

TABLE OF CONTENTS

I. Introduction	1
A. Statement of the Audit Requirements	1
B. Project Objectives	1
C. Summary of the Applicable Standards.....	1
D. Summary of Recommendations	2
E. Project Scope	3
F. RECO Affiliates.....	5
II. Non-Discrimination Standards (14:4-5.3).....	12
A. Affiliate Preferences	12
B. Prohibited Transactions.....	15
C. Access to Information and Services	16
D. Short-Term Sales of Surplus Energy or Capacity.....	18
E. Long-Term Sales of Surplus Energy or Capacity.....	19
F. Discounts or Waivers of Fees or Charges.....	20
G. Documentation of Discount Bases.....	21
H. Non-Discriminatory Tariff Enforcement	22
I. Strict Tariff Enforcement.....	23
J. Processing Affiliate Service Requests.....	24
K. Tying Arrangements	25
L. Customer Assignments.....	27
M. Customer Enrollment, Marketing, and Business Development	28
N. Customer Advice or Assistance	29
O. Posting Discounts, Rebates, and Waivers.....	31
P. Information Retention for Discounts, Rebates, and Waivers	33
Q. Compliance With FERC Record Keeping Requirements	34
III. Information Disclosure Standards (14:4-5.4)	35
A. Providing Customer Proprietary Information	35
B. Providing Other Non-Public Information	36
C. Providing Lists of Generation or Gas Service Providers	38
D. Providing Affiliates Information Concerning Unaffiliated Suppliers.....	39
E. Soliciting Release of Information Concerning Unaffiliated Suppliers.....	40
F. Highlighting Affiliates in Lists of Providers	41
G. Supplementing Information About Affiliated Providers	42
H. Record Keeping Concerning Transactions With Affiliates	43
I. Record Retention Requirements For Transactions With Affiliates.....	44
J. Inspection of Records.....	45
K. Bid and Contract Records	45
IV. Separation Standards (14:4-5.5)	47
A. Separate Corporate Entities.....	47
B. Separate Books and Records.....	48
C. Conformity of Books and Records with USOA.....	48
D. Availability of Books and Records for Board Examination	49
E. Sharing of Space, Services, and Equipment.....	50
F. Authorized Joint Products and Services	52
G. Joint Purchases.....	53



H. Pricing and Reporting of Joint Purchases	55
I. Shared Services.....	57
J. Protection of Confidential and Market Information.....	74
K. Use of Utility Name and Logo.....	76
L. Non-New Jersey Use of Utility Name and Logo.....	78
M. Promising or Implying Preferred Treatment	78
N. Use of Utility Advertising Space	78
O. Joint Advertising or Marketing.....	79
P. Joint Employees.....	82
Q. Common Directors and Officers.....	83
R. Employee Transfers.....	85
S. Use of Utility Information After Employment Transfers.....	87
T. Service Transfers.....	88
U. Utility Asset Transfers	90
V. Utility Competitive Business Segments (14:4-5.6).....	92
A. Review and Approval of Competitive Services.....	92
VI. Prior Audit Recommendations.....	93
A. Background.....	93
B. Summary of Audit Activities	93
C. Recommendation IV.B(1) - Formalize and test employee understanding of the information disclosure rules.....	93
VII. Financial Relationships between Utilities and their Non-Regulated Affiliates	95
A. Background.....	95
B. Summary of Audit Activities	96
C. Findings.....	96
D. Conclusions.....	98
E. Recommendations	98



I. Introduction

A. Statement of the Audit Requirements

The New Jersey Board of Public Utilities (“Board” or “BPU”) issued a March 20, 2002 Request for Proposal (“RFP”) pursuant to N.J.S.A. 48:3-55, 48:3-56 and 48:3-58 to secure the services of a third party or parties to conduct audits of the competitive business segments of all New Jersey electric and gas utilities (“Utilities”).

B. Project Objectives

The objectives of these audits are to assure that:

- Neither the Utilities nor their related competitive business segments (“RCBSs”) enjoy an unfair competitive advantage over their competitors
- There is no form of cross-subsidization of competitive services by utility operations or affiliates with which they are associated.

The audits were guided by the Board’s Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements (“Standards”), which implement the applicable provisions of New Jersey’s Electric Discount and Energy Competition Act, N.J.S.A. 48:3-49 *et seq.* (the “Act”), that regulate utility affiliate transactions, and direct the Board to establish standards of conduct in providing competitive services to retail customers in New Jersey.

C. Summary of the Applicable Standards

For purposes of the Standards, there are five principal types of entities:

- Electric or gas public utilities
- Retail competitive business segments of the electric or gas public utilities
- Public utility holding companies
- Retail competitive business segments of the public utility holding companies
- Service companies

The principal components of the Standards fall into four main categories:

- Non-Discrimination (Section 14:4-5.3)
- Information Disclosure (Section 14:4-5.4)
- Separation (Section 14:4-5.5)
- Utility Retail Competitive Business Segment Standards (Section 14:4-5.6)

These four components do not apply to the same types of transactions. For example, the standards set forth in Sections 14:4-5.3, 14:4-5.4, and 14:4-5.5 apply to transactions between the utility, on the one hand, and its public utility holding company or an RCBS of its public utility holding company that is offering or providing retail services to customers in New Jersey, on the other hand. These three components do not apply to transactions between a utility and an RCBS under its ownership, however. Conversely, the standards of Section 14:4-5.6 do apply to



transactions between a utility and its own RCBS. They do not apply to transactions between the utility and its public utility holding company or an RCBS of its public utility holding company. There is substantial overlap among the standards set forth in Sections 14:4-5.3, 14:4-5.4, and 14:4-5.5, however. Similarly, there is overlap among the standards set forth in Section 14:4-5.6.

The next chapters of this report separately address each of these four elements of the Standards.

D. Summary of Recommendations

The following is a summary of the recommendations made in this report.

