Final Report
Focused Audit of Affiliated Transactions and Management Audit of the New Jersey Natural Gas Company

Volume Two: Cost Allocations and Affiliate Relationships

Public Version
(No Confidential Version Exists)

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Cost Allocations and Affiliate Relationships
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I. Background

This portion of Liberty's audit report addresses affiliate relationships and cost allocation methods. It focuses on the affiliate transaction-related aspects of Liberty's examination of relationships among NJNG and its affiliates. This chapter of the report excludes potential cross-subsidization of non-utility affiliates through holding-company financial structure or through gas-procurement activities. Separate chapters address those topics.

A. Approach

Liberty's examination of cost allocations focused on assessing whether NJNG, and by extension, NJR and its subsidiaries, used accounting policies and operating practices sufficient to assure that NJNG was not subsidizing the operations of its affiliated non-utility companies. Liberty began by gaining an understanding of:

- The structure of NJR and its subsidiaries
- How they are organized and staffed
- How they account for transfers of services, goods, and assets between themselves.

Liberty then examined the policies, procedures, methods, and activities for assuring that the entities involved properly record all such transfers and price them in a manner that precludes any subsidy by utility operations of non-utility enterprises. Liberty also performed sample tests to assure that the NJR family of companies provided for sufficient control over the authorization, recording, and pricing of affiliate transactions.

B. Summary of Recommendations

NJR governs affiliate transactions between NJNG and its affiliates that involve common corporate services through service agreements filed yearly with the BPU as part of its EDECA Compliance Plan. Another category of affiliate transactions generally involve pass-through charges for outside vendor invoices or for portions of company-wide costs such as employee benefits and pensions. Relatively few affiliate transactions fail to fall squarely into one of these two categories. Liberty observed no evidence of improper transactions.

Liberty found that NJR and NJNG use reasonable methods for allocating or assigning costs between NJNG and affiliates, and that those methods have resulted in an equitable distribution of costs, and have avoided subsidization by NJNG of affiliates. The company's procedures, policies, and systems adequately ensure that these transactions pose no financial harm to utility customers and that the utility meets its objectives at an effective cost for utility-service customers. The utility receives payment for the services it provides to affiliates based on fully allocated cost, and the utility pays for services that it receives at no more than fully allocated costs.

Liberty's audit work did, however, disclose a number of improvement opportunities, which are as follows:

CA-1 Include allocations for NJNG general services to NJR Corporate in the Allocation Statements to Affiliates report.

CA-2 Develop a new, expanded CAM.

CA-3 Update Service Agreements and the CAM to reflect current practice.

CA-4 Develop a written policy concerning the types of costs that the company would retain at the corporate level.

CA-5 Require NJR Corporate executives to prepare actual time sheets at least quarterly.

CA-6 Monitor the cost of fringe benefits to ensure that the company collects an appropriate amount in shared services charges.

CA-7 Include depreciation expense associated with new assets the company uses to provide shared services in the charges to Home Services.

CA-8 Modify the calculation of billing rates to more accurately represent the true cost of this function, as well as the customer inquiry, remittance processing, and credit and collections functions.

CA-9 Include the cost of building rent and maintenance in vehicle maintenance shared service charges.

CA-10 Include depreciation expense associated with new assets used to provide general services.

CA-11 Update the service agreement for general services to remove print shop and postage services.

CA-12 Update the general services agreement to remove applications development, and move this function entirely to the Service Company.

CA-13 Revise the CAM to clarify the description of the allocation process for hardware and software maintenance.

CA-14 True up the employee labor charges from NJRES to NJNG to actual time sheets.

CA-15 Maintain the algorithm used to calculate CR&R's share of headquarters expense in order to reflect CR&R's current share of the building.

CA-16 Formalize the agreement between NJNG and NJR Home Services for payroll employee support.

C. Structure of NJNG's Affiliates

NJR is an energy services holding company formed in 1982 pursuant to a corporate reorganization. NJR was an exempt holding company under the Public Utility Holding Company Act of 1935, which was repealed effective February 2006. NJR (NJR Corporate) has five major subsidiaries:

- New Jersey Natural Gas Company (NJNG): the local-distribution public-utility company that provides regulated retail natural gas to customers in central and northern New Jersey and participates in the off-system sales and capacity release markets
- NJR Energy Services (NJRES): formed in 1996 to provide unregulated wholesale energy services
- NJR Capital Services (Capital Services): a sub-holding company of NJR formed as an unregulated affiliate to consolidate the Company's unregulated energy-related and real estate investments
- NJR Retail Holdings (Retail Holdings): a sub-holding company of NJR formed in 2001 as an unregulated affiliate to consolidate the Company's unregulated retail operations
- NJR Service Corporation (Service Company): an unregulated company formed in 2000 as a wholly owned subsidiary of NJR to provide shared administrative services for NJR and all of its subsidiaries.

NJNG comprises NJR's largest and most important business unit, in terms of profit contribution and assets, but NJRES outpaces it in operating revenues due to the nature of the energy trading business. NJR Capital includes three wholly-owned subsidiary companies: (1) Commercial Realty & Resources (CR&R), formed in 1966 to hold and develop real estate, (2) NJR Investment, formed in 2000 to make certain energy-related equity investments, and (3) NJR Energy Holdings, which includes NJR Energy, a company that invests primarily in energy-related ventures through its operating subsidiary, NJNR Pipeline. Retail Holdings has as a wholly-owned subsidiary NJR Home Services (Home Services), formed in 1998 to provide appliance service repair. The Company formed NJR Plumbing Service in 2001 as a subsidiary of NJR Home Services to provide plumbing services. The following table shows recent year operating results by line of business by fiscal year, which at NJR ends on September 30.

Operating Income by Line of Business

Business Line	2006	2005	2004	2003
Operating Income				
Gas Utility Operations (NJNG)	$88,029	$97,502	$98,823	$97,408
Energy Services (NJRES)	53,745	31,426	24,868	19,454
Retail and Other	4,689	9,440	3,527	2,975
Total Operating Income	$146,463	$138,368	$127,218	$119,837
Operating Revenues				
Gas Utility Operations (NJNG)	$1,138,774	$1,138,280	$928,902	$759,878
Energy Services (NJRES)	2,133,540	1,973,268	1,582,103	1,766,265
Retail and Other	27,568	36,900	22,698	20,413
Inter-segment Revenues	(274)	(186)	(96)	(3,691)
Total Operating Revenues	$3,299,608	$3,148,262	$2,533,607	$2,542,865

Thousands of Dollars

The following tables show that gas operations comprise by far the largest portion of NJR's assets and employees.

Assets by Line of Business

Business Line (year ending Sept 30)	2006	2005
Gas Utility Operations (NJNG)	$1,586,934	$1,581,758
Energy Services (NJRES)	714,867	$501,051
Retail and Other	107,213	$127,019
Inter-segment Assets	(10,086)	
Total Assets	$2,398,928	$2,209,828

Thousands of Dollars

NJR Employee Distribution

Entity	Employees
NJR Corporate	7
NJNG	500
CR&R	2
NJRES	34
NJR Service Company	103
NJR Home Services	117
NJR Plumbing Services	7
Total	770

at 2006 Fiscal Year End

NJR considers the following to be the products and services of its companies:

- New Jersey Resources: Parent holding company
- New Jersey Natural Gas Company (Utility): Energy services to residential, commercial, and industrial customers in Monmouth and Ocean counties, and part of Morris and Middlesex counties
- NJR Service Corporation: Shared administrative services for all affiliates
- NJR Retail Holdings (Retail affiliate): Owns NJR Home Services Company and NJR Natural Energy Company
- NJR Home Services Company (Retail affiliate): Appliance installation, sales, and repair services; owns NJR Plumbing Services
- NJR Plumbing Services, Inc. (Retail affiliate): Plumbing services for customers of NJR Home Services
- NJR Energy Services Company (Non-retail affiliate): Unregulated wholesale energy services, including natural gas supply, pipeline capacity, and storage management; owns NJR Storage Partners
- NJR Storage Partners (Non-retail affiliate): Natural gas storage capacity and wholesale natural gas marketing

- NJR Capital Services Corporation (Non-retail affiliate): Owns Commercial Realty & Resources Corporation, NJR Investment Company, and NJR Energy Holdings Corporation
- Commercial Realty & Resources Corporation (Non-retail affiliate): Development and ownership of commercial office and mixed use commercial and industrial real estate projects
- NJR Investment Company (Non-retail affiliate): Energy-related equity investments
- NJR Energy Holdings (Non-retail affiliate): Owns NJR Energy Corporation
- NJR Energy Corporation (Non-retail affiliate): Investment in energy-related ventures through two wholly-owned subsidiaries, NJR Pipeline Company and NJNR Pipeline Company
- NJR Pipeline Company (Non-retail affiliate): Pipeline investments
- NJNR Pipeline Company (Non-retail affiliate): Ownership of percentage of Iroquois Gas Transmission System, L.P., an interstate pipeline subject to FERC jurisdiction.

D. Services Provided among NJR Companies

The four main categories of services provided among NJNG and its affiliates comprise:

- Governance-level corporate services provided by NJR Corporate to affiliates
- General services provided by NJNG to affiliates
- Shared services provided by NJNG to Home Services
- Corporate services provided by NJR Service Company to affiliates.

Service agreements covered these four categories of transactions during the audit period. These agreements explained the services provided and the cost assignment and allocation methods used. These service agreements contain exhibits describing affiliate allocation and billing procedures. All of the charges under these agreements flow through inter-company accounts, which practice facilitates efforts to validate them.

These four categories do not cover all of the affiliate transactions that Liberty observed. These other, miscellaneous transactions defy neat categorization. NJR accounts for them generally as either direct or pass-through charges. For example, NJNG pays (on behalf of itself and affiliates) for such items as premiums for medical and dental insurance and telephone and cellular service charges, and assigns affiliates their share through inter-company charges. CR&R, for another example, charges NJNG for executive time. The dollar value of these miscellaneous transactions outweighs those covered by formal service agreements. Some of these miscellaneous transactions flow through inter-company accounts, depending upon the circumstances.

NJNG provides the general services listed in the following table to affiliates CR&R, Home Services, and NJRES, as well as to NJR Corporate.

NJNG General Services

Building Maintenance Services	Postage
Vehicle and Transportation Services	Application Development
Audio Tie-Line Services	Hardware/Software Maintenance

Print Shop Services	Communication Equipment
Inserter Room Services	Energy Services

The service agreement with NJNG calls for each affiliate to designate which of the above services it requires. For example, NJRES takes energy services, but not vehicle and transportation services; CR&R takes neither.

In addition to providing it general services, NJNG also provides certain shared services to NJR Home Services. The following table lists them. The agreement between the parties also provides for NJNG to purchase Home Service's accounts receivable.

Shared Services Provided by NJNG to NJR Home Services

Building Maintenance	Technical Training
Customer Inquiry	Transportation/Vehicle Maintenance
Billing	Credit and Collections
Remittance Processing	Performance Measurement/Support

NJNG and Home Services also have a separate Emergency Services Agreement, which provides for Home Services to provide NJNG with employees and equipment to assist in restoration of natural gas service or in repair of natural gas equipment in the event of an emergency. Liberty observed no transactions under this emergency service agreement during the audit period.

NJR Service Company provides to affiliates the corporate services listed in the following table.

NJR Service Company Corporate Services

Accounting	Legal
Internal Auditing	Office Services
Communications - Regular	Purchasing
Communications - Website	Quality/Continuous Improvement
Facilities	Training
Human Resources	Treasury
Information Technology	

NJR Corporate provides governance level services that it distributes to all affiliates, including NJNG.

II. Accounting Issues

A. Accounting Systems, Controls, and Reporting

1. Background

Liberty reviewed the adequacy of the accounting system that the company uses to record affiliate transactions and of the controls in place to ensure the accuracy of its affiliate transaction reporting. Liberty also reviewed the company's progress in implementing recommendations from the prior audit regarding the preparation of periodic reports, documentation of procedures, and work paper support.

2. Findings

The company uses a fully integrated JD Edwards enterprise accounting system that contains functions including general ledger, fixed assets, payroll, human resources, inventory, accounts payable, work order management, customer accounting, budgeting, purchasing, and job costing. The company's separate FODS system can also interface with the JD Edwards system. Each affiliate has its own separate general ledger. The Service Company accounting personnel maintain the books for all NJR entities and the books for NJNG are maintained in accordance with the Uniform System of Accounts. The company manages cross-charges between affiliates as debits and credits in inter-company accounts. NJNG has separate inter-company account numbers for its activity with each affiliate and with NJR Corporate, and a separate account for federal income taxes. Affiliate transactions can be traced on the books and records of the affiliates involved.

Charges to affiliates under the existing service agreements flow through inter-company accounts. The company records affiliate transactions in inter-company accounts through both automatic and manual journal entries. Charges from NJNG to affiliates for general services are examples of journal entries that the accounting system processes automatically. Some of the other types of transactions not covered by service agreements also flow through inter-company accounts, but many do not. For example, NJR Corporate pays the bill for certain forms of insurance (*e.g.*, property and general liability insurance, and workers' compensation), and accounting prepares paper invoices to charge each entity for its share.

Affiliates settle charges through wire transfers. The Service Company finance and accounting group produces inter-company control reports and settlement sheets that it uses to ensure that it has recorded affiliate transactions accurately on the books of both parties. The company indicated that it settles the account balances each month.

Liberty reviewed the company's Financial Procedures Manual, which covers subjects such as accounts payable, invoice and check processing, inter-company asset transfers, work orders, and fixed asset accounting. As the company intended, the manual does not specifically address affiliate transactions, or provide details on financial closing procedures, but is adequate for its purpose. The finance and accounting group maintains its own checklists of activities and procedures that take place during the closing process. The development of these tools came in connection with Sarbanes-Oxley compliance efforts. These company procedures were designed to ensure the accuracy of financial statements. The Internal Auditing department has responsibility for ensuring adherence to Sarbanes-Oxley requirements throughout the company. Liberty reviewed the company's Sarbanes-Oxley documents related to the accounting closing process. The documents set out detailed control objectives, control activities, and persons responsible for ensuring compliance. These controls do not, however, directly address affiliate transactions. However, Liberty concluded that the company's internal controls overall were adequate, and should result in the proper identification and recording of inter-company transactions.

In addition to reviewing the formally documented accounting controls, Liberty discussed with personnel from the finance and accounting group the more specific processes and procedures used to calculate and record the various kinds of affiliate charges. Liberty found company personnel to be diligent about ensuring that they properly identified and calculated affiliate transaction charges. The auditor who performed the last EDECA audit recommended that the company improve procedural documentation. As a general matter, detailed knowledge about the very specific procedures and processes for affiliate charges is concentrated in relatively few people. These finance and accounting personnel have, however, maintained their own detailed documentation and checklists surrounding the calculation and accounting for various affiliate transactions allocations.

Liberty requested that the company provide information on internal audits related to affiliate transactions and cost allocations conducted over the last several years. Such audits generally follow a five-year audit. The most recent audits were completed in 2001 and 2006. As part of the 2001 audit, the internal auditing group selected a sample month in 2001 and: (1) recalculated cost pool allocations, (2) tested automated journal entries associated with Service Company allocations, (3) traced Service Company charges to supporting documentation, (4) reconciled labor charges to supporting time sheets, and (5) substantiated documentation underlying charges to Home Services.

In the 2006 audit, the internal auditing group reviewed cost allocations for reasonableness, including a review of underlying work sheets used to calculate allocation percentages. Because the EDECA audit in 2003 had reviewed cost allocations in some detail, the company decided to place a stronger emphasis in the 2006 audit on operational issues. Work completed as part of the 2006 audit included: (1) reviewing customer service representatives (CSRs) handling calls for NJNG and Home Services either by live observation or by listening to recorded conversations, (2) reviewing system access controls, (3) reviewing employee transfers, (4) reviewing the effectiveness of the company's training on affiliate standards, and (5) reviewing affiliate rules regarding external complaint procedures.

The prior EDECA auditor recommended that the company improve work paper support for Service Company and NJNG cost allocations. Liberty observed the primary finance and accounting personnel responsible for the charges under the service agreements to exhibit strong organization. Liberty found that they maintained a considerable amount of back-up information and reports. During the course of its detailed review of each type of affiliate transaction, Liberty had the opportunity to review intermediary work papers, accounting reports, and similar documents, such as:

- Printouts of actual and budgeted monthly cost data for NJNG departments that provide shared and general services, for NJR Corporate, and for Service Company departments
- Work papers on the development of provisional and actual rates used for shared services
- Examples of documents used to develop allocation factors, such as call activity reports
- General ledger reports of NJNG inter-company transactions with affiliates
- Calculations of allocation percentages for NJNG general services
- Memos supporting NJR Corporate officer time reporting
- Summary time reporting information
- Inter-company account settlement reports.

Liberty believes that the company has put together considerably detailed supporting work papers for inter-company charges under the service agreements. Liberty also observed that the finance and accounting personnel has developed additional control reports for its own use, so that it is prepared to field detailed questions about charges among affiliates.

The prior EDECA auditor recommended that NJNG prepare periodic statements of inter-company services and charges for review by the business units and departments charged. Such reports are important for NJNG because, in most cases, the company does not generate formal bills for services. Liberty believes that the company has addressed the reporting issue. Each quarter, the finance group prepares and issues a report titled “Allocation Statements to Affiliates.” Each affiliate receives a report showing:

- Charges from Service Company showing major expense categories
- Detail of the labor allocation from Service Company, showing departmental sources of labor
- Allocations from the NJNG general services pools.

The report shows allocations of the NJNG general service costs to individual NJNG departments, the Service Company, and to affiliate, but not to NJR Corporate. These allocations are being performed but have not been included in the Quarterly Allocation Statements to Affiliates.

The Allocation Statements to Affiliates report shows the allocated and direct charges from NJNG to Home Services for shared services. It also lists charges from NJNG for energy services to NJRES and NJR Energy. This report does not show the allocations from NJR Corporate. Instead, the accounting group issues routine letters to affiliates regarding their yearly allocation of NJR Corporate charges and any true-ups. The report was designed to focus on allocated charges; it generally does not reflect direct charges to affiliates for general services, or charges for miscellaneous transactions such as employee benefits. The report also does not show the charges from NJRES to NJNG for energy-related employees, as these comprise direct charges.

Although the company does not have formal reports, it did prove able to produce detailed general ledger printouts of all inter-company charges involving NJNG, which Liberty used to cross-check affiliate charges shown on the Allocation Statements to Affiliates report.

3. Conclusions

1. The company's accounting systems, procedures, and controls are adequate to ensure accurate recording and reporting of affiliate transactions.

The methods of accounting for affiliate transactions are adequate. NJNG and each affiliate maintain a separate general ledger. The JD Edwards integrated accounting system records affiliate transactions in separate inter-company accounts in the general ledger. NJR uses inter-company debits and credits to identify and maintain control over affiliate transactions. Finance and accounting group personnel reconcile affiliate accounts to verify the accuracy of recorded transactions, and the company settles its inter-company accounts promptly. The company appears to have reasonably comprehensive accounting control procedures and processes in place. Liberty also found that the company improved its maintenance of support work papers and has developed a reasonably complete report of charges for inter-company services.

2. The company conducts internal audits specific to affiliate transactions and cost allocations on a five year cycle.

Liberty reviewed the company's recent internal audits of affiliate transaction and cost allocation issues and found that the audits were of sufficient frequency, scope, and depth.

3. Although the Company does compute allocations to NJR Corporate from NJNG, the Allocation Statements to Affiliates report does not show allocations of NJNG general services charges to NJR Corporate. *(Recommendation #1)*

The company's quarterly Allocation Statements to Affiliates report shows how NJNG allocated charges for general services to its own departments, to the Service Company, and to affiliates, but not to NJR Corporate, although that computation is being done.

