchase deals on a particular pipeline system are priced at a premium relative to the market price on that particular pipeline system, but may be more cost effective than the next available alternative supply. Accordingly, they consider that such deals are meant to be used when they provide the required security of supply in a cost-effective manner or when it is not considered advisable to try to obtain the required supply from the open market as to do so might drive up the cost of supply.

It is accepted that peaking transactions are appropriate for days when management has to acquire large volumes of gas. However, the review of such transactions suggests that the use of peaking deals is a common occurrence, rather than an isolated one caused by scarcity of supply or a wish to avoid undesirable market responses. The analysis indicates that peaking deals are being used on an almost daily basis, often to acquire relatively small volumes of gas. This usage does not correspond with management's stated view of when it is appropriate to use such transactions.

Impact:
Using peaking transactions when there is no market-related reason to do so may result in additional cost to customers, with no offsetting benefit.

Recommendation:
It is recommended that management review the use of peaking purchase deals in more detail and establish more concrete principles for the use of such transactions, including setting a cut-off volume level, below which such transactions would not be carried out.

Management's Response:
DERS endeavours to purchase gas at the least cost possible for its regulated customers. This has led to a hierarchy of supply, inverse to price, as follows:

- Tier One – Purchase supply from shippers on the ATCO Pipelines system. The avoided costs of transportation or exchange are shared between shippers and customers, and the gas is traded at a reference to the AECO/NIT price.
- Tier Two – Purchase supply from peaking suppliers on the ATCO Pipelines system. This is done when those peaking supplies are priced lower than or equal to the AECO/NIT price.
- Tier Three – Purchase supply from the TCPL Alberta system based supply and/or NGX, priced at NIT.
- Tier Four – Purchase supply from peaking suppliers on the TCPL Alberta system. This gas is priced at a reference premium to AECO/NIT.

DERS would emphasize that the incremental cost of sourcing gas under the peaking arrangements with TCPL Alberta based suppliers is approximately 0.2% of the underlying commodity cost. These arrangements allow for access to meaningful quantities of gas so as to ensure security of supply, and ensure that DERS refrains from purchasing large quantities of gas in the open market. Under currently approved practice, DERS purchases monthly baseload supply determined by the warmest day of the month in the last 20 years. This places DERS in a "buy" position on most days, particularly when weather is normal or colder. This raises a concern with regard to market liquidity. On a cold day, DERS' customers can require up to 1 PJ of spot purchases. If DERS was to utilize NGX to acquire these volumes, this could represent in excess of 50% of the NGX market on a given day. Suppliers would quickly recognize that DERS was in the market in a must-buy situation, and there is a very real risk that this scenario would run up the market. In addition, deals made through NGX require that customers bear the cost of the supporting letters of credit.

In addition to the market liquidity/cost concern discussed above, there are other considerations underlying the use of peaking arrangements. DERS is precluded, under direction from Board Decision 2001-75, from using storage to satisfy customer requirements. This direction is applicable to all regulated retailers, and previously applied to the ATCO companies, although ATCO Gas North was permitted to continue using the Salt Cavern storage facility because it is required for operational flow to satisfy peak demand conditions. The peaking arrangements are a cost effective method of replacing the supply security that would otherwise be available through storage. The peaking arrangements also provide a high degree of operational effectiveness and efficiency, in that significant volumes can be accessed with relatively modest effort. Finally, these arrangements are consistent in nature with arrangements previously held by ATCO Gas.

DERS would note that the months examined, those being June and September 2004, the peaking purchases made on the ATCO Pipelines system were priced at AECO/NIT flat. By accessing gas at this price point on the ATCO Pipelines system, DERS' customers were spared the TCPL Alberta FTA toll of $0.014 per GJ that would have been incurred had these purchases been made at the AECO/NIT price on the TCPL Alberta system.

DERS acknowledges the recommendation respecting the use of these arrangements, including the implementation of a minimum volume threshold for the use of peaking arrangements. DERS has, effective immediately, instituted a policy whereby peaking arrangements on the TCPL Alberta system will only be utilized when the incremental daily demand to be satisfied is greater than 50,000 GJ.

Estimated Completion Date:
Adjustments to DERS' policy respecting the use of TCPL Alberta system peaking arrangements are in place.