- 1. Require the disclosure necessary to examine relationships and transactions that exist between either O&R and RECO, on the one hand, and all RCBS of CEI and CECONY as a common service supplier, on the other hand. (Page 11)**
- 2. Treat all CEI RCBSs as covered by the Standards if they have or offer to serve retail customers in New Jersey, whether or not in the RECO service territory.**
- 3. Verify that regular customer communications comport with the obligation not to provide a preference to an RCBS. (Page 11)**
- 4. Amend the RECO Compliance Plan to clearly prohibit tying activity to any RCBSs of O&R or CEI that serves in-state customers, whether or not in the RECO's New Jersey utility service territory. (Page 14)**
- 5. Include in the RECO website section "Shopping for Savings" a link to the BPU website. (Page 31)**
- 6. Verify that RECO's regular communications with customers do not make representations of the type prohibited by Sections 14:4-5.3(n). (Page 31)**
- 7. Revise Company policy to permit access to affiliate books and records as necessary to verify compliance with the Standards. (Page 50)**
- 8. Strengthen IT security policies and procedures to address the information exchange provisions of Section 14:4-5.5(e). (Page 52)**
- 9. Introduce a method by which indirect costs for joint purchases are properly assigned. (Page 57)**
- 10. Update the corporate accounting policies regarding the distribution of costs between companies and conform them to the Standards; develop a clear and consistent set of methods for implementing these policies. (Page 66)**
- 11. Improve existing procedures to strengthen control over the data collection, analysis and pricing calculation for shared services. (Page 70)**



12. Conduct an examination by Internal Audit to validate that data collection, analysis and pricing of shared services are done accurately and consistently. (Page 70)
13. Conduct an examination of all shared administrative services costs for the years 2001 and 2002 to determine the extent of errors similar to those uncovered during transaction testing, make necessary corrections, and validate the accuracy and completeness of administrative services costs. (Page 70)
14. Develop and institute an A&G loader to be included in standard rates used for direct charges to non-regulated affiliates and CEI. (Page 71)
15. Provide for a systematic review of unrecorded usage of CECONY shared administrative services by the non-regulated affiliates. (Page 71)
16. Reconcile the standard rate to actual costs for shared services directly charged to unregulated affiliates and CEI. (Page 73)
17. Reposition the duties of individuals who serve as a Director and/or an Officer for both a utility and a related competitive business segment of the utility's holding company so that RECO and O&R are in compliance with the standard. (Page 85)
18. Revise the Compliance Plan to incorporate the requirements of Section 14:4-5.5(u)(2) with regard to the transfer of assets from a PUHC RCBS to the utility. (Page 91)
19. Make training in the O&R Standards of Competitive Conduct mandatory for all new employees. (Page 94)
20. Include routinely scheduled, mandatory refresher training that is appropriate to the nature and extent of employee involvement in activities affected by the Standards. (Page 94)
21. Confirm the permanent implementation of the proposals related to employee understanding of information disclosure rules as set forth in the February 28, 2002 letter to the Board in the compliance plan. (Page 94)

E. Project Scope

This audit examined the competitive service offerings of Rockland Electric Company and related competitive business segments for compliance with:

- The Electric Discount and Energy Competition Act (“the Act” or “EDECA”)
- The Board’s Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements.

More specifically, this audit addressed:



- Validating the existence of strict separation and allocation of utility versus competitive business segment(s) revenues, costs, assets, risks, and functions
- Identifying any cross subsidization by the utility segment of the competitive business segment(s)
- Assuring that the separation of the utility and non-utility organizations or units is in accord with affiliate and fair competition standards
- Determining any impact on utility customers from the provision of non-safety related competitive services
- Identifying any effects on utility workers
- Assessing the effects of utility practices on the market for such services
- Ensuring compliance with the Act
- Reviewing implementation of Board-accepted recommendations from the last round of similar audits
- Examining the validity of the recommendations that the Board deferred in its order of February 8, 2002
- Determining whether any additional services offered constitute competitive services as defined by the Act.
- Quantifying any amounts that may have been unfairly allocated to the competitive business segment(s)
- Verifying that management fees charged by or allocated from the parent and affiliates to the utility are appropriate
- Verifying the assignment of at least fully allocated costs to Appliance Service fees or charges(for those utilities with an appliance service business).

The audit scope included the following RFP-listed subject areas, whose review and examination provided a comprehensive basis for drawing conclusions and formulating any appropriate recommendations in the areas of focus listed above:

- Corporate Planning
- Executive Management
- Organizational Structure
- Communication and Control
- Cost Allocation Methods
- Centralized services
- Transfers and uses of utility assets, property, or plant by competitive business segment(s)
- Personnel assignments and loans
- Employee sharing
- Employee training
- Use of subcontractors
- Inter-/Intra-company billings
- Program-related revenues and expenses (direct and indirect)
- Compensation (including all applicable loadings)
- Record-keeping
- Support services
- Marketing



F. RECO Affiliates

1. Background¹

Rockland Electric Company (“RECO” or “Rockland”), a New Jersey corporation, is the electric-utility subsidiary of Orange and Rockland Utilities, Inc. (“O&R”) that the Board regulates. O&R also owns Pike County Light & Power Company, which provides electric service in a small section of Pennsylvania, but its primary service territory is in southeastern New York State. O&R is a subsidiary of Consolidated Edison, Inc. (“Con Edison” or “Con Ed” or “CEI”), which is a holding company under the federal Public Utility Holding Company Act of 1935, but it is exempt from all provisions of the act except one subsection.²

The holding company, CEI, operates through its subsidiaries. Its principal assets consist of its ownership interest in its subsidiaries. The largest subsidiary, Consolidated Edison Company of New York, Inc. (“Con Edison of New York” or “CECONY”) is a combination electric, natural gas, and steam utility that serves New York City and most of Westchester County. CEI’s next largest subsidiary is O&R.

RECO is the legal entity that is the regulated utility, but has no employees of its own. In a practical sense, RECO represents a utility service territory in which O&R employees carry out the functions it takes to provide customers with electric utility service. RECO’s direct parent, O&R has been owned by CEI since July 1999. CEI owns the much larger utility subsidiary, CECONY, and a number of active non-utility related subsidiaries, which this report describes below. O&R provides most of the resources that relate directly to utility functions in the RECO service territory. CECONY also contributes significantly in supporting those activities through a number of services it provides. Many of these services are similar to those that dedicated utility service companies generally provide and that the service companies for the other three New Jersey electric companies do in fact offer.