4. Recommendations

1. Include allocations for NJNG general services to NJR Corporate in the Allocation Statements to Affiliates report. *(Conclusion #3)*

Liberty believes that the company should include allocations of general services to NJR Corporate in its quarterly reports. This will allow the company and auditors more easily to reconcile total yearly charges with total allocation pool expenses.

B. Time Reporting and Hourly Billing Rates

1. Background

Liberty reviewed the company's time reporting process and procedures to determine if it would ensure accurate reporting of employee time spent working on behalf of affiliates.

2. Findings

Time Reporting

All employees fill out a payroll time sheet to report sick time, vacations, etc., although some employees submit such time sheets on an exception basis only. Utility union employees must submit a time sheet each week and report their time by work type. The company implemented in 2002 an on-line affiliate transfer time sheet system; it captures time for people who work for any business entity other than their own. Most NJNG employees use the affiliate-transfer time-sheet to report time spent on non-utility work. All Service Company personnel, as well as other employees in the NJR organization that do significant amounts of work for others, must submit their time in the affiliate-transfer worksheet system.

Some employees do work for others very infrequently; the company still uses paper time affiliate transfer time sheets for them because it is not worthwhile to set the employee up in the automated system for infrequent occurrences. Certain NJR employees do not record their time in the affiliate transfer system at all. The IT department has its own separate version of time reporting, which is set up more like a work order system. It captures time on a project-by-project basis. Customer Service Representatives allocate their time electronically using a customer contact tracking screen of the Customer Information System (CIS).

Liberty reviewed the company's written time sheet policies and procedures, and found them adequate. The company's Time Sheet Policy and Procedure states that the Board's affiliate rules require that all NJR, NJR Service, and NJNG employees who perform work for NJNG or any other NJR affiliate are required to submit a monthly time sheet. The Service Company finance and accounting group maintains a list of the employees that must submit affiliate transfer timesheets and makes sure that all are received and input before it processes any affiliate charges. The company diligently tracks time sheets; it believes that all required timesheets are completed as necessary, but cannot tell if there are any exception-basis time sheets missing.

Hourly Billing Rates

An inter-company hourly billing rate should leave the billing company at least no worse off by having lost the benefit of an employee's time spent serving another entity. Meeting this test in the case of labor requires that the employing company secure reimbursement for the employee's direct salary, with adjustments to account for:

- Non-productive time, such as vacation, holiday, and sick time
- Payroll taxes
- Employer costs for benefits, such as pensions and medical and dental coverage.

Hourly billing rates based on the principle of fully allocated costs should also include an additional loader for overhead costs.

The company calculates hourly billing rates for relatively few affiliate transactions. For NJR Corporate, NJNG shared services, and NJNG general services transactions, the company each month allocates costs that include labor, fringe benefits, and overhead using a given factor, and performs a true-up to actual costs at year-end. The company therefore never develops or uses an hourly billing rate for direct charges for these services. All entities that receive charges bear the full burden of employee costs, including employee non-productive time, and overhead.

Similarly, the company each month allocates actual Service Company corporate function costs to affiliates using time sheet estimates, and performs a true-up using actual time sheet data each quarter. With few exceptions, there is no separate hourly billing rate for Service Company functions. The company calculates an hourly charge for the purposes of charging for print shop services. Any time that was not charged on time sheets to affiliates becomes part of the Service Company residual, which includes sick, vacation, and holiday time, as well as any time that would otherwise be charged to NJR Corporate. The company allocates this residual to affiliates in the same proportion as it charged for identifiable time. All entities that receive charges bear the full burden of employee costs and overhead.

There are a few recurring instances in which the company derives an hourly billing charge:

- Charges from NJRES to NJNG for employee time
- Charges from NJNG to Home Services for payroll employee time
- Charges from NJNG to NJR Energy Holdings for executive time
- Charges from NJNG to NJRES.

As a general matter, the company develops for the employees a rate that includes fringe benefits and overhead. The company did not follow this approach for NJRES charges to NJNG (*i.e.*, it charged no overhead), which Liberty discusses in more detail in Section III.C. Liberty discusses the charges from NJNG to Home Services and to NJR Energy Holdings in more detail in Section III.E.

3. Conclusions

1. The company's time reporting process and controls are adequate.

Liberty believes that the company's time reporting process and procedures provide reasonable assurance of accurate reporting of employee time spent working on behalf of affiliates.

4. Recommendations

Liberty has no recommendations in this area.

C. Cost Allocation Manual and Service Agreements

1. Background

Typically, a company's cost allocation manual *(CAM)* expresses the official statement of the policies and procedures on distributing costs among subsidiaries, a reference on the subject for employees, and a repository of information of why particular kinds of costs get distributed in specific ways. Having a CAM that describes how the distribution of costs will take place and that enunciates a philosophy of cost distribution that complies with the requirements of regulatory bodies is a necessary condition for compliance. An adequate CAM is not sufficient by itself, however, and the company needs to ensure that the results of accounting, documentation, authorization, and pricing decisions, as well as actions made by company employees, fully implement the letter and spirit of the CAM and the requirements of a utility's regulators.

Service agreements that describe the types of services provided between affiliates and that explain the allocation and billing procedures that will be used to charge for these services are also important tools in compliance. Procedures for billing and allocating charges in the service agreements and the CAM should of course be consistent.

2. Findings

NJR's finance and accounting group has primary responsibility for maintaining the CAM. The company's latest CAM version, entitled "NJR Service Corp. & NJNG Allocations Manual," bears an August 2005 date. The CAM states that it provides "a verbal explanation of methods, procedures, and the sequence of events involved in allocating" costs for shared functions. The CAM contains separate sections for the Service Company clearing and closing process, allocations of NJNG shared services to Home Services, and NJNG general service pool expense allocations to affiliates.

The company's CAM is brief, comprising only about 20 pages, and difficult to understand. It offers more a list of journal entry procedures for the accounting group than an explanation of activities and processes in the form of policies and procedures. The CAM section on Service Company costs is particularly cryptic. It lists a series of automated journal entry procedures designed to create debits and credits to specific accounts for such cost categories as labor, computer pool costs, and payroll taxes. The procedure descriptions provide little insight. For example, one procedure reportedly accumulates and allocates "the bulk of the overhead pool" and another accumulates and allocates "the second part of the overhead pool." The costs apparently being allocated by the procedures do not correlate easily to the services provided, or to the terms of the service agreement. The portions of the CAM devoted to NJNG general services and to shared services also read like detailed journal accounting procedures, and primarily explain the accounts to which pool expenses are charged. The CAM does however state the basis upon which the company allocates costs. These statements comport with the terms of the service agreements.

The CAM does not address some services at all. A service agreement broadly outlines the procedure for charging NJR Corporate costs, but the CAM does not address that subject. The company acknowledged that it probably should be included. Similarly, there exists an agreement for emergency service between NJNG and Home Services, but the CAM does not mention it. NJNG stated that such charges were not common and therefore not a regular method codified in the CAM. The current version of the CAM is also missing sections for two specific NJNG general services; *i.e.*, the inserter room general and energy services.

The CAM also does not include a detailed explanation of the company's method for deriving hourly billing rates for direct charging affiliates. The CAM also does not address any related procedures, such as obtaining pre-approval for such charges. In addition, the CAM does not address the company's conventions for handling miscellaneous affiliate transactions that do not fall under one of the services agreements but yet nonetheless represent a large percentage of all affiliate transactions. Examples of such transactions include the lease between CR&R and NJNG for the headquarters building, employee benefits costs, and costs shared between NJNG and NJRES for energy-related software and subscriptions. The CAM does not document a number of important allocation assumptions. The company's process for deriving shared service billing costs (discussed in more detail in Section III.B) involves moving labor and other expenses to billing from shared service groups, such as customer inquiry, remittance processing, and credit and collections.

Liberty's review identified several areas of the CAM that were out of date:

- The CAM lists telephone as a general service, although it is no longer part of the service agreement. Telephone is a general service allocation for budgeted services calculations. Telephone is not a general service allocation for actual expenses. Actual telephone expenses are specifically identified by entity and charged accordingly.
- The CAM indicates that NJNG uses historical estimates to allocate the postage general service. NJNG changed to direct charging for postage in fiscal year 2000
- The CAM indicates that NJNG uses historical estimates to allocate print shop general services. NJNG changed to direct charging for the print shop for fiscal year 2004.

Some general criteria that Liberty considers when it evaluates the clarity and completeness of governing documents and procedures such as the CAM:

- There should be sufficient documentation to establish clear rules for pricing all services
- The rules should provide for a clear and consistent set of methods for price determinations
- The rules should be in accord with requirements established by regulatory standards.

The company's CAM falls short with regard to the first two criteria; the rules are not clear and the level of documentation is thin. Very detailed affiliate transaction accounting procedures and processes do not need to be contained in the CAM, if they take some structured, accessible form. The company does not support the CAM with any other formal written documentation although, as noted earlier, finance and accounting personnel maintain their own detailed documentation and procedural checklists. One cannot determine whether the CAM comports with regulatory requirements from a plain reading. One has to rely instead upon service agreements and detailed discussions with finance and accounting personnel.

One of the most comprehensive CAMs that Liberty reviewed recently was that of South Jersey Industries. That CAM included more than mere compilations of policies and procedures, it contained copies of memoranda, analyses, and invoices that serve as models, documentation, examples, and instructions on how to distribute costs among affiliated businesses. It also contained a useful introduction and explanation of its contents. While a CAM of this level of detail may not be necessary, NJR should have a CAM that clearly sets forth the method employed for all direct charges and allocations between and among all NJR affiliates. The underlying principal should be the use of a fully distributed cost alignment, based on the premise that both direct and indirect costs are identified for products and services. At a minimum, the company should maintain a CAM that describes (or refers to supporting documentation that describes) its costing system, the rules that govern service pricing and charging to the affiliates, time reporting, and the billing process.

Liberty asked the company to provide copies of all existing agreements regarding the transfer of goods and services NJNG referred Liberty to the service agreements that it filed in its

Compliance Plans. The 2006 Compliance Plan contained copies of agreements between NJNG and each of its affiliates (CR&R, NJR Home Services, NJRES, and NJR Corporate) for general services. The agreement between NJNG and NJR Corporate contains additional procedures that address the allocation of NJR Corporate costs. The Plan included the agreement between NJR Service Company and NJNG, and the emergency services agreement between NJNG and Home Services.

Liberty found that the 2006 Compliance Plan documents were incomplete; two exhibits in the general services agreements included in the prior year's Compliance Plan were missing. One exhibit covered NJNG's provision of shared services to Home Services. The other covered NJR Energy Service's provision of specific functions; *i.e.*, software development, credit and contract functions, and contract negotiations, to NJNG. The company later confirmed that it failed to include these exhibits. The company indicated that it intended to revise the service agreements to include missing information.

The service agreements that the company had in place prior to 2004, as reflected in its 2002 and 2003 Compliance Plans, contained less detail about the nature of service and approach to allocation and billing, but were consistent with later agreements. The prior EDECA auditor recommended that the company expand its service agreements between NJNG and affiliates to describe the nature, terms, and prices charged for services. The newer versions of the service agreements reflect the increased specificity. Liberty believes that the terms of the service agreements comply with requirements for transactions among members of a holding company.

Based on its review of general services, Liberty recommended certain changes in the general services to be provided by NJNG. If adopted, they would imply a change to the service agreements and to the CAM. As an example, Liberty recommends that the application development general service be eliminated from the NJNG service agreement, and instead allocated from the Service Company. Liberty discusses these recommendations in more detail in Section III.C.

New Jersey statutes (N.J.S.A. 48:3-7.1) require that a utility secure BPU approval for certain "management, advisory service, construction, or engineering contracts between a utility and an affiliate." The BPU has not approved service agreements between NJNG and its parent and between NJNG and a number of affiliates. NJNG has submitted those agreements with annual EDECA compliance plan filings, most recently in October 2006. The cover letter for that filing stated that the agreements were being submitted, "for the Board's review and approval pursuant to N.J.S.A. 48:3-7.1." NJNG has not, however, made formal submissions in the manner that a number of other New Jersey utilities have done. This statutory provision requires the BPU to consider the pricing of those contracts in its review. The CAM operates as a principal source of guidance for the pricing of services among NJNG and its affiliates.

3. Conclusions

1. **The company's CAM is missing some pertinent details and is not sufficiently explanatory.** *(Recommendation #1)*

The company's CAM requires improvement in comprehensiveness, clarity, and general usefulness. One cannot clearly determine compliance with regulatory requirements. NJNG's CAM does not address the allocation of NJR Corporate costs, or pricing under the agreement for emergency service between NJNG and Home Services. It is particularly important to capture the method for distributing NJR Corporate costs, as this affects all affiliates, and appears to be addressed only in the contract between NJR Corporate and NJNG. The CAM also fails to address general service inserter room and energy services. It also provides no guidance on calculating fully allocated hourly billing rates, or for assigning costs for certain miscellaneous transactions such as the lease between CR&R and NJNG, employee benefits, and energy-related software and subscription costs between NJNG and NJRES.

The company's current CAM is primarily a list of accounting procedures, not a clear set of rules that govern affiliate transaction pricing. Even when viewed strictly as an accounting document, the CAM is written like a set of notes useful to a small group of finance and accounting personnel, rather than something useful to employees in general.

2. **The CAM and Service Agreements require updating.** *(Recommendation #2)*

Neither the shared services provided by NJNG to Home Services nor the charges from Energy Services to NJNG for certain energy-related functions are addressed in the service agreements filed in the 2006 Compliance Plan. The company agreed that it should update these agreements.

The CAM and the allocation and billing procedures in the service agreements do not reflect more recent changes in NJNG's allocation procedures for general services. As an example, the CAM does not reflect the fact that NJNG stopped using historical estimates to allocate postage in fiscal year 2000, and to allocate print shop expenses in fiscal year 2004. The CAM also lists telephone as a general service, although it is no longer contained in the service agreements.

3. **Service agreements and the CAM have not received BPU approval.** *(Recommendation #3).*

New Jersey statutes (N.J.S.A. 48:3-7.1) require service agreement approval. NJNG has requested review and approval in the cover letters of annual compliance plan filings, but has not made the kinds of formal submissions that other New Jersey utilities have. The CAM's operation as a principal source of guidance for the pricing of services among NJNG and its affiliates makes its inclusion appropriate in a formal request for review and approval.

4. Recommendations

1. **Develop a new, expanded CAM.** *(Conclusion #1)*

The company's should develop for the next annual compliance-plan filing a clearly-written CAM that, at a minimum, describes the company's costing system, the rules that govern service pricing and charging to the affiliates, time reporting, and the billing process. It should be apparent from a plain reading of the CAM that the company's methods comply with relevant regulatory requirements. The CAM should incorporate procedures for calculating hourly billing rates, as well as related policies such as pre-approval. The new CAM should also address the myriad of charges for miscellaneous affiliate transactions not otherwise covered by service agreements, including insurance and employee benefits. The new CAM should also incorporate procedures that relate to NJR Corporate costs and emergency services.

2. Update Service Agreements and the CAM to reflect current practice. *(Conclusion #2)*

The company should ensure for the next annual compliance-plan filing the execution of service agreements for all services between affiliates each year, and file them with the Compliance Plan. NJNG should also incorporate any changes to its policies and procedures for assigning or allocating charges, such as those for postage and inserter room charges, into the next version of the CAM and Service Agreements. Liberty found that the Service Company finance and accounting personnel responsible for cost allocation were not familiar with the content of the service agreements. The company should therefore ensure that the CAM and service agreements are consistent.

3. Make a formal filing seeking BPU review and approval of Service Agreements. *(Conclusion #3)*

This filing should take the form used by other state utilities that have made a formal request and it should include the CAM as a principal source of pricing guidance.

III. NJNG Transactions

A. NJR Corporate Costs

1. Background

NJR Corporate provides to its subsidiaries corporate support services in the areas of executive leadership, control, tactical and strategic planning, and corporate governance by the Board of Directors. NJR does not include top executives in the Service Company, but handles these corporate level costs separately. The nature of NJR Corporate costs have not changed much over the audit period, with the exception of costs associated with Sarbanes-Oxley compliance and the fact that there are now five officers instead of three. NJR Corporate distributes all of its costs to the subsidiaries, and confirmed that it retained no costs during the audit period. The company also charged no separate management fees to the utility or any affiliate during the audit period.

For the purposes of reviewing NJR Corporate costs, Liberty focused on budgeted and actual expenses for fiscal year 2006, and on NJR's method for allocating these costs under the principle of fully allocated costs.

2. Findings

The company develops a budget each year for the expected total costs for NJR Corporate, which includes five officers: Chairman and CEO, Senior Vice President Corporate Affairs, Senior Vice President and CFO, Vice President, General Counsel, and Corporate Secretary, and their administrative support personnel. The budget includes salaries, fringe benefits, and payroll taxes. It also includes costs allocated to NJR Corporate from NJNG for general services such as rent and IT, as well as director's fees, insurance, and interest fees. This budget forms the basis for allocations to affiliates during the year.

The Service Company's finance and accounting group uses officer time estimates and NJR Corporate budgeted payroll costs during the yearly budgeting process to calculate allocation percentages. These payroll costs include budgeted amounts for salaries, bonuses, and long-term incentives (*e.g.*, stock options), which totaled approximately $2.3 million for fiscal year 2006. The total includes $387,700 for long-term incentives and auto allowance. Officers provide memos estimating the percentage of time they will spend on each affiliate and on NJR Corporate work for the next year; officers assign no time to the Service Company. The finance and accounting group divides the budgeted payroll cost for each corporate employee among entities (*i.e.*, affiliates and NJR Corporate) based on the employee's percentage time estimates. The payroll dollars associated with administrative assistants follow the officers for whom they work. The group then totals payroll costs for all employees by entity, and calculates an allocation percentage for each affiliate and for NJR Corporate; this percentage is the ratio of each entity's budgeted payroll dollars to total budgeted payroll dollars.

The practice of not retaining any costs at NJR Corporate requires NJR to adjust the affiliates' allocation percentages to distribute the costs for NJR Corporate work. The finance and accounting group recalculates each affiliate's percentage by comparing its total budgeted dollars to the total for all affiliates (*i.e.*, total budgeted costs less those costs budgeted to NJR

Corporate). The following table summarizes the initial and revised budget allocation percentages for fiscal year 2006.

Fiscal 2006 Budgeted Allocation Percentages

Company	Initial	Revised
NJR Corporate	39.94	
NJNG	45.56	75.86
CR&R	0.80	1.33
NJR Energy Holdings	1.23	2.06
NJR Energy Service	10.75	17.90
NJR Home Services	1.71	2.85
NJR Investments	0.00	0.00
Total	**100.00**	**100.00**

The finance and accounting group uses the revised allocation percentages to determine the amount of budgeted NJR Corporate costs assignable to each affiliate. NJR Corporate does not issue bills, but sends a memo at the beginning of each fiscal year to each affiliate showing its budgeted dollar assignment for the year. Each month, the affiliates record a journal entry for $1/12^{th}$ of their share of budgeted corporate costs.

During the year, the finance and accounting group may notify the affiliates to modify their journal entries to reflect variances from budget. The officers prepare at the end of the fiscal year memos documenting where they actually spent their time. Accounting performs a true-up after calculating new allocation percentages based on actual hours spent on behalf of each affiliate. The following table summarizes the actual fiscal year 2006 allocation percentages.

Fiscal 2006 Actual Allocation Percentages

Company	Initial	Revised
NJR Corporate	38.05	
NJNG	46.48	75.03
CR&R	0.81	1.30
NJR Energy Holdings	1.27	2.05
NJR Energy Service	11.61	18.74
NJR Home Services	1.78	2.87
NJR Investments	0.00	0.00
Total	100.00	100.00

NJNG had a slightly lower actual allocation percentage than budgeted because of a small increase in officer work performed on behalf of NJRES.

