

A STRATEGY FOR THE TIMES:

FROM WELLHEAD TO BURNER TIP

DIRECT ENERGY: IN THE HUNT FOR ALBERTA GAS

It's a company that many people think of only as a gas retailer that offers flat-price energy plans to businesses and consumers wanting certainty amidst volatile energy prices. Even those in the oil and gas fields of Alberta don't think of Direct Energy Marketing Ltd. first as a gas producer, or as a potential buyer for gas-producing assets.

But look a little closer at the wholly-owned subsidiary of British energy giant Centrica PLC, and you find one of southern Alberta's most active producers in these otherwise grey days for the energy patch. It's driven by an integration strategy to grow its natural gas and energy-generating holdings, to give it greater stability and

flexibility in supplying its more than three million residential and commercial North American gas and electricity customers.

Last year, that strategy was backed with a \$303-million investment, \$170 million for two gas acquisitions that added about 24 million cubic feet per day of production. This year, Direct Energy's upstream gas group has a capital budget of \$128 million, with 60% to 70% targeted for acquisitions that have so far given it production of another 10 million cubic feet per day, bringing total capacity to about 115 million cubic feet per day, about 95% of it being natural gas from about 3,600 wells.

But its purse actually goes deeper. "Centrica has told us they have additional appetite for acquisitions above and beyond our budget, depending on the opportunities presented" says Wes Morningstar, senior vice-president of the upstream gas group, which employs about 80 people in Calgary and another 80 in the field throughout southern Alberta.

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CASH IN HAND

The acquisition agenda sets Direct Energy apart at a time when many gas producers are cutting back on their capital outlays due to low market prices. Like the others, Direct Energy is not drilling nearly as aggressively, paring back to barely 100 wells this year from 326 in 2008. But unlike them, in this market where buying makes more sense than drilling, Direct Energy has cash, thanks to Centrica's historically conservative balance sheet and a share offering in the U.K. last fall. So, when other gas producers want to unload non-strategic assets, Direct Energy could be their next call, as long as they are looking for cash, not shares, and their assets fit the profile Direct Energy is looking for.

That profile is driven by the company's desire for profitable growth compared to junior resource companies' typical focus on volume growth. "We look to spend our dollars where we can get our best return," says Morningstar. "In upstream gas, we want to be a low-risk, low-cost producer." Right now, the company estimates its best bet to meet that prescription is in shallow gas and coalbed methane fields in the triangle around Edmonton, Calgary and Medicine Hat. These kinds of plays present a high degree of certainty as to the presence of gas; only the rate is uncertain. Therefore, if producers in these fields can control costs, they can make money – and Direct Energy is well positioned to control costs because it owns much of its own infrastructure of pipelines, compressors and facilities.

Building its gas and electricity generation capacity gives Direct Energy a hedge against the energy price increases that industry watchers believe are inevitable. Centrica, a global operator, is pursuing a similar strategy in Europe and elsewhere. It's all built around the conviction that the integrated energy strategy confers retail strength at the customer end.

“When customers have to determine who they want as their energy provider, clearly they want one committed to the market, not one that's simply trying to distribute their output,” says Weston. “We want to be an energy partner that our residential and business customers know will be there in good and bad times...”

Chris Weston, President and CEO of Direct Energy

“At our core, we are a retail energy partner to millions of residential and business customers across North America,” says Chris Weston, president and CEO of Direct Energy. “But delivering energy to customers on this scale requires that we strike a balance between the upstream assets that we own and the customer load. By increasing the amount of power generation and natural gas output, as we intend to do with our Integrated Energy, Retail Strength strategy, we are able to increase the proportion of retail sales that we source from our own physical assets, rather than relying on the volatile commodity markets.”

Last year's acquisitions of Rockyview Energy Inc. for \$113 million and the Canadian assets of TransGlobe Energy Corp. for \$57 million, plus the three smaller deals this year, have boosted production capacity by about one-third, from 30 billion cubic feet (bcf) per year in 2007 to 40-plus bcf this year, which represents about 20% of annual sales in North America through Direct Energy's marketing of natural gas contracts to businesses, government, institutions and consumers. Weston says the company is targeting 60 bcf by 2012.



Wes Morningstar



Chris Weston



PRODUCTION CAPACITY FOR RETAIL STRENGTH

Direct Energy, the leading independent gas marketer in Canada, came under the Centrica umbrella in 2000, the same year Centrica acquired Energy America in the U.S. Centrica itself was formed from the 1997 de-merger of British Gas, assuming the downstream wholesale and retail operations. After acquiring Direct Energy, Centrica added Ontario's Enbridge Services to the Direct Energy fold in 2002 and nearly 1 million gas and electricity customers of Alberta's ATCO in 2004. The company also operates home and business services supplying air conditioning, water heaters, building automation and other energy-related benefits.