The use of O&R as the principal provider for resources that perform RECO’s utility management and operations functions makes its employees much more likely than those of the typical holding company to have the direct relationships with the marketplace that the Standards address. The particular structure of CEI also makes the O&R/CECONY/CEI relationship the one that best fits, from a practical and operating sense, the utility/service company/holding company model that the Standards address. RECO’s lack of employees makes its direct relationships largely irrelevant to examine in validating Standards compliance in this case. The CEI structure assures that RECO employees have minimal or no direct relationships or contacts with any non-utility related CEI subsidiary or with CECONY. However, this fact does not mean that there were no relationships or contacts of consequence under the Standards during the audit period.

Put simply, CECONY serves RECO as do the dedicated services companies of the other three New Jersey electric utilities. Moreover, O&R acts as an even broader scale service company, by providing all the non-service company employees that RECO uses to provide utility services. Therefore, if CECONY and O&R have contacts or relationships with holding company RCBSs,

¹ DRs #2, 4 through 9, 21, and 33.

² Con Edison’s 2001 Form 10-K.



then RECO does because those contacts or relationships are made on behalf of RECO. Otherwise, the Standards could be gutted by the creation of a series of shell companies. In addition, if any of the Con Edison companies have retail business activities in New Jersey outside of the traditional regulated business of RECO in RECO's service territory, then those businesses fall under the purview of EDECA and thence the Board and this audit. Liberty discusses these issues at greater length in this report.

CECONY's status relating to the service-company provisions of the standards also raises interesting questions under the Standards. The Standards talk about services from "separate business segments of the public utility holding company created solely to perform corporate support services." Unlike the case of service companies of the other three New Jersey electric utilities, services come from departments in the utility, CECONY, rather than from a service company that exists as a separate corporate entity. As an exempt holding company, CEI is not required to have a separate service company. CECONY, Con Edison, O&R, and the other subsidiaries provide services to each other using cost-allocation processes approved by the New York Public Service Commission. These cost-allocation processes formed the basis for the estimated merger synergy savings that the Board relied upon in approving the merger. RECO filed its cost allocation procedures with the Board in compliance with the Board's directive in its Order dated April 1, 1999 in Docket No. EM98070433 (Merger Proceeding). As the largest CEI subsidiary by far, CECONY uses a number of its departments collectively to fulfill functions similar to those of a service company for the other CEI companies, including both utility and non-utility related entities.

Liberty interprets the Standards as supporting the rule that separate corporate departments of an affiliated utility meet this definition, provided those departments were created and are operated to provide services to multiple affiliated entities. The support services that CECONY provides out of these common work groups are substantial. CECONY provided services to its affiliates in total the amounts of \$40.3 million, \$21.1 million, and \$22.1 million in 2001, 2000, and 1999, respectively. Of these amounts \$13.6 million, \$10.8 million, and \$8.6 million were support provided to O&R's regulated operations (including RECO and Pike County Light & Power Company ("Pike")). CEI charged its affiliates \$14.1 million, \$11.4 million, and \$16 million in 2001, 2000, and 1999, respectively.³ The majority of these amounts comprised redistribution back to its subsidiaries of costs charged to the holding company for services received from its subsidiaries.⁴

In addition to its two major subsidiaries, the regulated utilities, Con Edison also has four unregulated subsidiaries:

- Consolidated Edison Solutions, Inc. ("Con Edison Solutions" or "Solutions") sells electricity and gas to delivery customers of utilities and energy-procurement and energy-management services. Solutions is licensed by the Board to provide retail gas and electric commodity services in New Jersey.⁵
- Con Edison Communications, LLC ("Con Edison Communications" or "Communications") is building and operating a fiber-optic network in New York City in

³ Con Edison's 2001 Form 10-K.

⁴ Work session October 31, 2002.

⁵ Letter from Con Edison to Liberty dated October 18, 2002.



order to provide telecommunications services. Con Edison Communication's net assets at the end of 2001 were \$72.8 million, which were principally comprised of fiber-optic cable and associated telecommunications equipment, mostly in the New York City area.

- Consolidated Edison Development, Inc. ("Con Edison Development" or "Development") owns and operates electric generating plants in the Northeast. In June 2000, Con Edison Development bought an 80 percent interest in a partnership that owns a 236 megawatts ("MW") electric-generating unit in Lakewood, New Jersey for \$98 million.⁶ The output of that unit is sold to Jersey Central Power & Light under a long-term contract.⁷ At the end of 2001, Con Edison Development owned interests in 406 MW of electricity-generating capacity, with another 741 MW under construction. It had total net assets of \$291 million.⁸
- Consolidated Edison Energy, Inc. ("Con Edison Energy" or "Energy") is an energy-supply company at the wholesale level, *i.e.*, to entities in the Northeast who then resell that electricity or natural gas, such as energy-service companies, other utilities, energy-trading companies, non-utility generators of electricity, municipalities, and cooperatives. Con Edison Energy sells the output from the plants owned by Con Edison Development and others, as well as to providers of natural gas and related services. Con Edison Energy also provides power marketing and fuel-management services for the plants owned by Con Edison Development and electricity and natural-gas supply-management services for Con Edison Solutions.

CEI's non-utility related subsidiary companies are substantial, but they represent only a small part of the operations of the combined entity. In 2001, the unregulated companies accounted for about 8 percent of the total operating revenues, 2 percent of the net income, and 5 percent of the total assets of Con Edison.⁹ Employee numbers provide another indicator of relative size. CEI, the holding company, has no employees. At the end of 2001, Con Edison of New York had 12,651 employees, O&R had 1,006 employees, and the unregulated companies had 296 employees.¹⁰ The non-utility related affiliates account for a small part of the payroll of the combined company.

CEI and CECONY bill O&R every month for the cost of services provided to O&R. RECO then receives its allocated share of those costs. As noted above, CECONY serves as the primary provider of these services, which are mostly for general and administrative activities like corporate governance, finance and accounting, investor relations, information resources, legal, human resources, and energy management services. The cost of these services was \$10.7 million for 2000 and \$14.4 million for 2001.¹¹

O&R also provides services to CECONY. These services include processing of customer bill payments, testing rubber goods used by transmission and distribution personnel, and some

⁶ Con Edison's 2001 Form 10-K.