Accounting directly charges to an affiliate any NJR Corporate cost that relates specifically to the affiliate or a subset of affiliates, such as a portion of an outside legal or audit bill. These costs are directly charged through the company's inter-company accounts; they do not form part of the

NJR Corporate charges allocated to all affiliates. The following table summarizes the components of actual allocable NJR Corporate expenses for fiscal year 2006.

NJR Corporate Actual Costs – Fiscal 2006

Cost Component	Amount
Salaries	$2,552,379
Fringe benefits	346,549
Deferred compensation	1,798
Payroll taxes	192,619
Employee expenses	198,286
Insurance	986,516
Donations	507,883
Other expenses	339,441
Interest	1,574,273
Equity-related expenses	421,045
Directors fees	1,166,289
Legal fees	122,848
Audit fees	514,324
Total	$8,924,250

Audit fees include NJR Corporate's shared of regular audit and Sarbanes-Oxley audit fees. The initial budget for fiscal year 2006 was $7.1 million, compared to actual costs of $8.9 million. Some of the larger variances involved donations ($0.4 million), interest ($0.4 million), and miscellaneous equity costs ($0.2 million).

The following table summarizes the allocated charges from NJR Corporate to affiliates during the audit period.

NJR Corporate Charges to Affiliates

Entity	2006	2005	2004	2003
NJNG	$6,696,239	$5,727,063	$6,169,545	$7,555,769
CR&R	115,980	98,032	94,967	178,636
NJR Energy Holdings	183,125	105,821	96,528	104,996
NJR Energy Service	1,672,534	1,184,058	554,753	357,045
NJR Home Services	256,375	87,708	61,453	61,029
Total	$8,924,253	$7,202,682	$6,977,246	$8,257,475

The resulting allocation percentages, which assign 76 percent of corporate level costs to NJNG, appears reasonable. Prior to fiscal year 2004, the company used an equity allocator to spread to affiliates NJR Corporate residual costs; *i.e.*, the costs associated with NJR Corporate work. The company discontinued this practice based on a recommendation in the prior audit. According to the prior auditors, NJNG bore 93 percent of corporate costs when it allocated residuals using the equity allocator method. The effect of discontinuing the method appears to be considerable.

Liberty examined available executive time sheet memos, and compared the fiscal year 2006 budget memo (dated September, 2005) and the actual time memo (dated September 2006) for the two executives for which NJR provided complete data. The following table shows that comparison.

Fiscal Year 2006 Officer Allocation Percentages

Officer	NJNG	NJR	NJRE	CR&R	NJRHS	NJRES
CEO Initial	50.00	30.00	0.00	0.00	1.00	19.00
CEO Year-end	50.00	30.00	0.00	0.00	1.00	19.00
Corp Serv Initial	75.00	25.00	0.00	0.00	0.00	0.00
Corp Serv Year-end	75.00	25.00	0.00	0.00	0.00	0.00

The time distribution for these executives appears reasonable. However, the fact that the percentages did not change over the course of a year suggests a lack of detailed year-end review. It is important that officers lead by example and convey the importance of accurate time reporting and ensuring that the utility does not pay a disproportional share of costs.

Liberty tested a number of actual NJR Corporate costs for fiscal year 2006. Liberty asked the company to trace through its accounting system a legal bill that came in to NJNG, and was then charged out to affiliates, including NJR Corporate. The company was able to show the invoice in the accounts payable system and substantiate the portions assigned to each of three affiliates. Liberty also verified with the company the share of audit fees that remained at NJR Corporate.

Liberty found that, during prior years, the company allocated a percentage of the costs of Sarbanes-Oxley audits (approximately 50 percent) to NJNG, and the rest remained at NJR Corporate for allocation to all affiliates. NJNG therefore received approximately 87.5 percent of these costs, *i.e.*, 50 percent of the total bill plus approximately 75 percent of the NJR Corporate portion of the bill through allocation. Beginning in 2007, the company decided to retain all of the Sarbanes-Oxley audit costs at the NJR Corporate level and assign them to affiliates along with other corporate costs. In the future, NJNG will therefore receive less of these audit costs than it did in prior years.

Liberty also questioned the company about the costs in the NJR Corporate budget for stock options. The company stated that the expense relates to the granting of stock options. The company accounts for these options according to Financial Accounting Standards. The value of the stock options is based on a Black Scholes analysis, and reflects the fact that there is a four-year vesting period for options.

3. Conclusions

1. The company's approach for allocating NJR Corporate costs is reasonable.

Liberty found that NJR's method for allocating NJR Corporate costs, *i.e.*, executive time sheets, is reasonable, and results in an equitable distribution of corporate costs such that NJNG is not subsidizing affiliates.

2. The company had no written policy covering situations under which costs should be retained at the corporate level and not allocated to affiliates. *(Recommendation #1)*

Liberty believes that there are circumstances, such as officer time devoted to new business development, which should not be assigned to affiliates. The contention that the company had no activity of this type during the audit period does not mean that it will not do so in the future. The company has no written policy to make explicit what types of costs should be retained.

3. Annual executive time reconciliation does not indicate sufficient attention to detail. *(Recommendation #2)*

Liberty reviewed the time estimates that two officers prepared at the beginning of the 2006 fiscal year and the actual time they reported at year-end. The estimated and actual percentages of officer time devoted to each affiliate were the same, which gave Liberty the impression that actual figures may not be accurate.

4. Recommendations

1. Develop a written policy concerning the types of costs that the company would retain at the corporate level. *(Conclusion #2)*

The company should include as part of the written policies and procedures in the CAM a description of conditions under which it would retain costs at the corporate level. The policy should address costs incurred at both the NJR Corporate level and at the affiliate or utility level.

In the prior audit, the auditors recommended that corporate development costs directed at non-regulated projects in the consideration, planning, or development stages should not be part of the NJR Corporate cost pool and charged predominantly to NJNG regulated operations. Liberty echoes the recommendation.

2. Require NJR Corporate executives to prepare actual time sheets at least quarterly. *(Conclusion #3)*

NJR Corporate costs amount to nearly $9 million per year, and it is important that they be allocated correctly. It is not unusual for top executives to prepare time sheets as frequently as monthly. Liberty believes that the corporate officers need to demonstrate that they take this allocation exercise seriously, as it sets an example for others throughout the organization. Liberty therefore recommends that NJR executives report actual time at least quarterly.

B. NJNG Shared Services Provided to NJR Home Services

1. Background

NJNG provides certain of its own utility services to Home Service that it does not provide to other affiliates, in particular customer inquiry, billing, remittance processing, and credit and collections support. It also provides building maintenance, technical training, and vehicle maintenance. These services are separate from the general services that NJNG provides to all affiliates. The utility reports actual charges, budgeted charges, and variances to Home Services in the quarterly Allocation Statements to Affiliates report.

The company's allocation method is designed to charge Home Services fully allocated costs for shared services. The company indicated that its approach for allocating these costs had not changed substantially during the audit period. For the purposes of reviewing the company's process for allocating shared services costs, Liberty focused on budgeted and actual expenses for fiscal year 2006.

2. Findings

NJNG maintains a series of cost pools that it uses to collect costs for shared services that it provides under a service agreement to Home Services. The following table summarizes them. NJNG stated that it ceased providing dispatch service to Home Services in September 2003, when the affiliate began providing the service itself.

Shared Services Pools

Non-HQ Building Maintenance	Technical Training
Customer Inquiry	Vehicle Maintenance
Billing	Credit and Collections
Remittance Processing	Performance Measurement/Support

In addition to these services, the service agreement between the parties also provides for NJNG to purchase Home Services' accounts receivable at a discount.

NJNG uses specific allocation factors to determine the percentage of costs in the shared services pools attributable to Home Services. The following table summarizes them.

Shared Services Pools Allocated to NJR Home Services

Shared Service Pool	Allocation Factor
Non-HQ Building Maintenance	Square footage
Customer Inquiry	Call count
Billing	Equivalent bills
Remittance Processing	Remittances
Technical Training	Actual time sheets
Vehicle Maintenance	Mechanic hours
Credit and Collections	Revenue dollars subject to C&C
Performance management/support	Gross expenses of relevant departments

The company's allocation factors for the shared service pools are reasonable. For two pools, technical training and vehicle maintenance, the company uses actual time reporting to allocate costs. For the others, the company has selected allocation factors, such as square footage or bill counts, which provide a good match to the actual costs associated with a given service.

The company's CAM lists performance management and support (Department 800) as a separate shared service, but it is actually an overhead cost NJNG adds to the costs of certain shared service functions. The department contains management personnel that support all customer service areas, both those that are shared with Home Services, *i.e*., billing, remittance, and credit and collections, and those that are not, such as marketing and sales.

The following table summarizes the charges to Home Services for shared services during the audit period.

Shared Services Charges to Home Services

Shared Service	2006	2005	2004	2003
Building Maintenance	$7,939	$8,330	$25,854	$31,247
Customer Inquiry	796,690	801,782	769,647	703,222
Billing	440,072	422,389	376,688	337,116
Remittance Processing	159,439	144,990	136,466	110,532
Training	47	8,265	6,967	26,571
Transportation	193,929	198,446	268,286	219,185
Credit/Collections	41,272	55,311	53,630	0
Dispatch	0	0	0	434,352
Total	$1,639,388	$1,639,513	$1,637,538	$1,862,225

The charges to Home Services have been relatively constant over the audit period. There was a significant change from fiscal year 2003 to fiscal year 2004. NJNG began to charge Home Services for credit and collections services. NJNG charges decreased overall nevertheless, because it ceased providing dispatch services.

NJNG develops a provisional or budgeted rate for each shared service at the beginning of each fiscal year. It first develops a yearly projection of allocation factor units (*e.g.***,** number of bills, revenue). NJNG asks Home Services to estimate what it believes its volumes will be, and combines it with estimates for its own usage to determine the projected number of allocation factor units for each service. NJNG then calculates a provisional rate for each service, based on the budgeted expenses for each service department and projected allocation factor units. NJNG uses the projected number of allocation units only for the purposes of deriving a rate. Each month, NJNG bills for shared services based on actual units times the provisional rate.

In the last two months of the fiscal year, NJNG performs a true-up. The first true-up accounts for differences between the actual and provisional rate. The company calculates the revised actual rate for each shared service based on actual expenditures and actual numbers of allocation units for the first eleven months of the fiscal year. To true up for the first eleven months, the company multiplies Home Services' actual units for the first eleven months by the difference between the actual and provisional rates, and records the appropriate adjustment. The company then uses the revised actual rate to calculate charges for September, the last month of the fiscal year, by multiplying the new rate times the actual units for September. The company acknowledged that using the revised rate for the last month is less than perfect, because it reflects eleven rather than twelve months of actual costs, but stated that it cannot wait until it closes the books to derive actual costs for the twelfth month. Liberty believes that this convention is reasonable under the circumstances.

The rates that the utility uses to assign costs for shared services consist primarily of labor-related costs, fringe benefits, and overhead. When calculating total budgeted department expenses for the purposes of allocation for fiscal year 2006, the company applied 31.1 percent to labor charges to account for fringe benefits. The company stated that its fringe benefit rate includes: payroll taxes, medical and dental benefits, pension, vacation, savings plan matching, tuition reimbursement, life insurance, temporary disability, long-term disability, employee activities, employee training, post-retirement benefits, fitness center, pension fees, ERISA fund evaluation, and other miscellaneous benefits.

The company separately breaks out the fringe benefit portion of the shared service rate. From an accounting perspective, NJNG does not actually assign fringe benefit costs to individual service departments. Instead, it carries them in a separate NJNG department. NJNG credits the fringe benefits costs paid by Home Services in shared service rates against the separate fringe benefit account, not against the individual service departments. The company performs a true-up of the fringe benefit rate as it does for other shared service rates. In 2006, the company used a true-up fringe benefit rate of 33 percent.

Liberty asked the company to provide back-up information on the fringe benefit rate. The company provided a printout from GEAC, its Windows-based reporting and budgeting software program. The printout showed a budgeted fringe benefit rate of 33 percent and an actual fringe benefit rate of 39 percent for fiscal year 2006. The company explained that, because the GEAC software was new, it was not yet comfortable relying on the higher figures, and instead used 31 percent as the budgeted rate, which was consistent with prior year experience. Similarly, it was not comfortable with the GEAC-reported actual rate of 39 percent, and instead used an actual rate of 33 percent for the purposes of the true-up. The company has since become more comfortable with the GEAC reports, and has increased the budgeted fringe benefit rate for fiscal year 2007 to 39 percent, which is more consistent with the rise in actual costs due to increases in medical benefit and pension costs. The company noted that this issue does not affect, for example, Service Company allocations, because it allocates actual costs each month, which would reflect true benefit costs.

Liberty believes that NJNG may have used too low a fringe benefit rate for fiscal year 2006. If so, the total shared service function costs that it calculated for allocation purposes would be understated. Home Service's portion of shared service charges related to fringe benefits would also be too low, which means that NJNG retained a larger share of fringe benefits costs associated with shared services than it should have.

When building up the rate for the shared service functions, the company assigns a portion of overhead costs such as postage, inventory stock, and vouchers, to each department. Some of these overhead costs consist of allocations from NJNG general service pools, such as for hardware and software maintenance and headquarters building maintenance. The company does not include related depreciation expenses in its shared service rates. Other than buildings, the capital assets that the utility uses to provide shared services include an inserter machine, remittance mail opener, data monitoring systems, a portion of some computer network services, equipment and computer network software, and furniture. The company's capital accounting system does not capture individual assets, just categories of assets, so the company cannot identify the value of a given building or piece of equipment. As such, it cannot directly calculate depreciation for a specific item. The company indicated that the equipment is generally old and that the book values are low; as such, resulting depreciation if calculated would be insignificant. The company is installing a new fixed asset accounting system that should address this problem, but only for new assets moving forward.

NJNG applies a loader for performance management and support to certain shared service department budgets. Performance management and support department costs include labor and fringe benefits costs for management personnel, plus overhead costs for general services like hardware and software maintenance, building rent and maintenance, and application development. This department also provides oversight for engineering and marketing departments, and the company has a determined that approximately 23 percent of total department expenses pertain to customer service departments.

NJNG derives the loader as the ratio of budgeted management expenses to the gross budgeted expenses of all customer service departments to which it is allocated, such as meter reading, customer inquiry, billing, credit and collections, remittance processing, dispatch, and customer service. NJNG calculated a budgeted rate of 2.6 percent for this loader for fiscal year 2006, which it applied to total budgeted expenses, except for fringe benefits, for the customer inquiry, billing, credit and collections, and remittance processing departments.

Liberty reviewed how NJNG derived the budgeted rate of 2.6 percent. Based on the information provided by the company, Liberty was unable to replicate the company's figure, but instead calculated a loader of 1.8 percent, which the following table summarizes.

Derivation of Performance Management and Support Loader
For Customer Service Functions

Item	2006 Amount
Labor	$951,965
Less engineering portion	($157,776)
Less marketing portion	($576,982)
Subtotal Labor	$217,207
Fringe benefits @ 31%	$67,334
Overhead	
Demonstration/sales expense	23,000

Officers expense	10,000
General office employee expense	500
Building rent/maint. allocation	50,738
Telephone	1,790
Cell phone expense	1,800
Application development allocation	91,415
HW/SW maintenance allocation	11,035
Data communication allocation	1,086
Subtotal Overhead	$191,364
Engineering/marketing portion (77%)	(147,350)
Customer service portion	$44,014
Total Labor plus Overhead	$328,555
Gross Expenses – Cust. Service Depts.	$17,986,006
Rate	1.8%

The company subsequently confirmed that it had an error in its calculations, and that the budgeted loader rate should have been 1.8 percent. The company had the same error in its calculation of the eleven-month true-up, and used a loader of 2.0 percent that should have been 1.0 percent. The company therefore slightly overstated its expenses for the customer inquiry, billing, credit and collections, and remittance processing shared services. Accordingly, the rates it charged to Home Services were also slightly overstated.

Liberty reviewed with NJNG how it developed the provisional and actual rates for each of the shared service functions for fiscal year 2006. Liberty also reviewed with NJNG how it developed the total costs for each shared service department and the total allocation factor units. The following table summarizes NJNG charges to Home Service for fiscal year 2006.

Fiscal Year 2006
Shared Services Charges to NJRHS

Shard Service	Total Charge
Building Maintenance	$7,939
Customer Inquiry	796,690
Billing	440,072
Remittance Processing	159,439
Training	47
Credit and Collections	41,272
Transportation	193,929
Total	$1,639,388

The allocation factor for non-headquarters building maintenance costs, square feet of occupied space, is generally static. NJNG can therefore calculate monthly charges using actual dollars and actual units each month. It does not need to perform a true-up. Home Services rented non-headquarters space at NJNG-owned Manahawkin and Lakewood facilities during the audit period. Home Services rented 883 square feet of space at Manahawkin until January 1, 2004. At Lakewood, Home Services rented 5.3 percent, or 2,438 square feet of space. However, NJNG re-measured the building in early 2006 and revised the figure to 4.3 percent, or 1,878 square feet, effective April 1, 2006. NJNG's charge to Home Services of $7,936 reflects the change in the percentage of occupied space during the year.

Liberty reviewed NJNG general ledger reports for 2006 building maintenance costs totaling $182,466, which includes such items as outside maintenance, janitorial services, and utilities. NJNG owns the Lakewood building but, as noted above, it included no depreciation charges in shared services pools. Therefore, NJNG inappropriately retained any depreciation expense associated with the buildings.

NJNG bases the allocation of customer inquiry expenses on the number of calls. At the conclusion of a call, NJNG's customer service representatives in the call center categorize the type of call received (customer inquiry, billing, etc.) and to which entity it pertains; *i.e.*, NJNG or Home Services, and enters an appropriate code into the Customer Information System (CIS). Since only one code can be entered for each call and a call can sometimes address more than one issue or concern more than one company, it is NJNG's procedure that any call in which Home Services is mentioned be recorded as a Home Services call.

Liberty reviewed with the company a sample report summarizing the actual number of calls for August 2006. The call coding system is reasonably extensive. For example, major categories under Home Services are information, retention, billing, account information, scheduling, and parts. Each of the major categories has a number of specific call types. Information, for example, has eleven different call types, including equipment information and installation requests, although, unlike the other categories, most of the calls in this category end up as type "other." The company indicated that it can only categorize 95 percent of its calls, and uses the distribution of those calls between NJNG and Home Services to determine the distribution for the remaining five percent.

Liberty reviewed the fiscal year 2006 budgeted expenses for NJNG's customer inquiry department, which performs several services, including call center operations and billing. Some of the costs in the customer inquiry center department are more accurately related to the billing function, and the company moves some of the customer inquiry department costs to billing before deriving the rate for the customer inquiry function. In addition to labor, benefits, and management costs, the customer inquiry budget includes overhead allocations of NJNG general services costs such as headquarters building rent and maintenance, hardware and software maintenance, and data communication. The budgeted fiscal year 2006 rate is summarized in the table below**.**

Customer Inquiry Budgeted Rate Calculation

Cost Component	**Amount**
Labor	$1,907,800
Vouchers	15,500
Stock issues	23,428
Building maintenance allocation	436,673
Telephone	176,845
Print shop	291
HW/SW maintenance allocation	623,865
Data comm. allocation	60,751
Subtotal	3,245,153
Management support (2.6%)	84,374
Fringe benefits	591,418
Total expenses	**$3,920,945**
Total Calls	728,180
Rate	
Expense	$4.57
Fringe	0.81
Total Rate	**$5.38**

Actual costs for the customer inquiry function were higher than planned. NJNG performed a true-up for the differential in rates in August 2006, and used the actual rate based on eleven months to calculate the allocation for September. The following table summarizes the total 2006 fiscal year allocation to Home Services.