But Direct Energy has always considered production and generating capability a reinforcement of its retail strength. It now owns three gas-fired generating plants in Texas as well as power purchase agreements with five farms in the state to augment its wholesale market participation.

"When customers have to determine who they want as their energy provider, clearly they want one committed to the market, not one that's simply trying to distribute their output," says Weston. "We want to be an energy partner that our residential and business customers know will be there in good and bad times, and one who has invested in the production capacity to guarantee it."

Of course, buying oil and gas fields in a down market comes with its challenges. Deals can take many months to complete. "Companies are not ecstatic about selling at the bottom of the market," says Morningstar. "So there continues to be a large delta between the asking price and the price buyers are willing to pay. And some would prefer to take shares

[as payment] instead of cash and participate in the upside when the price of gas rebounds. But I feel we're getting a reputation as a fair dealer. People view us as a good company to do business with."

A PATIENT BUYER

Typically, it's Morningstar's group that initiates the discussions. "We pride ourselves on finding deals we want to do," he says. "We identify the companies or assets that we're interested in, knock on the door and ask whether they might be interested in selling." From that point on, he says, companies' boards of directors take pains to properly evaluate their assets to fulfill their duties to their shareholders.

"What Centrica does well is that it's a patient buyer," he says, noting that the company stayed away from acquisitions during the high-flying 2005-2006 period. "Now, gas prices are low, and it's a good time to buy." And as long as gas prices stay below a level that makes drilling economical, time continues to be on Direct Energy's side.

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Wes Morningstar, S.V.P. of Upstream Gas, Direct Energy



SECRET TO ENERGY-SAVING INNOVATION: KEEP IT SIMPLE

One of the best investments in smart energy use may simply be to let people see how much power they're paying for and then make it easy to stop wasting what they're not using and change the way they use the rest.

That seems to be the message from Direct Energy's energy-efficiency innovations in Canada and Texas. David Dollihite, vice-president of product development, says that with meaningful dashboard-style information, people can be as vigilant about energy use in their homes and businesses as they are with their cars. Homeowners need something they can understand, and can relate to the choices they make about their lifestyle.

"Thirty to forty percent of the energy you pay for is wasted," he says. "If your car's miles-per-gallon dropped by half, you'd have it in the shop the next day. But with your house, you don't have a benchmark to know what it's costing you or even if it's a reasonable cost for your particular house."

A Direct Energy pilot project in Milton, Ont., developed with Milton Hydro and Bell Canada, shows how that can change. Between July 2007 and September 2008, 209 households used a web portal and software that let them monitor and remotely control thermostats, home lighting and energy-intensive appliances with their laptops or handheld devices. The top 10% cut their electricity use by 16% over 12 months and 18% off peak-period consumption, the most expensive power in most jurisdictions. The keenest users cut peak consumption by 44%.

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David Dollihite, V.P. of Product Development, Direct Energy

Direct Energy hopes to use the Milton project to develop a wider Ontario Peak Energy Saver program which could incorporate aspects of other successful projects run in Texas, where the company is the third-largest electricity provider. In Houston, it became involved in the city's Residential Energy Efficiency Program (REEP) in 2007, providing energy audits and improvements such as blown-in cellulose insulation, duct sealing, caulking and pipe and water-heater insulation to older homes. On average, homeowners saw a 19% reduction in their electricity use.

SAVING MONEY: KEY TO PARTICIPATION

The secret to success, however, is getting people to participate. In Houston, the city did the marketing and REEP did away with most of the forms and worked through churches and community groups to gain trust. Direct Energy's auditors went door to door in some cases, and the project started to get 30% to 40% participation, reaching 70% in some neighbourhoods.

"We're positioned to offer programs that people will accept," says Dollihite. "The homeowner has to agree to these kinds of measures. The [household energy] information belongs to them, and they have to let us into their homes. But it's almost always about the money. Green is good, but they have to know they're saving money."

All these trials and objectives are coming together in yet another project that Direct Energy is working on in Corpus Christi, Texas. This summer, 350 customers are getting the full energy audit and whole-home weatherization, as well as programmable thermostats capable of receiving and displaying messages and turning back the air conditioning during peak periods. By making homes more efficient and keeping peak demand to a minimum, the hope is to keep energy costs down and give customers more control over their energy use.

MAKING A DIFFERENCE

"The size of the prize is huge," says Dollihite, describing the benefits to both consumers and suppliers such as Direct Energy. "We win when we get a new customer, and we get a new customer when we give good value. We want people to think of us as more than someone they write a cheque to each month. We want them to say, 'These guys make a difference to the bottom of my bill.'"