⁷ Letter from Con Edison to Liberty dated October 18, 2002.

⁸ Con Edison's 2001 Form 10-K.

⁹ Con Edison's 2001 Form 10-K.

¹⁰ Con Edison's 2001 Form 10-K.

¹¹ Con Edison's 2001 Form 10-K.



general and administrative activities. O&R charged CECONY \$8.3 and \$10.9.3 million for these services in 2000 and 2001, respectively.¹²

In addition to RECO and Pike County Light & Power Company, O&R owns subsidiaries named Clove Development and O&R Development. Rockland also has a number of subsidiaries, which include:

- Enserve Holdings, Inc.
 - Compass Resources, Inc. (inactive)
 - Palisades Energy Services, Inc. (inactive)
- Saddle River Holdings Corp.
 - Norstar Holdings, Inc.
 - Norstar Management, Inc.
 - Millbrook Holdings, Inc.
 - Norstar Energy Limited Partnership
 - Norstar Energy Pipeline Company, LLC

In its comments to the draft report for this audit, RECO represented that all of the other bulleted entities are inactive as of the present time as well. O&R's and RECO's non-utility subsidiaries are either inactive or are passive real-estate companies.¹³ CEI began dissolving O&R's and RECO's unregulated subsidiaries and dismissing their employees after its acquisition of these enterprises.¹⁴

Liberty asked RECO for the strategic and operational plans (or equivalent documents) for every regulated utility and unregulated affiliate of the parent/holding company. Liberty's purpose was to develop a more complete understanding of the traditional regulated and unregulated businesses of utility holding companies by reading the business plans of those companies. RECO's ultimate response to this request was the following:

*This discovery request is not applicable to RECO, since neither RECO nor its affiliates provide competitive services in RECO's service territory.*¹⁵

After some discussion between Liberty and Con Edison, Liberty was provided with several pages of documents summarizing the contents of the business plans. These summaries provided little in the way of specific information. To supplement these summaries, Con Edison arranged for Liberty to conduct telephone interviews with representatives of Con Edison Solutions, Con Edison Communications, Con Edison Development, and Con Edison Energy. To follow up on the telephone interview with the representative of Con Edison Solutions, Liberty asked for information about any customers in New Jersey in 2001 and 2002.¹⁶ Liberty's analysis of the information provided showed the following about Con Edison Solutions' activities in New Jersey:

¹² Con Edison's 2001 Form 10-K.

¹³ Consolidated Edison, Inc. and Northeast Utilities, Application/Declaration on Form U-1 under the Public Utility Holding Company Act of 1935, January 19, 2000.

¹⁴ DR #26.

¹⁵ DR #23.

¹⁶ DR #112.



- Con Edison Solutions had no customers for electricity in either year.
- Con Edison Solutions had three customers for energy services in the last two years whose payments to the company totaled \$1.3 million.
- In 2001 Con Edison Solutions had about 50 customers for natural gas, one of which was in New Jersey Natural Gas's territory, with the bulk being in PSE&G's territory. The company's total revenues from those customers were roughly \$524,000.
- In 2002 the number of gas customers fell to 11, all in PSE&G's territory. Revenues through October were about \$140,000. Only one invoice was rendered after August.

Solutions has a small number of retail customers in New Jersey, although that number fell during the audit period. None of these customers reside in the service territory of RECO. Communications also serves customers at retail in New Jersey. Communications has six New Jersey customers, in the sense that those customers' principal operations are in New York City. Communications provides a total of 12 circuits in New Jersey for 6 customers, and with one exception those circuits originate in New York and terminate in New Jersey, and retail customers use 10 of those 12 circuits. Communications also has five wholesale customers who reside in New Jersey. The customers are other telecommunications carriers who sell their services to retail customers.¹⁷

Energy and Development have no New Jersey retail customers; they operate at the wholesale level, selling to entities who in turn then resell to others what they buy from Energy and Development.

Absent complete disclosure by Con Edison of the business plans of its non-utility subsidiaries, however, Liberty is unable to form a firm conclusion that the CEI RCBSs have no relationships with O&R, and hence RECO, or activities in New Jersey, beyond that which Liberty describes in this report.

Liberty's audit of RECO was hampered by the company's initial position about what constituted proper limits on audit inquiries. RECO's responses to Liberty's first set of requests for documents drew two important distinctions that RECO apparently interpreted as meaning that the EDECA Standards did not apply to it.

RECO distinguished RECO and O&R, on the one hand, and CECONY and CEI and its subsidiaries, on the other hand, for purposes of the Standards, *e.g.*:

*... RECO would note that there have been no asset transfers, asset leases, asset rental, employee transfers, employees loaned, shared employees, and goods and services provided between Orange and Rockland/RECO and Solutions, Energy, or Development, respectively.*¹⁸

Furthermore, RECO would note that no costs were charged, assigned, or allocated between Orange and Rockland/RECO and either Consolidated Edison Solutions, Inc.

¹⁷ DR #111.

¹⁸ DR #26.



(“Solutions”), Consolidated Edison Development, Inc. (“Development”), or Consolidated Edison Energy, Inc. (“Energy”), respectively.¹⁹

These responses stated narrowly that there were no such activities or incurring of costs between O&R, RECO and any of CEI’s unregulated affiliates. Liberty does not believe that the Standards should be considered so limiting in this area or that the Board intended such limitations to apply to an audit of service company costs.

Another distinction that RECO drew (and that Liberty finds unsupported in the Standards) was that competitive products and services are only relevant if an RCBS of the holding company, CEI, has customers for such products and services in RECO’s service territory. The following response to a document request exemplifies this REC limitation:

This discovery request is not applicable to RECO, since neither RECO nor its affiliates provide competitive services in RECO’s service territory.²⁰

Liberty’s reading of EDECA and the regulations that the Board issued to implement the law is that the law applies to activities in the entire State of New Jersey, not just a utility’s service territory.