Home Services Customer Inquiry Allocation

Home Service Calls (10/05-8/06 Actual)	133,711
Budgeted Rate	$5.38
Total 11 month allocation	$719,365
Actual rate (based on 11 month actual costs)	$5.59
Rate differential	$0.21
True up for rate differential	$28,079
Home Service Calls - September 2006	8,805
Rate	$5.59
September 2006 allocation	$49,220
Liberty Calculated Total Allocation	$796,664
Total Per Quarterly Report	$796,690

Using the company's data, Liberty was able to replicate the result the company reported on its fourth quarter 2006 Allocation Statements to Affiliates report.

The company bases the allocation of billing expenses on the number of equivalent bills. Bills include those for Home Services service contracts and service type chargeable bills, and for utility bills. According to the CAM, because the billing invoice document for a Home Services bill always includes the customer's monthly utility billing, the one common invoice equates to two "equivalent" bills for the purpose of calculating the number of equivalent billings that NJNG uses to determine the allocation factor. Home Services therefore does not receive a "free ride" for piggybacking on NJNG's utility bills.

Liberty reviewed the fiscal year 2006 budgeted expenses for NJNG's billing function. Billing charges include some costs transferred from the customer inquiry cost center, as noted above, and costs transferred from credit and collections. Billing for gas transportation is handled by a separate group and is not part of the shared services billing cost pool. The budgeted fiscal year 2006 rate is summarized below.

Billing Budgeted Rate Calculation

Cost Component	**Amount**
Labor	$1,049,644
Inserter room allocation	47,510
Stock issues	189,769
Application development	259,139
Postage	1,664,800
Subtotal	3,210,862
Management Support (2.6%)	83,482
Fringe benefits	325,390
Total expenses	**$3,619,734**
NJNG Bills	5,428,326
Home Services Bills	764,625
Total Equivalent Bills	6,192,951
Rate	
Expense	$0.53195
Fringe	0.05254
Total Rate	**$0.58449**

Labor, fringe benefits, and postage costs comprise the majority of the budget for this function. NJNG's billing budget summarized above includes $189,769 for stock issue costs, primarily envelopes. However, the company's notation on its customer inquiry budget worksheet indicates that the company moved 90 percent of the total $234,283 stock issue budget for customer inquiry, or $210,855, to the billing budget. The company confirmed that it incorrectly reduced the $210,855 again by 10 percent, yielding the $189,769 figure shown in the table above, when it calculated the billing budget. The company also confirmed that it made the same error when it calculated the eleven-month actual rate. As a result, the company understated its 2006 actual billing expense. NJNG under-charged Home Services by approximately $2,225.

Unlike other shared services, the billing cost pool contains no allocation of headquarters building rent and maintenance, hardware and software maintenance, or data communications costs, nor direct charges for telephone services, and Liberty asked the company to explain. The company stated that the billing operation is not a unique department, such as customer inquiry and credit and collections. Instead, it is a collection of billing expenses from various departments. When developing the rates for billing, the finance and accounting group moves to billing certain costs for labor, postage, stock, and inserter room allocations from the costs of the customer inquiry, remittance processing, and credit and collections departments. It also moves the entire allocation for application development from customer inquiry to billing. However, the portion of the costs of rent, hardware and software maintenance, data communications, and telephone that would ordinarily be associated with billing remains with the other departments. Clearly, such costs are relevant to the billing function.

The company allocates to Home Services a different percentage of costs for each shared service. By failing to move a portion of certain overhead allocations to billing and instead leaving the costs in the other shared service functions, Home Services is under-paying for the billing function, while arguably over-paying for others. Liberty believes that NJNG should move a portion of the rent, hardware and software maintenance, and data communications allocations, as well as telephone charges, to the billing function to more adequately represent the true cost of this function. Liberty recognizes that the company will have to make certain assumptions in order to do so. As noted in Liberty's discussion of the CAM, the company should adequately document the assumptions it uses to move labor and other costs to the billing function from other shared service departments.

Actual costs for the billing function were lower than planned. The company performed a true-up for the differential in rates in August 2006, and used the actual rate based on eleven months to calculate the allocation for September. The following table summarizes the total fiscal 2006 allocation to Home Services.

Home Services Billing Allocation

Home Service Bills (10/05-8/06 Actual)	736,616
Budgeted Rate	$0.58449
Total 11 month allocation	$430,545
Actual rate (based on 11 month actual costs)	$0.55039
Rate differential	-$0.03410
True up for rate differential	($25,119)
Home Service Bills - September 2006	62,948
Rate	$0.55039
September 2006 allocation	$34,646
Liberty Calculated Total Allocation	$440,072
Total Per Quarterly Report	$440,072

Using the company's data, Liberty was able to replicate the result the company reported on its fourth quarter 2006 Allocation Statements to Affiliates report.

Liberty reviewed the fiscal year 2006 budgeted expenses for NJNG's remittance processing function. In addition to labor, benefits, and management costs, the remittance budget includes overhead allocations of NJNG general services costs such as building rent and maintenance, hardware and software maintenance, application development, and data communication. The following table summarizes the budgeted fiscal year 2006 rate.

Remittance Processing Budgeted Rate

Cost Component	Amount
Labor	$338,225
Vouchers	371,697
Building rent/maint. allocation	117,353
Telephone	7,200
App. development allocation	19,630
HW/SW maintenance allocation	56,847
Data communication allocation	5,424
Subtotal	916,376
Management Support (2.6%)	23,826
Fringe benefits	104,850
Total expenses	**$1,045,052**
Total NJNG Remittances	3,866,013
Total Home Services Remittances	764,625
Total Equivalent Remittances	4,630,638
Rate	
Expense	$0.20304
Fringe	0.02264
Total Rate	**$0.22568**

The company uses the number of bill remittances to distribute costs for remittance processing. When the company developed the budgeted rate for fiscal year 2006, it defined the number of remittances for NJNG to exclude electronic payments. By way of comparison, the company assumed approximately 5.4 million NJNG bills for the purposes of developing a billing shared service rate, compared to approximately 3.9 million NJNG paper remittances.

For Home Services, the number of remittances was the same as the number of equivalent bills. The company stated that it had previously excluded electronic remittances because it considered the remittance processing function to relate to handling paper payments. In prior years, there were relatively few electronic payments. In the last year, the company has been promoting electronic payments, and the number has increased dramatically. By the time of the eleven-month true-up, the company had decided to start including electronic remittances in its allocation unit count for NJNG. This definitional revision had the effect of lowering per-unit costs and increasing the costs retained at NJNG. Liberty believes that the inclusion of electronic remittances in allocation factor units is appropriate.

Actual costs for the remittance function were lower than planned. The company performed a true-up for the differential in rates in August 2006, and used the actual rate based on eleven months to calculate the allocation for September. The total allocation to Home Services is summarized below.

Home Services Remittance Processing Allocation

Home Service Remittances (10/05-8/06 Actual)	736,616
Budgeted Rate	$0.22568
Total 11 month allocation	$166,239
Actual rate (based on 11 month actual costs)	$0.19941
Rate differential	-$0.02627
True up for rate differential	($19,351)
Home Service Remittances - September 2006	$62,948
Rate	$0.19941
September 2006 allocation	$12,552
Liberty Calculated Total Allocation	$159,441
Total Per Quarterly Report	$159,439

Using the company's data, Liberty was able to replicate the result the company reported on its fourth quarter 2006 Allocation Statements to Affiliates report.

Liberty reviewed the fiscal year 2006 budgeted expenses for NJNG's technical training function. NJNG budgeted 658 hours for Home Services, at a total projected cost of $56,746, which includes labor, fringe benefits, and related overhead expenses. The actual charges to Home Services in 2006 for technical training were only $47, for less than one hour of services. Home Services' usage of trainers has been steadily declining since 2003, and it now performs training itself. Liberty did not investigate this shared service cost further.

The company bases the allocation of credit and collections expenses on revenue dollars subject to credit and collections, which excludes deposits or down payments on account, *i.e.*, forward payments. There is a one month lag built into the allocation of these costs. The company does not have the actual revenue figures prior to closing the books each month, and therefore it uses actual revenues from the prior month, *i.e.*, the May allocation is based on April actual revenues.

In response to a recommendation in the prior audit, the company began to charge Home Services for credit and collections as a specific shared service beginning in fiscal year 2004. Previously, NJNG received no fees for this function, although it did receive a discount on the Home Services receivables that it purchased.

Liberty reviewed the fiscal year 2006 budgeted expenses for NJNG's credit and collections function. In addition to labor, benefits, and management costs, the credit and collections budget includes overhead allocations of NJNG general services costs such as headquarters building rent and maintenance, hardware and software maintenance, application development, and data communication. The budgeted fiscal year 2006 rate is summarized below.

Credit and Collections Processing Budgeted Rate

Cost Component	Amount
Labor	$886,252
Transportation	$30,580
Vouchers	246,476
Stock issues	4,557
Building rent/maint. allocation	107,190
Telephone	23,821
Cell phone expense	5,700
Outside contractor damage	(48,000)
App. development allocation	256,424
HW/SW maintenance allocation	167,175
Data communication allocation	13,020
Subtotal	1,693,195
Management Support (2.6%)	44,023
Fringe benefits	274,738
Total expenses	**$2,011,956**
NJNG Base Revenues	$839,864,454
Home Services Base Revenues	20,043,262
Total Revenue	$859,907,716
Rate	
Expense	$0.00202
Fringe	0.00032
Total Rate	**$0.00234**

The company explained that it recognizes in Credit and Collections expense reductions for billing to outside parties such as contractors that accidentally damage NJNG underground piping and equipment. Actual costs for the credit and collections function were lower than planned. The company performed a true-up for the differential in rates in August 2006, and used the actual rate based on eleven months to calculate the allocation for September. The total allocation to Home Services is summarized below.

Home Services Credit and Collections Allocation

Home Service Revenues (10/05-8/06 Actual)	21,009,771
Budgeted Rate	$0.00234
Total 11 month allocation	$49,163
Actual rate (based on 11 month actual costs)	$0.00172
Rate differential	-$0.00062
True up for rate differential	($13,026)
Home Service Revenues - September 2006	$2,194,677

Rate	$0.00172
September 2006 allocation	$3,775
Liberty Calculated Total Allocation	$39,912
Total Per Quarterly Report	$41,272

Using the company's data, Liberty was not able to replicate the result the company reported on its fourth quarter 2006 Allocation Statements to Affiliates report. Liberty reviewed the company's work papers and found that NJNG used the budgeted rate to calculate the September 2006 charges, rather than the actual rate. The company confirmed the error, which resulted in an over-charge of $1,360 to Home Service for credit and collections.

Home Services owns its own light truck vehicles, and takes advantage of the vehicle maintenance services provided by NJNG. NJNG provides vehicle services as a general service to affiliates that it allocates based on number of vehicles. However, Home Services negotiated a separate allocation, based on mechanic hours, as part of its shared services agreement with NJNG. NJNG subtracts the charges paid to it by Home Services from relevant vehicle cost pools before it allocates the remainder as part of general services. NJNG subtracts the fringe benefit portion of the amount it allocates to Home Services from the NJNG fringe benefit account.

Liberty reviewed the fiscal year 2006 budgeted expenses for NJNG's vehicle service function. Each fiscal year, NJNG's vehicle repair manager estimates the number of expected mechanic hours by vehicle type and prepares a budget, which the company uses to develop a provisional mechanic hourly rate. The rate reflects some incidental costs (*e.g.*, oil, hardware), as well as overhead costs. The shared services mechanic hourly rate reflects the blended costs of all mechanics, not just those that work on light trucks. The budget for vehicle maintenance also includes an allocation of general services charges such as hardware and software maintenance, application development, and data communication.

Mechanics report their actual work hours for the month by vehicle, so NJNG can determine the actual hours attributable to Home Services vehicles each month. There is a one month lag for allocated vehicle maintenance costs. The company does not have the actual mechanic hours prior to closing and so each month NJNG uses the prior month's actual numbers, *i.e.*, the May allocation is based on April actual hours. The budgeted fiscal year 2006 rate is summarized below.

Vehicle Maintenance Budgeted Rate Calculation

Cost Component	Amount
Labor	$753,367
Vouchers	142,906
Stock issues	2,527
Building rent/maint. allocation	0
Telephone	7,008
Radio tie allocation	5,379
Other/accountable directs	4,824

App. development allocation	13,397
HW/SW maintenance allocation	59,625
Data communication allocation	4,341
Subtotal	$993,374
Fringe benefits	$233,544
Total expenses	**$1,226,918**
Total Vehicle Repair Hours	12,977
Rate	
Expense	$76.55
Fringe	18.00
Total Rate	**$94.55**

The company directly charges Home Services for identifiable expenses, such as invoices for work performed by outside vendors or for parts like tires or transmissions; the company excludes these direct charges from allocable expenses.

Actual costs for the vehicle maintenance service function were lower than planned. The company performed a true-up for the differential in rates in August 2006, and used the actual rate based on eleven months to calculate the allocation for September. The total allocation to Home Services, plus direct charges, is summarized below.

Fiscal Year 2006
Home Services Vehicle Maintenance Allocated and Direct Charges

Home Service Mechanic Hours (10/05-8/06 Actual)	1,381
Budgeted Rate	$94.55
Total 11 month allocation	$130,574
Actual rate (based on 11 month actual costs)	$76.32
Rate differential	-$18.23
True up for rate differential	($25,176)
Home Service Mechanic Hours - September 2006	240
Rate	$76.32
September 2006 allocation	$18,317
Liberty Calculated Total Allocation	$123,715
Direct Expense Charges	$70,237
Liberty Calculated Total Charges	$193,952
Total Per Quarterly Report	$193,929

Using the company's data, Liberty was able to replicate the result the company reported on its fourth quarter 2006 Allocation Statements to Affiliates report.

Liberty asked the company to explain why the budget for vehicle maintenance contains no building rent and maintenance allocation. The company stated that it intended to have garage building related utility and maintenance expenses included in garage department expenses. During the audit, it discovered that those expenses were inadvertently included in the building maintenance department for that location. The company stated that it intends to correct the problem. The finance and accounting group found that the costs associated with the garage are accumulated in a different department that is not picked up in the shared service budget. The garage accounts for 24 percent of the total combined floor space of the Maude building and garage. Fiscal year 2006 expenses for the building were $113,526, and thus $27,246 (24 percent) should have been included in vehicle maintenance costs. The effect is that NJNG under-charged Home Services by approximately $3,204. The company confirmed that it failed to include the building expenses in vehicle maintenance department expense for the entire audit period.

Liberty asked the company if it had analyzed whether Home Services pays more or less for vehicle maintenance under the shared services arrangement than if it received charges for light truck maintenance services under the general services agreement. The company indicated that it had not done such an analysis, but believes that its approach is reasonable.

Under the service agreement between NJNG and Home Services, NJNG purchases Home Service's accounts receivable at a discount. NJNG discounts the receivables it purchases by 0.42 percent to account for bad debt expense and the time value of money. This percentage has not changed since the prior audit. Every two weeks, NJNG sends cash to Home Services for accounts receivable that it assumed.

The prior EDECA auditor recommended that the company adjust the discount it applied to Home Services receivables to reflect properly the entire cost of credits, collections, and bad debt. The auditor estimated that the discount yielded approximately $86,000 to NJNG while the affiliate's share of credit, collections, and bad debt costs was actually over $200,000. NJNG now charges Home Services for credit and collections services at approximately $40,000 per year, which Liberty believes has been substantiated. This figure does not correlate with the shortfall implied by the prior auditors; that auditor's report did not provide the basis for that estimation.

The company also charges Home Services for the services of two NJNG payroll employees; these services are not part of the service agreement and Liberty discusses them later in Section III.E.

By way of additional testing, Liberty reconciled the allocated charges for shared services amounts in the Allocation Statements to Affiliate report to detailed charges in the inter-company accounts. Liberty also verified that the amount that NJNG charged its shared service departments for general services (*e.g.*, hardware and software maintenance) as reported in the Allocation Statements to Affiliates report matched the amount the company included in total shared service department expenses.

3. Conclusions

1. The company's approach for allocating shared services costs to Home Services is reasonable.

Liberty found that the company's method for allocating shared services costs is reasonable, and results in an equitable distribution of costs such that NJNG is not subsidizing the affiliate. The company does not overly rely on the use of general allocators, but rather has selected cost drivers that provide a reasonably good match to cost causation.

2. The company has been reasonably attentive to assuring that Home Services appropriately bears the full cost of shared services.

Liberty found that the company has devoted considerable effort to assuring that Home Services pays its fair share of shared service costs and is not cross-subsidized by the utility. Liberty did find a few errors in the company's implementation of its method, however. For example, the company had an error in its calculation of management support overhead, in its overhead cost for billing, and in its calculation of credit and collection rates. The effect of these errors was minor, and does not significantly compromise reported charges. There is, however, room for improvement.

3. The company used an apparently low fringe benefit rate for shared services in fiscal year 2006. *(Recommendation #1)*

The company was uncomfortable relying on reports from a relatively-new financial reporting system that indicated its actual fringe benefit rate for fiscal year 2006 was close to 39 percent. Instead, the company used a rate of 33 percent, which was comparable to prior year's experience. The company has since become more comfortable with the system, and has increased its budgeted fringe benefit rate for fiscal year 2007 to 39 percent, which is more consistent with recent increases in medical benefit and pension costs. If the company actually understated its 2006 rate, Home Service's portion of shared service charges related to fringe benefits was too low, and NJNG retained a larger share of fringe benefits costs than it should.

4. The company does not include depreciation expense in shared service charges to Home Services. *(Recommendation #2)*

The company does not include depreciation expenses for capital assets that the utility uses to provide shared services, which include non-headquarters buildings, an inserter machine, a remittance mail opener, data monitoring systems, a portion of some computer network services, equipment and computer network software, and furniture. The company cannot identify the value of a given asset in its current capital asset accounting system, and as such cannot directly calculate depreciation. The company indicated that the assets it uses to provide shared services are generally old and that the book values are low; as such, resulting depreciation if calculated would be insignificant. The company is installing a new fixed asset system that should fix this problem, but only for new assets moving forward.

5. The company understates the true cost of the billing shared service and overstates others. *(Recommendation #3)*

The billing function is not a unique department but instead a collection of billing-related expenses from three departments: customer inquiry, remittance processing, and credit and collections. The company does not include in its billing expense a share of headquarters building rent and maintenance, hardware and software maintenance, and data communications allocations, nor direct telephone charges, but rather leaves these costs in the three other shared service departments. By failing to move a portion of certain overheads to billing and instead leaving the costs in the other shared service functions, Home Services is under-paying for the billing function, while arguably over-paying for others.

6. The company understated the true cost of the vehicle maintenance shared service. *(Recommendation #4)*

The company failed to include a share of the cost of non-headquarters building rent and maintenance in its total expenses for vehicle maintenance shared services. The company failed to include approximately $27,246 for these costs in the vehicle maintenance expense pool for fiscal year 2006. Therefore, NJNG under-charged Home Services by approximately $3,204. The company indicated that the omission occurred for each year of the audit period.

4. Recommendations

1. Monitor the cost of fringe benefits to ensure that the company collects an appropriate amount in shared services charges. *(Conclusion #3)*

The company should proactively monitor its actual fringe benefits costs so that it can more accurately reflect their costs in the rates it charges to Home Services for shared services.

2. Include depreciation expense associated with new assets the company uses to provide shared services in the charges to Home Services. *(Conclusion #4)*

Liberty recognizes that estimating depreciation expense associated with older assets that NJNG uses in providing shared services may not be practical. However, to the extent that NJNG replaces existing assets or adds new ones in the future, it should quantify depreciation using its new capital asset accounting system, and include that expense in shared service rates.

3. Modify the calculation of billing rates to more accurately represent the true cost of this function, as well as the customer inquiry, remittance processing, and credit and collections functions. *(Conclusion #5)*

The company should charge a portion of the rent, hardware and software maintenance, and data communications allocations, plus direct telephone charges, to the billing function to represent more adequately the true cost of this function. Doing so would reduce the overhead costs of the three other shared service functions, and more adequately represent the true costs of these other functions as well.

4. Include the cost of building rent and maintenance in vehicle maintenance shared service charges. *(Conclusion #6)*

The company should modify the accounting procedures it uses to calculate vehicle maintenance shared service costs to include a share of building rent and maintenance costs in total expenses.

C. NJNG General Services Provided to Affiliates

1. Background

NJNG manages a number of general services performed for its own utility business, its affiliates, the Service Company, and NJR Corporate. CR&R manages space in the Wall headquarters building, and NJNG provides space to NJR Corporate and the Service Company. NJNG also provides communications equipment services used by nearly all affiliates. NJNG assigns general services cost to its own departments, and to departments within the Service Company, to NJR Corporate, and to affiliates, based on usage.

The company seeks to charge its affiliates, through the allocation of general service costs, its fully allocated costs for these services. The company has not changed its approach to allocating these costs substantially during the audit period. Liberty examined budgeted and actual expenses for fiscal year 2006, in order to evaluate the applicable allocation methods.

2. Findings

NJNG maintains a series of cost pools that collect costs for the general services performed for the utility's own use and provided to affiliates under service agreements, as outlined in the table below.

General Services Pools Costs

General Service Pool	Components of Cost
Headquarters Building Expense	Expenses for leasing, maintenance, and utilities at the Wall facility
Vehicle and Transportation Services	Labor, fringes, and overhead related to operation and maintenance of vehicles, plus cost of parts and outside repair
Radio Tie-Line Services	O&M costs of communication links between radio dispatch centers, radio towers, and vehicular radios
Print Shop Services	Expenses related to the O&M costs of the NJNG printing facility
Inserter Room Services	Expenses related to operation of the NJNG inserter room
Postage	Postage meter expenses
Applications Development	Labor, fringes, and overhead for application development
Hardware/Software Maintenance	Labor, fringes, and overhead, plus voucher expenses, for hardware and software maintenance
Communication Equipment	Expenses related to computer communication for PCs and networks
Energy Services	Labor plus applied fringe and overhead rate for energy-related services

NJNG uses specific allocation factors or methods to determine the percentages of each pool's costs to be assigned to its own departments and to affiliates. The following table summarizes these factors.

Allocation Factor for General Services Pools

Shared Service Pool	**Allocation Factor**
Building Maintenance Services	Square footage
Vehicle and Maintenance Services	Number of vehicles
Radio Tie Line Services	Number of radios
Print Shop Services	Actual time sheets
Inserter Room Services	Historical usage
Postage	Actual usage
Applications Development	Programmer time sheets
Hardware/Software Maintenance	CPU usage; number of PCs; number of FODS computers
Communication Equipment	Number of PCs
Energy Services	Pre-determined rate with annual true-up

The company's allocation factors for the general services pools are reasonable. For some pools, such as application development and print shop services, the company uses actual time reporting to allocate costs. For the others, the company has selected allocation factors, such as square footage or number of PCs, which provide a good match to the actual costs associated with a given service.

The CAM is out of date for some aspects of general services. It contains no section for inserter room services and energy services, and lists telephone as a general service, even though it is not part of the service agreement. Even though it is not a general service per se, the company reports telephone service charges in its quarterly Allocation Statements to Affiliates reports. Telephone is treated as a general service allocation in the budget but is a specific invoice related charge to each entity in the actual expenses.

NJNG serves as the primary provider of general services, but not all costs associated with general services originate at the utility. The Service Company, for example, originates the labor costs associated with building maintenance, print shop, application development, and hardware and software maintenance. In most cases, the company moves the relevant labor costs from the Service Company to NJNG before it allocates the total costs for these functions. The equipment for the inserter room and print shop reside at the NJNG level. The company stated that it had been its policy not to have the Service Company own assets, which is why these assets remain at the utility. However, the company noted that the Service Company decided to capitalize the costs for a financial system and retain them at the Service Company, and then charge out for depreciation expense. The labor costs associated with energy services, the inserter room, and vehicle maintenance originate at the NJNG level. IT-related costs at the NJNG level consist primarily of voucher expenses, such as software licenses and outside maintenance contracts.

The origination of some costs associated with general services outside NJNG requires a series of intermediary accounting steps to occur before the allocation of general service costs to affiliates.

The finance and accounting group must calculate and charge Service Company departments their share of NJNG-related general services costs first, so that these costs can become part of Service Company overhead. The Service Company cross-charges its non-IT departments for a portion of application development, hardware and software maintenance, and communication equipment expenses, which also become part of department overhead. The Service Company, in turn, must clear its accounts, and send certain labor and related charges to NJNG before the utility can distribute all costs associated with general services.

The company calculates the amount of each general service pool allocable to individual Service Company departments each month; however, those dollars do not literally move to the Service Company accounts until the following month. The Service Company has to close its books first; consequently, it cannot wait for final numbers from NJNG pools. It therefore uses actual dollars from the prior month. Liberty believes this convention is reasonable.

The company does not include related depreciation expenses in its general service rates, as is also true for its shared-service rates. The capital assets that the utility uses to provide general services include furniture, part of a few network servers, computer network software, two printing presses, a folder, collator, paper cutter, drill press, shrink wrapper, a plate burner, and a perforation machine. The company leases the headquarters building, vehicles, and most computer equipment and other office-related equipment. The company does not assign capital assets to individual NJNG departments. The company's capital accounting system can capture individual assets and categories of assets, but cannot associate individual assets to individual departments. That lack of association to a department in turn makes it impossible to calculate directly the depreciation for any specific department. The company indicated that the equipment is generally old and that the book values are low; therefore, resulting depreciation would be insignificant even if it were calculated and included.

The company does not use a uniform approach to distributing charges for general services. It derives allocation percentages for each department or affiliate at the beginning of the year for building services, vehicles services, radio tie-lines, communication equipment, and the inserter room. It then applies the percentages to actual expenses each month with no true-up. The allocation factor units for these services, such as the number of PCs or the number of radios, do not vary much during the year. This approach is reasonable. The company uses a similar approach for hardware and software maintenance, although it uses a more complex allocation percentage derived from a weighted average of three ratios: CPU clock tics, number of PCs, and number of FODS units.

For postage and print room services, the company charges actual costs to each NJNG department or affiliate based on actual usage, with no true-up being necessary. For energy services, NJNG charges to NJRES a pre-determined payroll distribution for each relevant employee's time, with a routine true-up to actual timesheet data. For the application development service, the company uses actual time sheet data each month to allocate charges, and therefore requires no true-up.

The following table summarizes NJNG's charges to affiliates and to its own departments since fiscal 2003. Figures exclude postage and print shop, which were directly charged for most of the audit period.

General Services Charges

General Service	NJNG	Serv. Co.	NJR ES	NJR HS	CR&R	Corp
			Fiscal Year 2006			
Bldg. Maintenance	$2,156,740	$1,856,198				$37,507
Vehicle Maintenance	3,223,897	34,005				
Radio Tie Line	157,194	704				
Inserter Room	83,669	4,895		3,008		
App. Develop. (net)	2,515,576			198,791		
HW/SW Maintenance	2,997,660	652,423	177,400	312,913	9,940	39,431
Comm. Equipment	245,696	63,880	31,485	25,382	1,749	7,000
Energy Services			152,077			
Total	$11,380,432	$2,612,105	$360,962	$540,094	$11,689	$83,938
			Fiscal Year 2005			
Bldg. Maintenance	$2,124,459	$1,828,412				$36,946
Vehicle Maintenance	3,203,216	40,852				
Radio Tie Line	82,732	373				
Inserter Room	64,596	7,074		2,085		
App. Develop. (net)	2,398,349			139,254		
HW/SW Maintenance	2,941,758	759,184	129,333	225,080	9,013	26,788
Comm. Equipment	288,374	47,243	18,266	49,461	1,262	3,780
Energy Services			1,240,328			
Total	$11,103,484	$2,683,138	$1,387,927	$415,880	$10,275	$67,514
			Fiscal Year 2004			
Bldg. Maintenance	$1,981,254	$1,705,153				$31,640
Vehicle Maintenance	2,955,047	32,369				
Radio Tie Line	169,336	735				
Inserter Room	55,964	615		4,920		
App. Develop. (net)	2,825,007			121,678		
HW/SW Maintenance	3,072,566	1,115,795	125,125	254,079	10,101	32,868
Comm. Equipment	310,073	90,483	25,416	20,892	2,034	6,934
Energy Services			958,098			
Total	$11,369,247	$2,945,150	$1,108,639	$401,569	$12,135	$71,442
			Fiscal Year 2003			
Bldg. Maintenance	$1,801,334	$1,731,453				$32,372
Vehicle Maintenance	2,750,264	44,714				
Radio Tie Line	169,739	0				

Inserter Room	75,759	7,131		2,675		
App. Develop. (net)	2,636,932			167,845		
HW/SW Maintenance	3,217,813	892,271	73,678	178,140	5,127	42,726
Comm. Equipment	303,863	81,352	0	19,621	0	6,756
Energy Services			629,933			
Total	$10,955,704	$2,756,921	$703,611	$368,281	$5,127	$81,854

Charges to affiliates have remained relatively stable and the general service costs retained by NJNG departments have remained stable in recent years. The major difference is the decrease in charges to NJRES from the NJNG energy service department.

Liberty reviewed with the company the actual expenditures for each of the general services for fiscal year 2006, the relevant allocation factor units, and the allocation of costs to departments and to affiliates. The next sections summarize the results of that review.

Building Maintenance Services

NJNG is the prime tenant of the Wall headquarters building, and bills the Service Company and NJR Corporate for rent and building expenses. As discussed in more detail in Section III.E, NJNG sub-lets approximately 24 percent of the space to CR&R, which in turn sub-lets to NJRES, NJR Home Services, and other non-affiliated tenants. In addition to lease costs, the building costs charged by NJNG to its tenants include the following types of costs:

Building Operations and Maintenance Expenses

Electric	Pest control	Janitorial/cleaning
Drinking water	Electrical repair	Plumbing
Locksmithing	Lawn maintenance	Carpentry
Geese control	Parking lot maintenance	Plant utility services
Painting	Rubbish removal	Window cleaning
HVAC maintenance	Elevator maintenance	Landscaping
Company used gas	Security guards/systems	Food service
Fire protection	Design/architectural	Miscellaneous repairs
Maintenance vehicle lease	Music/Muzak	Real estate taxes
Computer system costs	Data communication	Facilities staff expenses

Liberty reviewed the company's actual 2006 fiscal year expenses for building services, which the following table summarizes.

Actual Headquarters Building Expenses

Cost Component	**FY 2006**
Lease payments	$2,219,876
Service Company labor charges	349,980

Vouchers	1,278,317
Executive labor	60,000
Journal adjustments (gas, lease, wages)	(34,039)
Amortization of real estate taxes	177,423
Total	**$4,051,557**

The company explained that the journal entries related to, among other things, a credit for lease payments from the ABCO Federal Credit Union tenant, a true-up adjustment for company-used gas, and a left-over credit for vehicle charges from fiscal year 2005 (the group no longer has a vehicle).

Lease payments comprise the largest cost item. Service Company labor charges include payroll, fringe benefits, and other similar expenses. Voucher expenses include costs for security, company-used gas, janitorial services, and the like. NJNG receives a charge from CR&R of $5,000 per month for the time of its president or other employees that manage maintenance activities. This executive labor charge represents a negotiated flat rate between the parties; it is not a function of specific hours charged. The actual costs in the headquarters building pool exclude charges paid by CR&R for its share of the building, which includes building O&M, company-used gas, real estate taxes, maintenance salary and fringe benefits costs, and insurance.

The company uses square footage to calculate the allocation percentages for building expense. The company provided a list of the percentages (summarized in the next table) used during fiscal year 2006 to allocate building expenses to NJNG departments, to Service Company departments, and to NJR Corporate. The next table summarizes the fiscal 2006 percentages, the company's calculated expenses and Liberty's corresponding calculations.

Allocation of Headquarters Building Expense Pool

Affiliate	Allocation %	Amount Liberty	Company
Service Company			
Training	0.4570	$18,516	$18,511
Corp. Communications	0.6190	25,079	25,074
Website Admin	0.2580	10,453	10,450
Auditing	1.6830	68,188	68,169
General Counsel	0.3060	12,398	12,394
Human Resources	4.0760	165,141	165,095
Continuous Improvement	1.4410	58,383	58,366
Purchasing - Wall	2.9610	119,967	119,933
Info Systems General Office	18.6060	753,833	753,627
Treasury	0.2050	8,306	8,304
Financial and Rev Acct	8.9410	362,250	362,150
Office Services	6.2740	254,195	254,125
Total Service Company	45.8270	$1,856,707	$1,856,198

NJR Corporate	0.9260	$37,517	N/A
NJNG			
Environmental	0.5550	$22,486	$22,480
Right of Way	2.6480	107,285	107,256
Regulatory Affairs	2.3090	93,550	93,525
Government Affairs	1.1270	45,661	45,648
Consumer/Community Relations	2.5280	102,423	102,394
Energy Services	9.2450	374,566	374,463
Systems Engineering	5.6180	227,616	227,557
Cust. Service/Marketing General	3.0630	124,099	154,112
Operations Staff	1.9980	80,950	80,928
Central Dispatch	2.9090	117,860	117,827
Customer Service Management	1.2880	52,184	52,170
Gas Transportation	3.1740	128,596	128,561
Meter Read/Collect/Cash Process	2.7210	110,243	110,212
Customer Inquiry	11.0850	449,115	448,991
Remittance Processing	2.9790	120,696	120,662
Total NJNG Departments	53.2470	$2,157,332	$2,186,786
NJNG Correcting Journal Entry			($30,046)
			$2,156,740
Liberty Calculated Total	100.000	$4,051,556	N/A

Liberty calculated the amounts assignable to each entity using the total headquarters pool expenses and specific allocation percentages. The resulting Liberty amounts generally conformed to the figures that the company reported in the fourth quarter *Allocation Statements to Affiliates* report. There was one exception, however. Liberty calculated a lower cost allocation to Customer Service and Marketing than reported. The company investigated the difference and explained that it had previously issued an adjustment for a bad charge of $30,046 to this department after it had generated the Allocation report. This adjustment accounts for the different between the report and Liberty's figure.

Vehicle and Transportation Services

Liberty reviewed the company's actual 2006 fiscal year expenses in its four vehicle service pools, which the next table summarizes.

Actual Vehicle Maintenance Pool Expenses

Cost Component	Amount	Cost Component	Amount
Cars		**Medium Trucks**	
Labor	$7,768	Labor	$226,892
Vouchers	44,601	Vouchers	926,163
Accountable indirect costs	1,540	Stores	52

Total Car Expense Pool	***$53,909***	Contractors	16,998
		Accountable indirect costs	47,500
		Journal expenses	239,531
Light Trucks		***Total Medium Truck Pool***	***$1,457,136***
Labor	$245,936		
Vouchers	343,553	**Overhead**	
Stores	99	Labor	$265,800
Contractors	80,104	Vouchers	327,523
Accountable indirect costs	33,092	Stores	268
Journal expenses	502,174	Accountable indirect costs	182,721
Total Light Truck Pool	***$1,204,958***	***Total Vehicle Overhead Pool***	***$776,312***

Vehicle overhead pool labor consists primarily of supervisory and management labor, and includes union work that the company cannot designate as related to one specific vehicle type. The company spreads unproductive time (*e.g.*, vacations and sick days) across the four pools on the basis of the relative amount of labor in each pool, which it considers to be accountable indirect costs. Vouchers and journal expenses consist primarily of the cost of leasing the vehicles and the costs of parts, tires, fuel, and invoices from outside vendors for certain types of repair work. Voucher expenses in the overhead pool include the expense associated with renting the Atlantic Highlands garage facility.

The company removes from the general service vehicle pool the charges it sends to Home Services for vehicle maintenance. The finance and accounting group actually deducts the dollars charged to Home Services from the light truck vehicle cost pool before charging the light truck pool to affiliates. The shared service charges to Home Services include transportation overhead; therefore, the company in effect deducts both labor charges and overhead from the light truck cost pool, rather than deducting overhead from the overhead pool. The company acknowledged that its approach was not technically precise, but noted that the charges actually allocated out are so small that the error would be negligible. This convention does have only a very small effect (several hundred dollars per year at most, which would be exceeded by the cost of more refined measurements), because approximately 99 percent of vehicle maintenance costs remain with the utility.

The company also fails to add a loader for fringe benefits to the vehicle-maintenance general-service labor costs that it allocates to affiliates. The reason is to simplify its calculations, in light of the fact that the very small number of affiliate vehicles would make their share of fringe benefits insignificant. For example, the Service Company had four vehicles for fiscal year 2006. If the company included fringe benefits in its charges to the Service Company, the utility would receive most of it back in Service Company charges. The company's shorthand approach does not have a significant impact on the charges at issue; however, the CAM does not contain a supporting explanation.

The company uses the number of cars, light trucks, and medium trucks assigned to each department or affiliate to allocate the respective vehicle pools. It uses the number of total vehicles (regardless of type) to allocate the overhead pool, The company provided a list of the percentages used during fiscal year 2006 to allocate the various vehicle maintenance expenses to its own departments and to Service Company departments. The next four tables summarize those expenses for fiscal 2006.

Allocation of Car Maintenance Expense

Affiliate	Cars	Allocation	Liberty Calculation	Reported Allocation
Service Company				
Training	2	18.18%	$9,802	$10,120
Office Services	1	9.09%	$4,901	$5,060
Total Service Company	3	27.27%	$14,702	$15,180
NJNG Departments				
Stores	1	9.09%	$4,901	0
Environmental	1	9.09%	$4,901	5,060
Customer Service	1	9.09%	$4,901	5,060
Central Collections	4	36.36%	$19,603	20,238
Northern Operations	1	9.09%	$4,901	5,061
Total NJNG	8	72.73%	$39,207	35,419
Total	***11***	***100.00%***	$53,909	$50,599

Liberty calculated the amounts assignable to each entity using the total car maintenance pool expenses and specific allocation percentages. Liberty's calculations for the Service Company and most NJNG departments were generally consistent with the figures that the company reported in the fourth quarter *Allocation Statements to Affiliates* report. There was, however, one exception. The company report showed no expense allocated to the NJNG Stores department. The company subsequently explained that the department actually did receive a charge of $5,060, but that the algorithm that the company used to generate the allocation report failed to pick up that account. In addition, the company had previously issued a credit for $1,806 in the car expense pool. These two items yield a difference of $3,254, which is consistent with the difference with Liberty's calculations.

Allocation of Light Truck Maintenance Expense

Affiliate	LTS	Allocation	Liberty Calculation	Reported Allocation
Service Company				
Office Services	1	0.64%	$6,600	$6,589
Total Service Company	1	0.64%	$6,600	$6,589
NJNG Departments				
System Engineering	3	1.91%	$19,799	$19,751
Customer Service/Marketing	1	0.64%	$6,600	6,581
Stores	1	0.64%	$6,600	6,581

Northern Utility/Mtr Rdg	10	6.37%	$65,997	65,802
Bay Division Utility/Mtr Rdg	5	3.18%	$32,998	32,901
Monmouth Div/ Central Mtr Rdg	33	21.02%	$217,789	156,803
Ocean Division Utility/Mtr Rdg	34	21.66%	$224,389	223,710
Northern Ops/1st Responders	10	6.37%	$65,997	65,803
Bay Ops/1st Responders	14	8.92%	$92,396	92,115
Central Ops/1st Responders	16	10.19%	$105,595	105,294
Ocean Ops/1st Responders	23	14.65%	$151,793	151,249
Gas Control/PMT	3	1.91%	$19,799	19,743
Meter shop	3	1.91%	$19,799	19,761
Total NJNG	156	99.36%	$1,029,550	$966,094
Total	***157***	***100.00%***	$1,036,150	$972,683

Liberty calculated the amounts assignable to each entity using the total light truck maintenance overhead pool expenses and specific allocation percentages. Liberty's calculations for the Service Company and most NJNG departments were generally consistent with the figures that the company reported in the fourth quarter *Allocation Statements to Affiliates* report. There was a discrepancy of approximately $60,000, however, associated with the Central Meter Reading department. The department actually received the correct charges, but there was an understatement on the Quarterly Report. The company explained that it had correctly charged the $60,000 amount to the department, but, for the first portion of the year, charged the amount to a department sub-account that was not picked up by the report generation algorithm. The company subsequently corrected the sub-account designation and the charges were included for reporting purposes.