2. Conclusions

- a. Liberty believes that RECO’s that it or its direct holding company (O&R) must have an RCBS operating in its service territory in order to be subject to the requirements of the Standards is not supported by the applicable language.**

The wording of the Standards best supports the conclusion that an RCBS need only be providing or offering to provide goods or services anywhere within the State; there is no support for the contention that an RCBS must be doing so in the service territory of the utility. The intent of the regulations, as well as their express provisions, make it clear that a utility should not subsidize its affiliates to the detriment of competitors operating anywhere in the state of New Jersey.

It is also not proper to view the standards as applying only to the direct parent of a utility, like RECO, whose holding company (O&R) is in turn owned by another holding company. Otherwise, any company could avoid the regulations merely by creating two successive parent or holding company levels. A proper interpretation of the standards is that CEI, which is the parent of O&R, should also be considered to be RECO’s public utility holding company.

- b. O&R has no retail competitive business segments in New Jersey.**
- c. CEI has affiliates who provide products or services to end users in New Jersey, thus making them retail competitive business segments of RECO.**

¹⁹ DR #2.

²⁰ DR #2.



- d. **CECONY operates in the manner of a service company for RECO's regulated electric operations in New Jersey and for retail competitive business segments, thus making the propriety of its cost charges, assignments, and allocations a proper matter for Board scrutiny.**

4. Recommendations

1. **Require the disclosure necessary to examine relationships and transactions that exist between either O&R and RECO, on the one hand, and all RCBS of CEI and CECONY as a common service supplier, on the other hand.**
2. **Treat all CEI RCBSs as covered by the Standards if they have or offer to serve retail customers in New Jersey, whether or not in the RECO service territory.**



II. Non-Discrimination Standards (14:4-5.3)

Section 14:4-5.3 of the Standards applies to interactions between a utility and an RCBS of its holding company or the holding company itself if it offers or provides competitive services to retail customers in New Jersey. These standards do not, however, apply in cases where an internal RCBS exists within the utility itself and where there are transactions between the utility and such an RCBS. Separate standards, which are addressed in Chapter V of this report, apply to interactions between utilities and their internal RCBSs.

A. Affiliate Preferences

1. Statement of Applicable Requirements

Section 14:4-5.3(a) of the Standards provides that:

An electric and/or gas public utility shall not unreasonably discriminate against any competitor in favor of its affiliates(s) or related competitive business segment:

1. *An electric or gas public utility shall not represent that, as a result of the relationship with the electric and or gas public utility or for any other reason, a related competitive business segment of its public utility holding company, or customers of a related competitive business segment of its public utility holding company will receive any different treatment by the electric and/or gas public utility than the treatment the electric and/or gas public utility provides to other, unaffiliated companies or their customers; and*
2. *An electric or gas public utility shall not provide a related competitive business segment of its public utility holding company, or customers of a related competitive business segment of its public utility holding company, any preference (including, but not limited to, terms and conditions, pricing, or timing) over non-affiliated suppliers of their customers in the provision of products and/or services offered by the electric and/or gas public utility.*

2. Summary of Audit Activities

This standard set forth in Section 5.3(a) and many of the standards that follow it address the issue of discrimination. Those that follow tend to apply to specifically designated cases (see for example the requirements of Section 5.3(c) which are discussed several sections later in this report), while this subsection (a) sets forth two, more general rules. Specifically, this subsection of the Standards prohibits two specific forms of favoritism to affiliates:

- Making representations that any RCBS of its holding company or that any customers of such an RCBS will be treated differently by the utility



- Providing preferences to any RCBS of its holding company or the customers of such an RCBS with respect to terms, conditions, pricing, timing, or other aspects of utility services.

Liberty's examination of discrimination under its work addressing this subsection included the application of the following criteria:

- Whether the general paths used for regular customer communications make any direct or implied representations that selection of an RCBS would bring advantage to the customer in terms of utility service
- Whether the utility web-site makes any direct or implied representations that selection of an RCBS would bring advantage to the customer in terms of utility service
- Whether the utility compliance plan adequately addresses the requirements of this subsection
- Whether there is adequate employee training to support knowledgeable application of the requirements of this subsection.

Liberty identified what regular communications channels the utility used to communicate with customers during the audit period, and then gathered documents displaying the substance of those communications in order to examine them for evidence of prohibited discrimination. Liberty also reviewed the compliance plan to determine what standards of conduct it imposed with respect to employee representations to customers. Liberty examined the websites of the holding company and utility.

3. Findings

Liberty asked for details about customer information provided to unregulated affiliates of the parent/holding company or to unregulated business units within the utility.²¹ RECO responded by stating that Orange & Rockland/RECO has not provided customer information to Solutions, Development or Energy.²²

Liberty requested copies of RECO's communications with customers, specifically bill inserts and Energy Choice inquiries. RECO responded²³ that a customer requesting energy choice information gets a New Jersey Energy Choice Shopping Guide booklet explaining how to shop for a new supplier and a list of suppliers. The list includes each supplier's telephone number, web address, and customer types served. RECO also provides such customers with a report of their electric energy usage for the past 24 months to aid in estimating savings. RECO also provides information to aid other suppliers in load scheduling for the customer's account.

Regarding bill inserts, RECO initially responded that Liberty's request for them was not applicable because neither RECO nor its affiliates provide competitive services in RECO's service territory.²⁴ RECO also stated that it did not use any bill inserts relating to the competitive

²¹ DRs #46 and 52.

²² DR #46.

²³ DR #109.

²⁴ DR \$48.



services offered by Solutions, Energy, or Development.²⁵ RECO forwarded bill inserts and Energy Choice materials used during the audit period after the close of audit field work.²⁶

RECO's Compliance Plan, which the Company intends to be taken together with the Revised O&R Standards of Competitive Conduct and the Affiliate Relations Conditions, contains clear prohibitions against representing or providing preferential treatment to affiliates or customers of affiliates.²⁷ RECO's responses to data requests contain clear statements that there have been no transactions between RECO and unregulated affiliated companies.

RECO's website, www.oru.com, makes no reference to any unregulated affiliates. Visitors to the website can access information on CEI, which does have limited RCBS operations in New Jersey, by hitting a tab under "Orange and Rockland Utilities (ORU) – About ORU."

4. Conclusions

- a. RECO's Compliance Plan contains clear and sufficient prohibitions against representing or providing preferential treatment to affiliates or customers of its affiliates.**
- b. The RECO web site does not create any inappropriate suggestion or implication of preference.**
- c. Given RECO's failure to provide copies of its standard communications with customers in time for consideration in the audit, Liberty could not determine whether they violated the requirements of this provision.**

The clearest potential for harm from violating this provision comes in cases where a holding company RCBS operates in the service territory of the utility. The reason is that utility services generally extend only to the limits of its service territory. However, many customers have operations both inside and outside the service territory. While not necessarily likely, it may be that a RECO customer with a location inside and a location outside the territory (but within New Jersey) could be induced to take products or services from an RCBS at the outside location, in order to receive preferential treatment at its inside location. In such an instance, the harm generated is among those covered by this provision and it is the same as would occur if both customer locations were in the service territory.

The RCBSs of CEI have limited operations in New Jersey, which makes it very unlikely that such harm is now occurring.

5. Recommendations

- 3. Verify that regular customer communications comport with the obligation not to provide a preference to an RCBS.**

²⁵ DR #48.

²⁶ Supplemental Response to DR #48,.

²⁷ DR #8, Rockland Electric Company Compliance Plan, dated June 15, 2002, pp. 4-6.



RECO provided the necessary information to do so only after Liberty completed its draft report; Liberty therefore was unable to examine it before completion of the final audit report.

B. Prohibited Transactions

1. Statement of Applicable Requirements

Section 14:4-5.3(b) of the Standards provides that:

Transactions between an electric and/or gas public utility and a related competitive business segment of its public utility holding company shall be prohibited, except for the following...

Subsection (b) then goes on to list the following exceptions to the prohibition on transactions:

- Tariffed products or services
- Sales and purchases made generally available to all market participants through open and competitive bidding
- Joint purchases allowed by Sections 14:4-5.5(g) and (h)
- Corporate support allowed by Sections 14:4-5.5(i) and (j)
- Competitive products or services offered by an RCBS within the utility, as allowed by Sections 14:4-5.6(a) through (f).

2. Summary of Audit Activities

The effect of this section is to prohibit a utility and an RCBS of its holding company from engaging in any form of transaction not specifically authorized by the Standards. The first, second, and fifth exceptions have in common the fact that transactions generally available to all comers, whether affiliated or not, are acceptable to the extent that they are governed by standard or uniform prices, terms, and conditions. The third and fourth exceptions recognize the right to use internal economies of scale or scope to provide an affiliate with services that are not made available to outsiders. Liberty's examination of this standard focused on whether non-tariffed transactions (except for permitted common services for purchasing and corporate support) were made available to all market participants. Pricing questions were not examined here, but under Sections 5.3(f) through (i), which cover discounts, charge waivers, and strict tariff enforcement in transactions between the utility and a holding company RCBS. Therefore, the criterion that Liberty applied here was:

- Whether the utility made available to a holding company RCBS opportunities to purchase or sell goods or services (apart from the allowed common purchasing and support service) not also made available to other market participants.

Liberty's audit included efforts to identify the flow of goods and services between the utility and its affiliates. Liberty examined the transaction information provided by the utility for compliance with this criterion. Liberty supplemented these efforts by questioning the utility as to its involvement in any audit period transactions other than those allowed.



3. Findings

As an initial matter, Liberty asked O&R/RECO if, during the audit period, it had been involved in any transactions other than those allowed by Section 14:4-5.3 (b) of the Standards. O&R stated that there have been no transactions between O&R and any of CEI's unregulated affiliates, and that the only transactions with CECONY were those approved under the Shared Services agreement.²⁸

O&R has stated that no costs were charged, assigned, or allocated between O&R/RECO and either Solutions, Development or Energy, respectively.²⁹ O&R further clarified during a work session that O&R/RECO also had no transactions with Communications.³⁰ The Company also stated that there were no purchases of tariffed products and services by a non-regulated affiliate.³¹

Liberty undertook a program to test affiliate transactions; that testing disclosed no prohibited transactions.

4. Conclusions

- a. Liberty found no evidence of prohibited transactions with any RCBS of CEI during the audit period.**

5. Recommendations

Liberty has no separate recommendations regarding the requirements of this standard.

C. Access to Information and Services

1. Statement of Applicable Requirements

Section 14:4-5.3(c) of the Standards provides that:

An electric and/or gas public utility shall provide access to utility information, services, and unused capacity or supply on a non-discriminatory basis to all market participants, including affiliated and non-affiliated companies...

Listed exceptions are for:

- Joint purchases (Section 14:4-5.5)
- Corporate support (Section 14:4-5.5)
- Competitive products or services offered by an RCBS within the utility, as allowed by Sections 14:4-5.6.

²⁸ DR #157.

²⁹ DR #2.

³⁰ Work session December 11, 2002.

³¹ DR #79.



2. Summary of Audit Activities

This section's anti-discrimination provisions generally are the same as those set forth in Section 14:4-5.3(a). What makes it particularly different is the imposition of the following requirement regarding public posting of offerings made by the utility:

1. If an electric and/or gas public utility provides supply, capacity, services, or information to a related competitive business segment of its public utility holding company, it shall make the offering available, via a public posting, on a non-discriminatory basis to non-affiliated market participants, which include competitors serving the same market as the related competitive business segment of the electric and/or gas public utility's holding company.

This standard also, unlike the one set forth in preceding subsection (a), introduces the concept of utility provision of "information" as a possible source of preference or discrimination. This audit's examination of utility performance in making information available is addressed in other sections of this report, e.g., 5.3(m), 5.4(a), 5.4(b), 5.4(d), 5.4(e), 5.5(e), 5.5(j), 5.5(s), which address the sharing of information among affiliates.

Given the relationship of this subsection with others and the related audit work described under the portions of this report that address those other subsections, the criterion applied by Liberty here was:

- Whether the utility made a public posting of all offerings (if any) made available to a holding company RCBS.