Allocation of Medium Truck Maintenance Expense

Affiliate	MTs	Allocation	Liberty Calculation	Reported Allocation
NJNG Departments				
Stores	1	1.15%	$16,749	16,710
System Engineering	16	18.39%	$267,979	267,465
Northern Ops/1st Responders	8	9.20%	$133,990	133,718
Bay Ops/1st Responders	11	12.64%	$184,236	183,875
Central Ops/1st Responders	20	22.99%	$334,974	334,288
Ocean Ops/1st Responders	18	20.69%	$301,476	300,885
Gas Control	13	14.94%	$217,733	217,309
Total NJNG	87	100.00%		
Total	***87***	***100.00%***	***$1,457,136***	***$1,454,250***

Liberty calculated the amounts assignable to each entity using the total medium truck vehicle maintenance pool expenses and specific allocation percentages, and these were generally consistent with the figures that the company reported in the fourth quarter *Allocation Statements to Affiliates* reports. All expenses in this pool remained at the utility.

Allocation of Vehicle Overhead Maintenance Expense

Affiliate	Vehicle Count	Allocation	Liberty Calculation	Reported Allocation
Service Company				
Training	2	0.78%	$6,089	$6,118
Office Services	2	0.78%	6,089	$6,118
Total Service Company	4	1.57%	12,177	$12,236
NJNG Departments				
Environmental	1	0.39%	$3,044	$3,060
System Engineering	3	1.18%	9,133	9,180
Customer Service.Marketing	2	0.78%	6,089	6,118
Credit and Collections	4	1.57%	12,177	12,246
Stores	3	1.18%	9,133	9,178
Northern Utility/Mtr Rdg	10	3.92%	30,444	30,612
Bay Division Utility/Mtr Rdg	5	1.96%	15,222	15,315
Monmouth Div/Central Mtr Rdg	33	12.94%	100,464	101,006
Ocean Division Utility/Mtr Rdg	34	13.33%	103,508	104,074
Construction & Renewal	15	5.88%	45,665	45,913
Northern Ops/1st Responders	19	7.45%	57,843	58,160
Bay Ops/1st Responders	25	9.80%	76,109	76,523
Central Ops/1st Responders	36	14.12%	109,597	110,035
Ocean Ops/1st Responders	42	16.47%	127,863	128,556
Gas Control/PMT	16	6.27%	48,710	48,978
Meter shop	3	1.18%	9,133	9,180
Total NJNG	251	98.43%	764,135	768,134
Total	***255***	***100.00%***	$776,312	$780,370

Liberty calculated the amounts assignable to each entity using the total vehicle maintenance overhead pool expenses and specific allocation percentages. Liberty's calculations for the Service Company and most NJNG departments were generally consistent with the figures that the company reported in the fourth quarter *Allocation Statements to Affiliates* report.

<u>*Radio Tie Line Services*</u>

NJNG allocates the cost of radio tie lines by the number of radios. It uses one ratio for the year and performs no true-up, because the number of radios does not frequently change. All radios

(224 in all) were assigned to NJNG departments in fiscal year 2006; the company subsequently transferred the cost for one radio to the facilities area in the Service Company.

The total actual cost for radio tie lines for fiscal 2006 was $161,970, all of which came through vouchers. Liberty calculated a per-radio rate of $723 per year. The company's fourth-quarter 2006 *Allocation Statements to Affiliates* report used a value of approximately $704. The company explained that it had allocated only $157,898 of the $161,970 total expense in the pool, which is consistent with Liberty's calculated per-radio rate of $704. The company stated that it was not clear why it did not allocate out the entire actual expense, and that it was investigating the difference. In any event, the change in costs allocations would be insignificant. Including the expense difference of $4,072 in the allocation would only produce a $19 increase in the allocation to the Service Company, which has only one radio. The balance of the cost would remain at NJNG, as it has all the other radios.

Print Shop Services

Print shop assets remain at the utility level; however, as discussed earlier, NJNG recovers no depreciation expense for it. All print shop charges consist of labor-related costs that originate at the Service Company; NJNG charges no costs for this function. One employee in the Office Services group operates the print shop, and keeps track of time spent on behalf of NJNG departments or affiliates. The costs associated with the print shop general service no longer flow to NJNG. The Service Company charges whatever group uses print shop services. The Service Company derives a default labor distribution for the print shop during the budgeting process, and performs a quarterly true-up to actual time sheet data. Prior to the 2005 fiscal year, NJNG had allocated print shop charges similarly to those for the inserter room, based on historical percentages. The newer, direct-charge method constitutes an improvement.

Print shop services should be removed from the next version of the general service agreement, as NJNG no longer is directly involved in this service.

Inserter Room Services

Liberty reviewed the company's actual 2006 fiscal year expenses for inserter room services, which are summarized in the table below. Inserter room services consist primarily of the activities required to insert billing, advisory, advertising, and promotional material into envelopes to be sent to customers.

Actual Inserter Room Expenses

Cost Component	**FY 2006**
Labor - Office Services	$678
Transportation	3,295
Labor - Remittances	87,602
Total	**$91,575**

The costs of this function consist primarily of labor costs, plus vehicle charges assigned from an NJNG department. The company indicated that it captured the costs of any incidental supplies associated with the inserter room in Office Services or a similar group, rather than trying to associate such costs directly with the inserter room function for charging purposes.

The company uses the prior year's actual inserter-room usage, modified for any known changes, to develop its allocation percentages. The company uses these percentages to allocate actual costs each month, with no true-up. The company provided a list of the percentages that NJNG used to allocate inserter room expenses to its own departments, to Service Company departments, and to NJR Home Services. The next table summarizes expenses for fiscal 2006.

Allocation of Inserter Room Expense Pool

Affiliate	Inserter Count	Allocation %	Liberty Calculation	Reported Allocation
Service Company				
Financial	1,794	0.29	$270	$267
Human Resources	30,802	5.05	$4,628	$4,628
Total Service Company	32,596	5.35	$4,898	$4,895
NJR Home Services	20,024	3.29	$3,009	$3,008
NJNG				
Regulatory Affairs	16,847	2.76	$2,531	$2,531
Marketing	13,316	2.18	$2,001	$2,002
Customer Service	322,537	52.92	$48,461	$48,461
Gas Transportation	158,402	25.99	$23,800	$23,799
Utility Service	45,759	7.51	$6,875	$6,876
Total NJNG	556,861		83,669	83,669
Total	***609,481***	***100.00***	***$91,575***	***$91,572***

Liberty calculated the amounts assignable to each entity using the total inserter room pool expenses and specific allocation percentages, and these were generally consistent with the figures that the company reported in the fourth quarter Allocation Statements to Affiliates report.

Postage

NJNG does not allocate the cost of postage using an allocation factor, but rather directly charges to affiliates and departments based on usage. Prior to 2000, the company used historical usage to allocate postage. The company does not include directly-charged postage in its Allocation to Affiliates Statement report. Liberty believes that the company should remove postage from the next version of the general services agreement. The company handles postage the same way it handles other miscellaneous business costs like cell phone services and shipping services, by directly charging each department or affiliate for its actual usage.

Application Development

The next table summarizes actual 2006 fiscal year expenses for application development services.

Actual Application Development Expenses

Cost Component	FY 2006
Labor – Service Company	$2,676,402
Consulting	37,959
Total	**$2,714,361**

The application-development expense pool consists primarily of labor-related charges from the Service Company IT group, with some voucher-related NJNG costs. The IT department has its own version of time reporting, which operates more like a work order system. The Service Company finance and accounting group does not see the detailed data from the IT department for applications development time. The IT departmental managers send a report to accounting that summarizes the time that should be assigned to each affiliate, based on the amount of time their programmers spent on projects.

The Service Company retains application-development labor expenses that pertain to its own departments. Those expenses become part of departmental overheads, which do not enter the general services pool of costs for allocation. Time assigned to NJR and time that cannot be assigned directly to an affiliate becomes part of residual labor. The Service Company sends the net labor charges to NJNG, and the company allocates them to utility departments and to affiliates on the basis of the distribution of time directly reported on programmer time sheets. The charges for application development therefore consist of direct payroll, fringe and payroll taxes, overhead expenses, plus an allocation of the residual Service Company labor and related costs. The company allocates the residual in the same proportion as the direct charges. The use of actual time sheet data each month to allocate charges obviates the need for true-ups.

The next table summarizes actual fiscal 2006 charges to NJNG departments and affiliates; total allocated charges match total application development pool expenses.

Application Development Expense Charges

Affiliate	Allocation		
NJR Home Services	$198,791	Field Services	18,199
NJNG		Gas Transportation	64,100
Environmental	$30,902	Credit and Collections	163,669
Right of Way	5,711	Customer Inquiry	283,573
Regulatory Affairs	58,716	Remittance processing	35,843
Governmental Affairs	7,117	Construction & Renewal	8,755
Customer Relations	22,965	Operations/1st Responders	171,518
Energy Services	656,151	Meter Shop	35,127
Distribution Engineering	26,882	Transportation	20,255
Systems Enhancement	204,465	Stores	20,958
System Engineering	50,938	Gas Control/PMT	19,034
Marketing	90,195	Performance Management	161,591

Operations Management	75,894		
Utility Division/Meter Reading	86,435	*Total NJNG*	2,515,576
Central Dispatch	196,583	***Total***	*$2,714,367*

Hardware and Software Maintenance

Liberty reviewed the company's actual 2006 fiscal year expenses for hardware and software maintenance, which the next table summarizes.

Actual Hardware and Software Maintenance Expenses

Cost Component	**FY 2006**
Labor – Service Company	$1,729,875
NJNG Vouchers	2,440,272
Total	**$4,170,147**

The hardware and software maintenance expense pool consists of labor-related charges from the Service Company IT group, and voucher-type costs at the NJNG level. NJNG IT voucher expenses include costs associated with the lease on the mainframe or other equipment, software contracts or licenses, and maintenance contracts. The Service Company transfers labor-related charges to NJNG, which then allocates them along with voucher costs. The company confirmed that the Service Company IT labor-related charges include both fringe benefit and departmental overhead costs.

The company uses a complex method for allocating hardware and software maintenance. At the beginning of the fiscal year, the finance and accounting group develops three allocation percentages for hardware and software maintenance expense, based on CPU processing clock tics, the number of PCs, and number of FODS units from the prior 12-month period. The company designed the three ratios to match the three different types of expenses involved in hardware and software maintenance.

The next table shows a sample of the fiscal 2006 allocation percentages for selected affiliates and NJNG departments, as well as company-wide totals.

Allocation Percentages for Selected Affiliates and NJNG Departments

Affiliate	**CPU Seconds**	**Allocation**	**PC Count**	**Allocation %**	**FODS Count**	**Allocation**
Service Company (selected depts.)						
Human Resources	81,644,761	1.54 %	11	2.57 %	0	0.00 %
Finance/Accounting	1,985,250,072	37.36 %	26	6.07 %	0	0.00 %
NJR Home Services	173,213,219	3.26 %	29	6.78 %	59	24.08 %
NJRES	36,529	0.001 %	36	8.41 %	0	0.00 %
NJNG (selected depts.)						

Gas Supply/Energy Serv.	3,197,825	0.06 %	22	5.14 %	0	0.00 %
Transportation/Stores	6,966,551	0.13 %	8	1.87 %	23	9.39 %
Credit and Collections	226,639,171	4.27 %	12	2.80 %	3	1.22 %
Customer Inquiry	760,390,043	14.31 %	56	13.08 %	0	0.00 %
Total Corporation	**5,313,561,875**		**428**		**245**	

The company also develops a budget for its expected voucher costs for the fiscal year; the next table summarizes the fiscal 2006 budget.

Budgeted Hardware/Software Voucher Expenses

	Budgeted Expense	% of Total Vouchers
CPU Related Expenses	$1,243,173	48.14 %
PC Related Expenses	1,129,269	43.73 %
FODS Related Expenses	209,840	8.13 %
Total	**$2,582,282**	**100.00 %**

The finance and accounting group calculates the percentage of budgeted voucher expenses represented by CPU-related, PC-related, and FODS-related vouchers. To derive a weighted composite allocation factor for each NJNG department and affiliate, it uses the relative percentage of each type of voucher expense, 48.14 percent, 43.73 percent, and 8.13 percent, to weight the corresponding allocation percentage. The composite allocation factor percentages for selected affiliates and NJNG departments are summarized in the following table.

Composite Hardware/Software Maintenance Allocation Percentage
Selected Affiliates and NJNG Departments

Affiliate	CPU Allocation	PC Allocation	FODS Allocation	Weighted Average
Allocation Weighting	***48.14%***	***43.73 %***	***8.13 %***	
Service Company				
Human Resources	1.54%	2.57%	0.00%	1.864 %
Finance/Accounting	37.36%	6.07%	0.00%	20.643 %
NJR Home Services	3.26%	6.78%	24.08%	6.490 %
NJRES	0.001 %	8.41 %	0.00 %	3.679 %
NJNG				
Energy Services	0.06%	5.14%	0.00%	2.277 %
Transportation/Stores	0.13%	1.87%	0.00%	1.644 %
Credit and Collections	4.27%	2.80%	1.22%	3.379 %
Customer Inquiry	14.31%	13.08%	0.00%	12.611 %

The company uses the weighted composite allocation factor percentages to allocate actual NJNG voucher expenses each month. Liberty asked why the company did not simply separate actual voucher costs into those that related to each type of cost; *i.e.*, mainframe, PCs, and FODS, and then apply the appropriate allocation percentage to the appropriate voucher costs. The company's approach requires NJNG departments and affiliates with no FODS units to bear a portion of FODS voucher costs. The company stated that such an entity would not receive any FODS expenses, because it would have zero as the allocation percentage for FODS vouchers. This is not literally correct. Technically, each department and affiliate receives a portion of FODS costs, because it receives a portion of total voucher costs, although its weighted composite percentage is reduced by the zero FODS percentage. The company stated that it adopted this method to avoid unnecessary complication. Liberty did not have the data on actual voucher expenses broken into the three categories in order to test the effect that the company's method has on the allocation of voucher costs.

The company uses a different approach to allocate Service Company hardware and software maintenance labor. The finance and accounting group must perform the allocation in two steps, because it closes the Service Company books before those of NJNG. The company must identify the labor that is relevant for Service Company departments before it can send the remaining to NJNG to be allocated.

The finance and accounting group first computes the Service Company hardware and software labor-related costs that are associated with non-IT Service Company departments, using the weighted composite allocation percentage for each Service Company department. These costs become departmental overhead, which gets allocated each month. The finance and accounting group then adjusts the weighted composite allocation percentages for non-Service Company entities to account for 100 percent of the remaining labor costs. For example, if the Service Company retained 20 percent of labor, there would be 80 percent remaining to be allocated to affiliates. If one affiliate's weighted composite allocation percentage was 10 percent, the group would adjust it to 12.5 percent (10 divided by 80). Accounting would then use the adjusted composite allocation percentages to allocate remaining Service Company hardware and software maintenance labor-related costs to affiliates and NJNG departments.

The next table summarizes fiscal 2006 actual charges for hardware and software maintenance expense charged to the Service Company departments, to NJNG departments, and to affiliates.

Hardware and Software Maintenance Expense Charges

Affiliate	Allocation	Affiliate	Allocation
Service Company		Distribution Engineering	55,697
Training	$7,459	Systems Enhancement	88,251
Corp. Communications	18,223	System Engineering	68,799
Website Admin	4,982	Marketing	240,532
Auditing	21,599	Operations Management	107,543
General Counsel	3,523	Utility Division/Meter Reading	219,380
Human Resources	45,287	Central Dispatch	82,280

Continuous Improvement	9,791	Customer Service Mgmt	10,754
Purchasing	13,556	Northern Field Services	22,125
Treasury	6,487	Gas Transportation	334,654
Financial and Rev Acct	501,543	Asbury Customer Service	20,064
Facilities	4,958	Credit and Collections	162,953
Office Services	15,015	Customer Inquiry	608,108
Total Service Company	652,423	Lakewood Field Services	44,041
NJRES	177,400	Remittance processing	55,410
CR&R	9,940	Technical training	37,692
NJR Home Services	312,913	Construction & Renewal	20,108
NJNG		Operations/1st Responders	336,784
Environmental	$109,907	Meter Shop	66,453
Right of Way	19,718	Transportation	58,120
Regulatory Affairs	29,905	Stores	21,125
Governmental Affairs	4,929	Gas Control/PMT	42,373
Customer Relations	20,150	*Total NJNG*	2,997,660
Energy Services	109,805	***NJR Corporate***	39,442
		Total	***$4,189,778***

Liberty asked the company to explain why it allocated nearly $20,000 more than the total hardware and software-maintenance expense pool of $4,170,147. The company explained that it had not updated the allocation percentage for one NJNG department in time for October 2005, which is the first month of fiscal year 2006. As a result, the company over-allocated $9,445 to the department by using the prior year's allocation percentage for one month. The company indicated that the rest was due to rounding overages when it calculated the voucher and labor charges for each individual department.

The prior EDECA auditor found that Home Services was not paying its share of the costs of maintaining NJNG's AS400 computer database system, which also stores Home Service accounts. The auditor estimated that Home Services should pay 20 percent of the approximately $500,000 in hardware and software maintenance costs allocated to the NJNG customer inquiry department.

Originally, the company believed that the costs of the AS400 computer were fixed and already being paid by the utility, and that there were no incremental costs associated with use by NJR Home Services. The company removed the hardware and software-maintenance expense component of any of the shared service functions it allocated to Home Services -- not only customer inquiry, as the prior auditors assumed. Therefore, the utility fully absorbed those general service hardware and software maintenance costs that were allocated to the shared services functions. The company also did not allocate to Home Services any general services hardware and software maintenance costs directly. The company reconsidered its approach, and beginning in fiscal year 2004 it began charging Home Services for hardware and software maintenance as a general service, and retained the expense as a component of shared service rates.

Liberty's review of the CAM found the description for allocating hardware and software expenses to be at some variance to actual practice. The CAM suggests that the company keeps track of CPU-related expenses, FODS-related expenses, and mainframe expenses separately, and applies the relevant allocation factors to each type of expense separately. The company should clarify and expand the description of its allocation method.

Communications Equipment

The company allocates the cost of data communication expenses related to the internet and networks based on the number of PCs. The company develops the allocation percentage, and uses it to assign actual dollar expenses for the year. The total actual costs for data communication for fiscal year 2006 were $374,534, consisting entirely of vouchers.

The company provided a list of the percentages that it used during fiscal year 2006 to allocate the communication expenses to NJNG departments and to affiliates, which the next table summarizes.