3. Findings

Liberty requested information regarding transactions between the utility and an unregulated affiliate of the utility holding company for the sale or purchase of goods, property, products or services to assure that such offers were open to all market participants through an open, competitive bidding process. Liberty asked for copies of any public postings made during the audit period. RECO responded that it had no such transactions with any other affiliate of the holding company, which meant that there were no transactions requiring public posting.³²

Representatives of the CEI non-utility companies told Liberty that none of them had any dealings with RECO or O&R during the audit period.³³ Therefore, no posting obligations arose. The CEI non-regulated companies reportedly had no customers in RECO's service territory during the audit period.³⁴ Liberty has therefore concluded that no RECO customer information was used for CEI non-utility customers, since O&R provided no services and had no occasion for otherwise dealing with non-regulated customers.

³² DRs #104 and 105.

³³ Telephone interviews with representatives of CEI non-regulated companies, October 31, 2002.

³⁴ Telephone interviews with representatives of CEI non-regulated companies, October 31, 2002.



4. Conclusions

- a. During the audit period, RECO engaged in no activity to which the requirements of Standards Section 14:4-5.3 (c) would apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

D. Short-Term Sales of Surplus Energy or Capacity

1. Statement of Applicable Requirements

Section 14:4-5.3(d) of the Standards provides that:

An electric and/or gas public utility selling or making an offer to sell surplus energy, kWh and/or Dth, respectively, and/or capacity, kW or therms, respectively, on a short term basis to its PUHC or a related competitive business segment of its public utility holding company, shall make the offering available on a non-discriminatory basis to non-affiliated electric or gas marketers, via a public posting.

2. Summary of Audit Activities

These provisions require that if the utility offers to sell surplus energy or capacity to its PUHC or an RCBS of its PUHC on a short term basis (transactions of 31 days or less), the utility must make the offering available to non-affiliated companies via a public posting. Because the requirements for short- and long-term sales are similar, Liberty examined both types through the same audit activities.

Liberty first sought information from the utility about its selling of excess energy and capacity on both a short-term and long-term basis. Liberty asked for information about the acquisition and disposition of power and capacity, including summaries of any power contracts and a breakdown of customers using basic generation service and third party suppliers. Liberty also reviewed the utility compliance plan, specifically any portions dealing with surplus energy and capacity.

Liberty applied the following criteria in its evaluation of performance under this standard:

- Whether the utility's compliance plan adequately addresses the requirements applicable to offerings made to an RCBS
- Whether the utility made a public posting of all offerings (if any) made available to a holding company RCBS



3. Findings

During the audit period, neither RECO nor O&R owned generation. O&R completed the divestiture of its generation in June 1999.³⁵ Prior to March 2002, RECO was an all-requirements customer of O&R pursuant to a FERC-approved Power Supply Agreement.³⁶ To fulfill its role as provider of last resort, O&R, on behalf of itself, RECO and Pike, contracts with third party suppliers of energy and capacity. RECO's Compliance Plan noted that, to the extent that the O&R system has surplus energy and/or capacity, O&R planned to sell it to third parties through the New York Independent System Operator ("NYISO").³⁷ Effective March 1, 2002, RECO transferred operations control of its Eastern Division (approximately 90 percent of its total load) from the NYISO to the PJM Interconnection, LLC. The FERC-approved Power Supply Agreement was modified to allow RECO to purchase energy and capacity on its own behalf for its Eastern Division.

The Electric Supply Department of CECONY served as the purchasing agent for O&R. In that capacity, CECONY purchased capacity, energy, and ancillary services solely from unaffiliated parties. Since all generation was purchased for O&R and its affiliates, there were no net shortfalls or excess to be managed.³⁸

4. Conclusions

- a. RECO represented that any excess supply or capacity has not nor was it allowed to be sold to affiliates**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

E. Long-Term Sales of Surplus Energy or Capacity

1. Statement of Applicable Requirements

Section 14:4-5.3(e) of the Standards provides that:

An electric and/or gas public utility selling or making an offer to sell surplus energy, kWh, and/or Dth, respectively, and/or capacity, kW or therms, respectively, on a long term basis to its PUHC or a related competitive business segment of its public utility holding company, shall make the offering available on a non-discriminatory basis to non-affiliated electric or gas marketers, via a public posting.

³⁵ DR #8.

³⁶ DR #96.

³⁷ Rockland Electric Company Compliance Plan, dated June 15, 2002.

³⁸ DR #96.



2. Summary of Audit Activities

These provisions require that if the utility offers to sell surplus energy or capacity to its PUHC or an RCBS of its PUHC on a long term basis (transactions of greater than 31 days), the utility must make the offering available to non-affiliated companies via a public posting.

Liberty's audit activities were the same as those set forth for Section 14:4-5.3(d).

3. Findings

Liberty's findings are the same as those set forth for Sections 14:4-5.3(d).

4. Conclusions

Liberty's conclusions are the same as those set forth for Sections 14:4-5.3(d).

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

F. Discounts or Waivers of Fees or Charges

1. Statement of Applicable Requirements

Section 14:4-5.3(f) of the Standards provides that:

Except when made generally available by an electric and/or gas public utility through an open, competitive bidding process, an electric and/or gas public utility shall not offer a discount or waive all or part of any other charge or fee to a related competitive business segment of its public utility holding company, PUHC, or offer a discount or waiver for a transaction in which a related competitive business segment of its public utility holding company is involved unless the electric and/or gas public utility shall make such discount or waiver available on a non-discriminatory basis to other market participants.

1. An electric and/or gas public utility shall not give its PUHC or a related competitive business segment of its public utility holding company involved in energy supply or marketing a preference with respect to tariff provisions that provide for discretionary waivers of fees, penalties, etc., unless offered to all others on a non-discriminatory basis.

2. Summary of Audit Activities

This section prohibits a utility from offering a discount or waiver of any charge to or for the benefit of an RCBS of its holding company, unless the same concessions are made to non-affiliates.



Liberty first sought to determine those instances during the audit period when the utility may have offered a discount or waiver to an RCBS. In the event that there were any, Liberty then intended to determine whether the utility made the same concessions available to non-affiliates through an open process.

As a first step, Liberty formally asked whether the utility provided any discounts, waivers, etc. to its holding company or to an RCBS of its holding company during the audit period from January 2001 through June 2002.