Allocation of Communications Equipment Expense Pool

Affiliate	PCs	Allocation	Calculated Allocation	Reported Allocation
Service Company				
Training	3	0.7009	$2,625	$2,627
Corp. Communications	7	1.6355	$6,126	$6,128
Website Admin	2	0.4673	$1,750	$1,749
Auditing	5	1.1682	$4,375	$4,375
General Counsel	1	0.2336	$875	$875
Human Resources	11	2.5701	$9,626	$9,624
Continuous Improvement	3	0.7009	$2,625	$2,627
Facilities – Wall	2	0.4673	$1,750	$1,749
Purchasing	5	1.1682	$4,375	$4,375
Treasury	2	0.4673	$1,750	$1,749
Financial and Rev Acct	26	6.0748	$22,752	$22,752
Office Services	6	1.4019	$5,250	$5,250
Total Service Company	*73*	17.0561	$63,881	$63,880
NJR Home Services				
HS Plumbing	2	0.4673	$1,750	
Home Services Mgmt/Stores	27	6.3084	$23,627	
Total Home Services	29	6.7757	$25,377	$25,382
NJRES	36	8.4112	$31,503	$31,485
CR&R	2	0.4673	$1,750	$1,749

NJR Corporate	8	1.8692	$7,001	N/A
NJNG				
Environmental	6	1.4019	$5,250	$5,250
Right of Way	4	0.9346	$3,500	$3,501
Regulatory Affairs	6	1.4019	$5,250	$5,250
Government Affairs	1	0.2336	$875	$875
Consumer/Community Relations	4	0.9346	$3,500	$3,501
Energy Services	22	5.1402	$19,252	$19,250
Distribution Engr/Gas Control	10	2.3364	$8,751	$8,748
Systems Engineering	17	3.9720	$14,876	$14,877
Corrosion Engineering	12	2.8037	$10,501	$10,500
Cust Service/Marketing General	33	7.7103	$28,878	$28,875
Operations Staff	4	0.9346	$3,500	$3,501
Division Utility/Meter Reading	13	3.0374	$11,376	$12,053
Central Dispatch	11	2.5701	$9,626	$9,624
Customer Service Management	1	0.2336	$875	$875
Gas Transportation	2	0.4673	$1,750	$1,749
Asbury Park Customer Service	3	0.7009	$2,625	$2,627
Central Credit and Collections	12	2.8037	$10,501	$10,500
Lakewood Field Services	5	1.1682	$4,375	$4,375
Remittance Processing	5	1.1682	$4,375	$4,375
Customer Inquiry	56	13.0841	$49,004	$49,004
Training	7	1.6355	$6,126	$6,128
Construction and Renewal	1	0.2336	$875	$875
Division Oper/1st responders	21	4.9065	$18,377	$18,380
Meter Shop	12	2.8037	$10,501	$10,500
Transportation/Stores	12	2.8037	$10,501	$10,503
Total NJNG Departments	*280*	65.4206	$245,022	$245,696
Calculated Total	***428***	***100.0000***	***$374,534***	

Liberty calculated the amounts assignable to each entity using the total communications equipment pool expenses and specific allocation percentages, and these were generally consistent with the figures that the company reported in the fourth quarter *Allocation Statements to Affiliates* report. There was one exception, however. Liberty calculated a lower cost allocation to NJNG division and meter reading departments than reported. The company explained that it had not updated the allocation percentages for the data communications pool in time for October 2005, which is the first month of fiscal year 2006. As a result, the company used the prior year's allocation percentage for one month, which for these departments was higher in fiscal year 2005 than fiscal year 2006.

Energy Services

NJNG charges the time for some of its energy-related employees to NJRES as a general service under the service agreement. Under the same agreement, NJRES charges time for some of its employees to NJNG. The company uses journal entries to transfer these costs through inter-company accounts.

Each month NJNG charges NJRES a pre-determined amount for energy services employees; the company performs a routine true-up to actual time sheets. These charges are based on a pre-determined payroll distribution for each relevant employee, and include fringe benefits and the relevant calculated overhead for the utility energy services group, approximately 125 percent. The finance and accounting group adjusts for actual overhead costs at the same time as it performs the regular true-up to actual time sheets, typically at the end of each quarter.

Each month NJRES also charges NJNG a pre-determined amount for energy services employees. NJRES bases these charges on a pre-determined payroll distribution for each relevant employee, and includes fringe benefits, but not overhead. The company does not perform any true up to actual time sheets. During the budgeting process, the NJRES accounting group asks relevant employees for an estimate of the percentage of their time they expect to work for NJNG versus NJRES. The company uses those percentages throughout the year to charge NJNG. For fiscal year 2003, the affiliate billed NJNG based on actual hours during the year, and did not begin regular monthly charges until the following year.

The following table summarizes the charges between the parties since fiscal 2003.

Charges between NJNG and NJRES
for Energy-Related Employee Time

	FY 2006	**FY 2005**	**FY 2004**	**FY 2003**
Charges from NJNG to NJRES	$152,077	$1,240,328	$958,098	$629,933
Charges from NJRES to NJNG	$522,000	$330,000	$330,000	$75,672

Liberty could not directly determine whether or not NJNG benefited from NJRES' billing method, or whether it paid more than fully allocated costs. On one hand, the utility did not have to pay for overhead costs. On the other hand, the utility may have paid for more labor hours than it actually received. The only way to verify that NJNG does not pay more than fully allocated costs is to perform a routine true-up to actual time sheets. The company stated that NJRES planned to implement true-ups beginning in fiscal year 2007.

By way of additional testing of general services charges, Liberty reconciled the allocated charges for general services amounts in the *Allocation Statements to Affiliate* report to detailed charges in the inter-company accounts. Liberty also examined the total fiscal year 2006 expenses for headquarters building maintenance; Liberty substantiated that NJNG charged CR&R through the inter-company accounts for 24 percent of real estate taxes, maintenance salaries and fringe benefits, and building O&M. This was not the case for company-used gas, however. The next table summarizes the fiscal 2006 costs for the company-used gas included in the NJNG general service pool and the gas charged to CR&R.

Company-Used Gas Charges

General Service Building Pool	$170,025	81.33 %
Charges to Home Services	$39,027	18.67 %
Total Company-used Gas Cost	**$209,052**	

CR&R received something less than 24 percent of the total cost of company-used gas costs at the headquarters building. The company subsequently stated that CR&R had likely received 20 percent of building costs in the past, and the company had failed to update the formula for this particular line item in its algorithms. The company stated that it would correct the error for fiscal year 2007. Liberty estimates that CR&R paid approximately $11,145 too little for company-used gas for fiscal year 2006.

3. Conclusions

1. The company's approach for allocating general services costs to affiliates is reasonable.

Liberty found that the company's method for allocating general services costs is reasonable, results in an equitable distribution of costs, and avoids NJNG subsidization of affiliates. The company does not overly rely on the use of general allocators, but rather has selected cost drivers that provide a reasonably good match to cost causation.

2. The company has been reasonably attentive to assuring that affiliates appropriately bear the full cost of general services.

Liberty found that the company has devoted considerable effort to assuring that each affiliate pays its fair share of general service costs and is not cross-subsidized by the utility. Liberty did find some small errors. For example, the company did not update its allocation percentages for data communication expense in a timely fashion. It also had errors associated with vehicle maintenance expenses, and apparently has an error in the algorithm it used to generate the Allocation Statements to Affiliates report. The errors affect allocations to NJNG departments, not other affiliates. There is, however, room for improvement in the company's procedures.

3. The company does not include depreciation expense in general service charges. *(Recommendation #1)*

The company does not include depreciation expenses for capital assets that the utility uses to provide general services, such as part of a few network servers, computer network software, two printing presses, a folder, collator, paper cutter, drill press, shrink wrapper, a plate burner, and a perforation machine. The company can identify the value of a given asset and the values by category in its capital asset accounting system but it cannot associate individual assets with individual departments; therefore, it cannot directly calculate depreciation by department. The company indicated that the assets it uses to provide general services are generally old and that the book values are low, which would make resulting depreciation, if calculated, insignificant. The company is installing a new fixed asset system that should correct this omission, but only for new assets moving forward.

4. CAM treatment of print shop services and postage charges is not current. *(Recommendation #2)*

NJNG is no longer involved in the provision of print shop services, and no longer uses an allocation factor to distribute postage charges. All shop costs are incurred and distributed by the Service Company. NJNG does not use an allocation factor to distribute postage charges; instead, it handles postage the same way it handles other miscellaneous business costs like cell phones and shipping services, by directly charging each department or affiliate for its actual usage.

5. The company does not include fringe benefits costs in the vehicle maintenance general service expense pool.

The company excludes fringe benefits costs in the general-service vehicle-maintenance pool in order to simplify its calculations. The utility has nearly all vehicles, and the Service Company is the only affiliate currently receiving charges for this general service. Because the vast majority of Service Company charges are ultimately sent to the utility, NJNG would receive nearly all fringe benefits costs assigned to Service Company vehicles. Liberty believes that the company's shorthand approach is appropriate to these very specific circumstances. However, the CAM description should conform to actual practice.

6. The Service Agreement is no longer consistent with NJNG's only marginal involvement in providing the application development service. *(Recommendation #3)*

The application-development expense pool consists primarily of labor-related charges from the Service Company IT group, plus a very small amount of voucher-related costs at NJNG.

7. The CAM description of the company's allocation method for hardware and software maintenance is not sufficiently clear. *(Recommendation #4)*

The CAM description of the company's allocation method for hardware and software expenses implies that the company keeps track of CPU-related expenses, FODS-related expenses, and mainframe expenses separately, and applies the relevant allocation factor to its appropriate expense, which it does not do. Also, the CAM does not sufficiently describe the separate processes used to allocate NJNG voucher costs and Service Company labor.

8. The company uses different methods for calculating direct charges for NJNG energy service department employee time and NJRES employee time. *(Recommendation #5)*

The company's approach for charging NJNG employee time to NJRES is different from the one it uses for charging NJRES employee time to NJNG. Neither approach is adequately described in the CAM. The hourly labor charges from NJNG include fringe benefits and overhead, but those from NJRES include fringe benefits but no overhead. Both entities charge a fixed amount per month based on pre-determined labor allocations; however NJNG performs a true up to actual time sheet data, while NJRES does not.

9. The company slightly overstated the headquarters building expense because it did not charge CR&R its full share of company-used gas. *(Recommendation #6)*

CR&R leases from NJNG unused space in the Wall headquarters building, and pays its proportional share of lease costs, company-used gas, real estate taxes, maintenance salaries and fringe benefits, and building O&M. During fiscal year 2006, CR&R leased 24 percent of the building but paid somewhat less than 24 percent of company-used gas costs. Liberty estimates the underpayment at approximately $11,145. The company subtracts CR&R payments from the general services building expense pool. Therefore, the building expense pool was overstated by the same amount. The company explained that it likely failed to update a formula for this line item in its algorithms, and stated that it would correct the error for fiscal year 2007 forward.

4. Recommendations

1. Include depreciation expense associated with new assets used to provide general services. *(Conclusion #3)*

Liberty recognizes that estimating depreciation expense associated with older assets that NJNG uses in providing general services may not be practical. However, to the extent that NJNG replaces existing assets or adds new ones in the future, it should quantify depreciation using its new capital asset accounting system, and include that expense in allocated general service costs.

2. Update the service agreement for general services to remove print shop and postage services. *(Conclusion #4)*

The company should remove print shop services and postage from the general services agreement.

3. Update the general services agreement to remove applications development, and move this function entirely to the Service Company. *(Conclusion #6)*

The company should move the small amount of NJNG voucher and similar costs to the Service Company. Liberty recognizes that this would not necessarily simplify the accounting associated with the allocation, but would make the method more transparent.

4. Revise the CAM to clarify the description of the allocation process for hardware and software maintenance. *(Conclusion #7)*

The company should clarify the language in the CAM regarding the allocation process for hardware and software maintenance. The CAM should explain how the company derives the weighted composite allocation percentages that it uses to allocate voucher costs. The company should expand its description in order to allow the reader to differentiate between the processes it uses to allocate NJNG voucher costs versus the one it uses for Service Company labor costs.

5. True up the employee labor charges from NJRES to NJNG to actual time sheets. *(Conclusion #8)*

The company should ensure that NJNG does not pay more than fully allocated costs for employee time from NJR Energy Service. Using default allocations each month is reasonable; however, NJRES should perform a true-up to actual time sheet data on a routine basis.

6. Maintain the algorithm used to calculate CR&R's share of headquarters expense in order to reflect CR&R's current share of the building. *(Conclusion #9)*

Liberty found that the company's formula for calculating CR&R's share of company-used gas was outdated. The company stated that it would correct the error for fiscal year 2007 forward. Liberty believes that the company should routinely review its algorithm for calculating CR&R's share of building expenses to ensure that all formulas, including the one for gas, reflect CR&R's current agreement.

D. NJR Service Company Services Provided to Affiliates

1. Background

The Service Company provides corporate services that include accounting, human resources, and legal activities to NJR Corporate, NJNG, and its affiliates. The company bases assignment and allocation of these Service Company service costs on fully allocated costs. The company does not allocate any Service Company costs to NJR Corporate. Its approach for allocating these costs had not changed substantially during the audit period. Liberty focused on budgeted and actual expenses for fiscal year 2006 in reviewing service-company cost assignments and allocations.

2. Findings

The next tables list and summarize the costs of the corporate services that Service Company has provided to NJR Corporate, NJNG, and its affiliates since fiscal 2003.

Corporate Services

Accounting	Human Resources	Purchasing
Internal Auditing	Information Technology	Quality/Continuous Improvement
Communications - Regular	Legal	Training
Communications - Website	Office Services	Treasury
Facilities		

Service Company Allocations

Affiliate	2006	2005	2004	2003
NJNG General	$9,642,477	$8,047,529	$8,528,789	$9,252,097
NJNG Capital accounts	660,555	551,252	384,639	350,374
NJNG Applications Development	2,676,401	2,530,670	2,756,423	2,813,842
NJNG HW/SW Maintenance	1,750,172	1,632,856	1,584,850	1,703,340
NJNG Facilities	349,982	327,024	365,940	410,874
NJNG Purchasing	882,278	980,177	840,014	775,902
NJNG Office Services		(28,523)	110,136	332,867
NJR Administration/Misc.		(121)	545	9,839
Total NJNG	$15,961,865	$14,040,864	$14,571,336	$15,649,135
NJR Home Services	1,140,200	985,797	835,592	810,144
NJRES	815,685	685,259	661,822	691,520

CR&R	53,748	45,377	62,747	48,801
NJR Energy	115,286	26,900	60,822	28,443
Total	*$18,086,784*	*$15,784,197*	*$16,192,319*	*$17,228,043*

The Service Company provides services to NJR Corporate, but does not allocate associated costs to NJR Corporate. Instead, the company allocates Service Company costs to all other affiliates including NJNG.

The prior EDECA auditor found that NJNG bore 94 percent of Service Company costs in 2002. It appears that the prior auditor considered as exclusive to NJNG those costs of hardware and software maintenance, application development, and facilities management sent initially from the Service Company to NJNG, but then allocated as part of general services. A large percentage of these IT and facilities charges do, however, ultimately remain with the utility. For example, in fiscal year 2006, the utility retained approximately 72 percent of hardware and software charges and 93 percent of application development charges. Assuming that NJNG retains approximately 90 percent of general service pools, NJNG received approximately 86 percent of Service Company charges in fiscal years 2005 and 2006, 87 percent in fiscal year 2004, and 88 percent in fiscal year 2003. Approximately half of the increase in Service Company costs in fiscal year 2006 as compared to 2005 resulted from an increase in employee benefits-related costs.

Liberty reviewed the process for developing budgeted Service Company departmental expenses of $16.3 million for fiscal year 2006, which the next table summarizes.

Service Company Fiscal 2006 Budget

	Labor Related	**Vouchers & Stores**	**Account. Indirects**	**Non-IT Pools & Trans.**	**IT**	**Total**
Training	$183,113	$367,000	$0	$30,010	$25,120	$605,243
Corp. Communications	454,010	159,795	328,900	30,886	37,825	1,011,416
Website Admin	174,668	90,160	0	12,634	11,206	288,668
Internal Auditing	571,361	56,016	0	67,343	64,708	759,428
General Counsel	143,060	0	190,481	14,959	12,102	360,602
Human Resources	548,334	1,451,675	1,162,660	(116,087)	203,590	3,250,172
Continuous Improvement	732,422	32,400	0	57,815	30,627	853,264
Facility Maintenance	160,402	0	0	30,998	3,432	194,832
Purchasing	429,402	23,356	0	120,169	84,993	657,920
Info. Business Systems	2,478,011	72,900	0	(46,847)	0	2,504,064
Treasury	181,454	731,736	0	7,661	20,208	941,059
Accounting	2,100,819	89,400	1,500	102,960	1,587,918	3,882,597
Office Services	269,635	400,323	0	259,018	50,647	979,623
Total Service Company	**$8,426,691**	**$3,474,761**	**$1,683,541**	**$571,519**	**$2,132,376**	**$16,288,888**

The Service Company's budgeted labor expenses include wages, payroll taxes, car allowances and incentives. Payroll accruals comprise part of labor expenses. The company explained that it uses labor accruals because pay periods do not match up to month-end for all employees. For example, some employees are paid every two weeks; the company may have incurred the labor for some number of days towards the end of the month, but does not actually pay for it until sometime in the next month. The company uses a positive or negative accrual each month to synchronize payroll and costs.

Vouchers are typically invoices; for the Treasury department, roughly half of voucher expenses relate to annual meeting and bank fees. For the human resources department, vouchers include employee benefits, such as medical, dental, disability and life insurance premiums. Accountable indirect costs are also typically invoices; the largest of these expenses are in the human resources department, and relate to costs such as post-retirement benefits, savings plan matching, pensions, deferred compensation, and similar expenses. Accountable indirect costs for the general counsel consist of the cost of certain insurance types, including director and officer, and liability insurance. Accountable indirects for the corporate communications group include the cost of the annual report.

The transportation, IT, and non-IT pool expenses relate to general service allocations from NJNG. The IT expenses consist of the NJNG allocations for hardware and software maintenance vouchers, hardware and software maintenance labor, communication equipment, and applications development. Non-IT pool expenses consist of other NJNG allocations, such as headquarters building maintenance. The general services costs allocated from NJNG to the Service Company, as noted earlier, display a one month lag, because the Service Company has to close its books first, and needs to have NJNG cost number in order to clear its departmental accounts. In the Allocation Statements to Affiliates report, the general service allocation to the Service Company departments for a given month actually go into corresponding holding accounts, which hold the costs for each department until the next month.

The company provided a copy of a report of the detailed cost components of each Service Company department, including categories such as labor, vouchers, general service allocations, and accountable direct costs, for the month of September 2006 and fiscal year-to-date. The next table summarizes total departmental costs for fiscal 2006. Actual Service Company expenses ran approximately $1.7 million over budget.

Service Company Fiscal 2006 Actual Expenses

	Labor Related	Vouchers & Stores	Account. Indirects	Non-IT Pools & Trans.	IT	Total
Training	$177,914	$312,168	$0	$34,070	$22,871	$547,023
Corp. Communications	412,242	117,465	294,947	70,646	42,109	937,409
Website Admin	65,063	66,154	579	22,848	10,973	165,617
Internal Auditing	525,591	152,133	0	157,011	63,918	898,653
General Counsel	224,023	13,919	189,144	23,547	11,203	461,836
Human Resources	584,267	2,023,443	1,255,143	(18,827)	208,251	4,052,277

Continuous Improvement	613,373	127,483	1,105	157,320	37,808	937,089
Facility Maintenance	167,865	1,696	1,372	28,091	10,771	209,795
Purchasing	415,483	11,382	0	151,241	82,208	660,314
Info. Business Systems	2,348,194	32,920	0	82,903	0	2,464,017
Treasury	180,249	775,790	1,230	19,708	19,849	996,826
Accounting	2,404,879	311,834	1,696	691,787	1,354,445	4,764,641
Office Services	245,332	408,176	426	288,846	48,499	991,279
Total Service Company	**$8,364,475**	**$4,354,563**	**$1,745,642**	**$1,709,191**	**$1,912,905**	**$18,086,776**

Human resources department costs appear quite large because the costs of fringe benefits for the Service Company are carried in this department.

The Service Company uses time sheet estimates to allocate Service Company costs for the month for nearly all departments, applying budgeted time estimates to actual monthly costs. The company uses actual time sheet data to perform quarterly true-ups. A default labor allocation exists for each Service Company employee; it specifies the departments or affiliates to which the employee’s labor should ordinarily get charged. The Service Company can be one of the departments to which an employee charges his or her time on a default or exception basis. Nearly all Service Company personnel submit time-sheet data into the affiliate transfer time sheet system each month. Some do so only on an exception basis because they infrequently work for entities other than their home organization. These affiliate time sheets provide the data necessary for the finance and accounting group to perform the true-up.

The company uses head count figures, rather than actual timesheet data to assign and allocate the costs of the human resources department. The company has not found an effective way for these employees directly to identify the particular beneficiary of their time use. The accounting and finance group uses the headcount percentages to allocate actual human resources expenses each month, which obviates the need for true-ups.

The company also treats the treasury function differently from other Service Company departments. Treasury employees cannot directly identify the beneficiary of their services, which benefit the corporation as a whole. The finance and accounting group computes the percentage of Service Company labor dollars assigned or allocated to each entity; *i.e.*, the NJNG departments, NJR Corporate, affiliates, and the Service Company residual, for the other Service Company functions. It then allocates the treasury department expenses using those percentages. The group then re-totals the labor dollars to include the Treasury dollars, and can determine the ultimate percentage of Service Company labor that went to each affiliate and to NJR Corporate.

The Service Company provides services to NJR Corporate; however, it does not ultimately charge costs to NJR Corporate. Instead, Service Company department charges otherwise assignable to NJR Corporate become part of the residual for each Service Company department that is allocated to NJNG and other affiliates. Sick, vacation, and holiday time are assigned to the Service Company, and becomes part of the residuals allocated on the same basis as labor.

Labor hours drive how other departmental costs are allocated. In a non-true up month, the company performs the following steps to allocate each Service Company department's costs (except Treasury):

- Distribute labor costs to each affiliate, to NJR Corporate, and to Service Company departments based on default labor allocations or other methods (for Treasury and human resources)
- Distribute payroll taxes to the business entities using the same labor distribution
- Distribute the Service Company residual, *i.e.*, the labor-related costs that remained at the Service Company, to affiliates and to NJR Corporate based on each entity's percentage of non-residual labor
- Distribute the NJR Corporate share of labor-related costs to affiliate based on each affiliate's percentage of residual and non-residual labor
- Distribute Service Company fringes and overhead to affiliates based on each affiliate's percentage of total distributed labor and payroll taxes.

The company considers fringes for the purposes of this allocation to be the non-labor corporate training, legal, and human resources costs at the Service Company; the human resource department carries employee benefits costs, primarily as part of its voucher expenses. The overhead consists of remaining costs such as general service pool allocations.

Calculations of the allocation percentages treat hardware and software maintenance, application development, and facilities management as if they were separate NJNG departments, and the company allocates residual costs, fringes, and overheads like any other department. These costs become part of the general service pools that NJNG allocates to its own departments and to affiliates.

The capital assets utilized by the Service Company to provide services to affiliates consist of software related to some of the network systems. The company indicated that the depreciation expense related to this software was included in the overhead expenses, and allocated to all affiliates.

3. Conclusions

1. The company's approach for allocating Service Company costs is reasonable.

Liberty found that NJNG's method for allocating Service Company costs is reasonable. Liberty believes that the approach results in an equitable distribution of costs such that NJNG is not subsidizing the affiliate. The company uses actual Service Company time sheet data to true-up its allocations to NJNG and to other affiliates each quarter, which helps insure a good match to cost causation.

2. NJNG receives an appropriate share of Service Company charges.

Liberty found that NJNG received approximately 86 percent of Service Company charges in fiscal years 2005 and 2006, 87 percent in fiscal year 2004, and 88 percent in fiscal year 2003.

4. Recommendations

Liberty has no recommendations in this area.

E. Other Transactions Between NJNG and Affiliates

1. Background

A large number of affiliate transactions involving NJNG fall outside the explicit provisions of the existing service agreements. The company generally treats them either as direct or pass-through charges. These transactions defy simple categorization. The lease between NJNG and CR&R for a portion of the headquarters building offers an example. Other examples of miscellaneous charges involving NJNG include:

Employee, medical, dental, and life insurance	Stock options
Savings plan contributions/tuition reimbursement	Outside legal and consulting bills
State and federal unemployment taxes	Employee time not under an agreement
Insurance costs	Telephone, cell phone and pager charges
Shared energy-related subscriptions/software	Federal Express and UPS bills

Most of these transactions flow through the inter-company accounts. A few, such as insurance costs, get invoiced and paid through wire transfers. In a majority of cases, NJNG receives a bill and then allocates a share of a common cost to affiliates. In other cases, however, NJNG receives a share of a bill. NJR Corporate pays federal incomes taxes, for example, and then charges each affiliate, including NJNG, its appropriate share. As Liberty noted earlier in its discussion of the CAM, the company has not formally documented its method for allocating these miscellaneous cost allocations, and should do so in a revised CAM.

2. Findings

The dollar volume of the miscellaneous affiliate transactions that involve NJNG and a particular affiliate in many cases outweighs the charges covered by service agreements. For example, NJR Energy Service pays approximately $0.2 million to NJNG per year for general services, but over $1.5 million for communications and shipping bills, benefits-related costs, and business-related costs such as shared subscriptions, software fees, and promotional items. The next table provides examples of some of the more significant of these miscellaneous cost areas for fiscal 2006 costs for four NJNG affiliates. All of these costs flow through NJNG inter-company accounts.

Selected Inter-Company Charges

Net Charges	**Corporate**	**NJRES**	**NJRHS**	**CR&R**
General services	$91,968	$208,884	$569,570	$11,690
Shared services			1,697,514	
Comm./ship. (phone, Fedex)	21,808	40,148	128,065	1,725
Benefits-related	3,033,387	1,038,766	1,461,919	24,233

General business-related	15,177	447,360		(72,382)
Share of HQ Building costs				263,019

Some other charges, such as the payments from CR&R to NJNG for its sub-lease of the Wall headquarters building, and charges from NJR Corporate to affiliate for insurances, do not flow through the inter-company accounts. The company stated that not all legal bills and audit bills go through inter-company accounts. Each affiliate involved sends its own check in some cases to the audit or law firm for its share of the charges. Some human resources-related charges, such as those related to deferred compensation and tax associated with stock options, also may not always flow through inter-company accounts.

Liberty examined some of the miscellaneous transactions involving NJNG in some detail. Nearly all involve some form of cost allocation.

Wall Headquarters Building Sub-lease

CR&R sub-leases space from NJNG in the Wall Headquarters building. In 1995, the BPU approved a lease of the entire 157,511 square foot building between NJNG and an unrelated investment company. CR&R entered into a sub-lease with NJNG in 1995. CR&R sub-leases from NJNG any space that is not used by the utility. CR&R leased 24 percent of the building during fiscal year 2006. CR&R has two sub-leases in place with NJRES and Home Services, as well as other unaffiliated entities, and bills those tenants directly. The next table summarizes rental payments under the terms of NJNG's lease since 2003.

Date	Payment	Date	Payment
January 2003	$1,292,378	January 2005	$1,292,378
July 2003	$1,292,378	July 2005	$1,461,702
January 2004	$1,292,378	January 2006	$1,461,702
July 2004	$1,292,378	July 2006	$1,461,702

NJNG's lease cost for fiscal year 2006 was $2,923,404, and the base cost of the lease from NJNG to CR&R for 37,803 square feet was $701,606 per year. This cost to CR&R is consistent with its rental of 24 percent of the building square footage. CR&R sends a wire payment to NJNG twice a year for its share of lease costs. Liberty asked the company to substantiate the payments, and the company retrieved from its accounting system entries that demonstrated CR&R sent two payments of $350,803 during fiscal year 2006.

The terms of the lease require CR&R to pay for its prorated share of any O&M expenses (*e.g.*, taxes, gas, and maintenance). Liberty's testing of general service costs, in particular the headquarters building pool, verified that CR&R paid 24 percent of total building expenses, except for company-used gas. Liberty's conclusion and recommendation on company-used gas is discussed in Section III.C. The next table summarizes NJNG's charges to CR&R for building-related expenses in fiscal year 2006.

Building-Related Charges to CR&R

Item	Charge

Company used gas	$39,037
Real estate taxes	56,025
Building O&M	154,100
Maintenance Salary and fringes; insurance	13,856
Total	**$263,018**

Insurance

NJR Corporate pays for insurance costs, and then sends invoices to affiliates for their share of these costs. The amounts do not flow through inter-company accounts; each affiliate settles its account via wire transfer to NJR Corporate. The company develops allocation percentages for each type of insurance during the budgeting process, and applies the percentages to actual bills throughout the year. The company provided its allocation factors and budget allocation percentages for each type of insurance for fiscal year 2006; the next table summarizes them.

Type of Insurance	Basis for Allocation
Automobile	# of vehicles
All Risk Property	Fixed asset value
General Liability	Revenue dollars
Excess General Liability	100% to NJNG
Directors and Officers	# of directors and officers
Workmen's Compensation	# of incidents; # of inside and outside employees
Special Crime	100% to NJR
Fiduciary/Employee Benefits	100% to NJR
Comprehensive Crime	100% to NJR

The company also provided a summary sheet that itemized the insurance bills that NJR Corporate received in fiscal year 2006, along with the amounts billable to each affiliate. The company also provided copies of a sampling of approximately 20 invoices that NJR Capital sent to affiliates. Liberty confirmed that the company calculated the invoice amounts consistent with the established allocation percentages.

Employee Benefits

NJNG receives the bills for the majority of the company's employee-related benefit expenses, such as:

Blue Cross/Blue Shield	Tuition reimbursement
Delta Dental	Pension contributions
Total and long-term disability insurance	State and federal unemployment tax
COBRA	Deferred compensation
Savings plan/401K matching	Short-term incentives and stock options

NJNG pays these bills and charges affiliates for the appropriate amount. Liberty testing sessions included requests for the retrieval of JD Edwards system information for a monthly Blue Cross bill, so that Liberty could examine the journal entries the company uses to send each affiliate its share of costs. The company stated that the human resources group determines how such benefits bills should be allocated, and that the finance and accounting group implements those designations. Each business entity's allocation is based on specific plans to which its employees subscribe.

Liberty also asked the company about stock options. The company explained that when an officer exercises a stock option, there is typically a net gain that has to be taxed as income for the officer. Merrill Lynch handles this program, and withholds the taxes from the proceeds. Merrill sends the cash to NJNG because NJNG pays the taxes, and NJNG creates a receivable in the entity in which the officer resides. The company noted that many times it receives a wire transfer to settle the taxes; therefore, the taxes do not always go through the inter-company accounts.

Employee Time Charges

The company stated that NJNG utility employees do not work for affiliates other than pursuant to the service agreements for shared or general services. This is not correct. The utility does perform routine work for affiliates that is not covered by service agreements.

NJNG over the last few years has provided labor by its payroll clerks to summarize time sheets for Home Services. The company stated that NJNG initially assumed that it would be supplying this labor on a short-term basis, as it had done for stores and dispatching work. When it developed a rate for these employees, it applied a 31 percent fringe benefit rate, and used an estimated overhead rate of 100 percent. The company acknowledged that it used an estimate of overhead for this purpose, rather than calculating the actual overhead from the correct NJNG department. The next table summarizes charges from NJNG to Home Services for payroll services for fiscal years 2005 and 2006, and for payroll and stores labor for fiscal year 2004.

NJNG Charges to Home Services
For Payroll and Stores Labor

Fiscal Year	Total Charges
2006	$55,430.50
2005	48,608.11
2004	64,356.03
2003	NA

If the company expects this relationship to continue, it should develop a more accurate figure for the cost of the utility payroll clerks, taking into account actual fringe benefit and overhead costs. It should also consider adding this service to the shared services agreement in the future.

NJNG also charges NJR Energy Holdings for executive time on an as-needed basis. The company stated that it develops an hourly charge for the Vice President based on labor costs, fringe benefits, and overhead associated with the energy services group. When the executive indicates on an affiliate transfer time sheet that he spent time on NJR Energy Holding matters, the finance and accounting group creates a journal entry to charge directly the affiliate through inter-company accounts. The charges during the audit period are summarized below.

NJNG Executive Time Charges
To NJR Energy Holdings

Fiscal Year	Total Charges
2006	$8,248
2005	21,073
2004	15,446
2003	0

NJNG will also occasionally charge affiliates for employee time for one-time requests. For example, NJNG charged Home Services a total of $6,248 in fiscal year 2006 for time from the right of way, environmental, and energy services departments. Such charges are infrequent and the company records them as individual line items in the NJNG inter-company accounts. The rate developed for employees includes fringe benefits and overhead. In fiscal year 2005, for example, NJNG charged NJR Corporate approximately $20 thousand for employee time. The company explained that in this case, an NJNG employee transferred to NJR Corporate, but the employee's payroll transfer was delayed; therefore, NJNG had to transfer labor charges to NJR Corporate.

Other affiliates may charge NJNG for employee time as well. As discussed previously in connection with the general services building pool, NJNG receives a charge from CR&R of $5,000 per month for the time of the CR&R President or other employees to manage maintenance activities at the Wall headquarters building. This amount is not based on a specific hourly rate, however, but was rather a flat amount negotiated between the parties. Liberty confirmed the payments by NJNG to CR&R that appeared in the NJNG inter-company accounts.

The company should thoroughly document a detailed explanation of its method for deriving hourly billing rates for directly charging affiliates, and of any related procedures such as obtaining pre-approval for such charges. In the case cited above regarding CR&R charges to NJNG, and in Liberty's earlier discussion of charges from NJRES to NJNG for energy employee time, the affiliate appears to have charged NJNG less than fully allocated costs. To the extent that affiliates enter into employee time-related transactions that do not follow the standard method for hourly billing rates, the company should adequately document its reasoning. In no case, however, should NJNG charge affiliates less than fully allocated costs for its own employees.

Communication and shipping expenses

NJNG receives third party vendor bills for telephone, cell phone, pager, and related communications services, and allocates the charges to affiliates based on actual usage. NJNG also receives third party vendor bills for shipping services such as Fedex or UPS that contain charges for affiliates; NJNG charges actual amounts to the affiliates through the inter-company accounts.

Business-related expenses

NJNG receives bills for a wide variety of business-related charges, some of which are for products and services that are exclusively for the affiliate, and some of which are shared between one or more affiliates and NJNG, such as those shown in the next table. NJNG in turn directly charges the affiliates the appropriate portion of these charges.

Auditors and outside counsel	Office equipment leases and maintenance
Subscriptions	Furniture and building remodeling
Software licenses and support	Limousine services
Promotional items	Inventory items

A considerable number of inter-company charges flow from NJNG to NJRES, including the cost of various subscriptions and software licenses and support. NJNG paid invoices and charged NJRES for the following costs in fiscal years 2005/2006:

- Platt's Gas Daily and Inside FERC subscriptions, which are used by both NJNG and NJRES; the company currently assigns 30 percent of these costs to NJNG and 70 percent to NJRES
- Maintenance provided by Sungard for Zainet, which is software that can monitor financial trade data; the company currently assigns 50 percent of these costs to both NJNG and NJRES
- A license agreement for Future Source for software to model financial positions for financial reporting purposes; the company currently assigns 60 percent of these costs to NJNG and 40 percent to NJRES
- Computer software from DiaSpark; while the company previously assigned 50 percent of the costs to each affiliate, it currently assigns 100 percent of the cost to NJRES
- New Jersey Net season tickets; NJNG was the primary holder of these tickets until 2002, after which time NJRES assumed 100 percent of the costs.

Liberty's transaction testing included requests that the company retrieve invoices in its accounting system so that Liberty could substantiate each affiliate's share of these costs. Liberty also asked the company to provide additional information on two major capital projects that involved NJNG and an affiliate. Liberty asked the company to explain its rationale behind the allocation of the Gas Management System (GMS) rewrite project costs. The next table summarizes the allocation of costs between NJNG and NJRES for the various phases of the project.

Allocation of GMS Rewrite Project Costs

Project Components	NJNG	NJRES
Application Design	$8,000	$8,000
Proof of Concept	43,714	43,714
Phase 1 Transactions Analysis	310,000	310,000
Phase 2 Financial Reporting	144,000	144,000
Phase 3 EBB, NMS, Dispatch, Rate	158,100	33,900
Contract Module	13,500	13,500
General business-related	$677,314	$553,114

In general, the company split the costs 50/50 between the parties, except for Phase 3 costs. The company explained that some of the components of Phase 3, specifically the Electronic Bulletin Board (EBB), NMS, and Dispatch, were specific to the utility. As such, it assigned all costs for these components to NJNG. The Rates component pertained to both the affiliate and the utility, and the company split the cost 50/50 between the parties.

Liberty also asked the company for more information about how it allocated the costs for a FODS upgrade in 2004 and 2005. NJNG costs were approximately $820 thousand and NJR Home Services costs were approximately $307 thousand. The company explained that each affiliate paid the invoices for its own equipment, and provided copies of the invoices for each of the NJR Home Services purchases along with back-up accounting information.

Liberty reviewed detailed general ledger reports showing all inter-company charges involving NJNG for the audit period. Liberty questioned the company's finance and accounting personnel about the nature of these charges, and usually asked the company to provide further backup on these charges on a real-time basis using the JD Edwards accounting system. Examples of these charges include:

- A $2.1 million charge from NJNG to NJR Corporate in fiscal year 2006 for pension costs. NJNG recorded a contribution to its retirement fund of approximately $10 million, most of which related to the utility. The company charged NJR Corporate the portion that related to it and to affiliates, which NJR later redistributed.
- A $750 thousand charge from NJNG to the Service Company for an asset transfer in fiscal year 2005. The company stated that this charge related to GEAC, a Windows-based reporting and budgeting software program.
- A $450 thousand charge from NJNG to NJRES in fiscal year 2006 and a $499 thousand charge in fiscal year 2005. The company stated that NJRES contributed this amount towards bonuses for NJNG employees that also work for it.
- A $63 thousand charge from NJNG to the Service Company related to incentives. The company explained that this charge was the reversal of a short-term incentive for an officer of the Service Company. The credit should have gone to the Service Company, but its books were already closed. NJNG ultimately receives approximately 90 percent of Service Company costs; therefore, the company decided to credit the entire amount to NJNG, because it was not worth re-opening Service Company books for the difference.

Several of the charges that Liberty asked the company to research were pass-through charges. The company stated that NJRES can do wire transfers, but does not have its own checking account. As such, NJNG at times has to write checks on the affiliate's behalf. For example, in fiscal year 2003 NJNG paid $175 thousand for the termination of a Multi Options System (*MOSI*) software agreement. In fiscal year 2005, the utility paid $117 thousand for a tax bill in Louisiana associated with a NJRES facility, and over $300 thousand for a variety of invoices for construction costs associated with a trading floor. NJRES was responsible for all of these costs, but NJNG wrote the checks to various vendors, which explained why the items appeared in the inter-company data.

3. Conclusions

1. Transactions between NJNG and affiliates that are not covered by service agreements do not subsidize affiliates.

A large number of affiliate transactions involving NJNG are not explicitly covered by the service agreements. These transactions cannot be neatly categorized, but in general are handled by the company as either direct or pass-through charges. Based on those that Liberty examined, it appears that the transactions are of a routine business nature and result in no detriment to the utility or its customers.

2. NJNG and affiliates charge each other for employee time that is not covered by service agreements. *(Recommendation #1)*

During the audit period, NJNG payroll clerks provided labor to summarize time sheets for Home Services. The utility also provides executive labor to NJR Energy Holdings, and CR&R charges NJNG for its oversight of headquarters maintenance activities. While these types of transactions are routine, the affiliates can also charge each other for one-time requests for employee time.

4. Recommendations

1. Formalize the agreement between NJNG and NJR Home Services for payroll employee support. *(Conclusion #2)*

If NJNG continues to provide payroll employee labor to Home Services, Liberty believes that NJNG should develop a more accurate figure for the cost of the payroll clerks, taking into account actual updated fringe benefit and overhead costs. It should also consider adding this service to the shared services agreement in the future.