During interviews and document reviews addressing transactions among affiliates, Liberty also obtained substantial information about transactions between the utility and its affiliates. Liberty examined that information for evidence of any discount, waiver, rebate, etc. to an affiliate. In the event that any discounts or waivers were found, Liberty then intended to examine whether they were similarly offered to non-affiliates.

The criteria that Liberty applied in examining performance under this standard were:

- Whether the utility compliance plan adequately addresses its obligations under this standard
- Whether, in the event that there were any covered transactions, similar offerings were made to non-affiliates.

3. Findings

O&R has stated that no costs were charged, assigned, or allocated between O&R/RECO and either Solutions, Development or Energy, respectively.³⁹ O&R further clarified during a work session that O&R/RECO had no transactions with Communications.⁴⁰ The Company also stated that O&R/RECO did not provide any discounts or waivers.⁴¹

4. Conclusions

- a. Liberty found no evidence that RECO offered a discount or waiver to any RCBS of CEI during the audit period.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

G. Documentation of Discount Bases

1. Statement of Applicable Requirements

Section 14:4-5.3(g) of the Standards provides that:

³⁹ DR #2.

⁴⁰ Work session December 11, 2002.

⁴¹ DR #72.



An electric and/or gas public utility shall document the cost differential underlying the discount to its PUHC or a related competitive business segment of its public utility holding company in the Affiliate Discount Report described in (o) through (q) below.

2. Summary of Audit Activities

This section requires the utility to document the basis for any discount offered to the holding company or an RCBS of its holding company. Liberty first sought to determine those instances during the audit period when the utility may have offered a discount or waiver to its holding company or to an RCBS of a holding company. In the event that there were any, Liberty then intended to determine whether the company properly documented the basis for any discount offered to the RCBS.

3. Findings

As discussed immediately above in connection with Section 14:4-5.3(f), Liberty found no evidence that RECO offered discounts or waivers to any RCBSs of O&R or CEI. Therefore, documentation of such discounts was not required.

4. Conclusions

- a. RECO offered no discounts or waivers requiring documentation under Section 14:54-5.3(g).**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

H. Non-Discriminatory Tariff Enforcement

1. Statement of Applicable Requirements

Section 14:4-5.3(h) of the Standards provides that:

An electric and/or gas public utility shall apply tariff provision(s) on a non-discriminatory basis to its PUHC or related competitive business segments of its public utility holding company and to other market participants and their respective customers if the tariff provision allows for discretion in its application.

2. Summary of Audit Activities

These provisions prohibit a public utility from discriminating in favor of its holding company or an RCBS of its holding company in the following two ways:

- Failing to enforce tariff requirements fully



- Giving an affiliate relatively greater benefit where a tariff may allow the exercise of latitude.

As a threshold matter, Liberty sought to determine the full extent of tariff services provided by the utility to affiliates during the audit period. Liberty would use this information to determine whether the utility had engaged in any activity covered by the requirements imposed by this section of the Standards. Liberty would then identify and carry out any test activities considered appropriate in testing compliance with those requirements.

Liberty applied the following criteria in evaluating utility performance in areas related to this provision of the standards:

- Whether the utility compliance plan adequately addresses its obligations under this standard
- Whether, in the event that there were any covered transactions, similar offerings were made to non-affiliates.

3. Findings

RECO stated that it did not provide any tariffed services to any affiliate during the audit period.⁴² This response is consistent with the lack of operation by any affiliates of CEI in RECO's New Jersey service territory.

4. Conclusions

- RECO engaged in no activity to which the requirements of Section 14:4-5.3(h) would apply during the audit.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

I. Strict Tariff Enforcement

1. Statement of Applicable Requirements

Section 14:4-5.3(i) of the Standards provides that:

An electric and/or gas public utility shall strictly enforce a tariff provision if the tariff provision does not allow discretion in its application.

2. Summary of Audit Activities

This provision corresponds to the previous standard set forth in Section 14:4-5.3(h). The difference is that the previous standard applies to enforcement of tariff provisions that allow the

⁴² DR #79.



utility to exercise discretion, while this one applies to the enforcement of tariff provisions whose implementation does not allow utility discretion. Given the similarity in requirements, Liberty's audit activities and evaluation criteria were the same as those set forth for Section 14:4-5.3(h).

3. Findings

Liberty's findings are the same as those set forth for Sections 14:4-5.3(h).

4. Conclusions

Liberty's conclusions are the same as those set forth for Sections 14:4-5.3(h).

5. Recommendations

Liberty's recommendations are the same as those set forth for Sections 14:4-5.3(h).

J. Processing Affiliate Service Requests

1. Statement of Applicable Requirements

Section 14:4-5.3(j) of the Standards provides that:

An electric and/or gas public utility shall process all requests for similar services provided by the electric and/or gas public utility on a non-discriminatory basis for its PUHC or a related competitive business segment of its public utility holding company and for all other market participants and their respective customers.

2. Summary of Audit Activities

These provisions prohibit a public utility from discriminating in favor of its holding company by giving affiliates faster, cheaper, or technically superior service when they request new service, changes in existing service, or eliminations of current service. As a threshold matter, Liberty sought to identify all service requests from affiliates during the audit period. Liberty would use this information to determine whether the utility engaged in any activity covered by the requirements imposed by this section of the Standards. Liberty would then identify and carry out any test activities considered appropriate in determining compliance with those requirements.

The criteria that Liberty applied in examining utility performance under this standard were:

- Whether the utility compliance plan adequately addresses its obligations under this section of the standards
- Whether there is any evidence that the utility offered its holding company or any holding company RCBS a preference in responding to service requests.



3. Findings

RECO stated that it did not receive any service requests from any affiliate during the audit period.⁴³ This response is consistent with the lack of operation by any affiliates of CEI in RECO's New Jersey service territory.

4. Conclusions

- a. RECO engaged in no activity to which the requirements of Section 14:4-5.3(j) would apply during the audit period.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

K. Tying Arrangements

1. Statement of Applicable Requirements

Section 14:4-5.3(k) of the Standards provides that:

An electric and/or gas public utility shall not condition or otherwise tie the provision of any products and/or services provided by the electric and/or gas public utility, nor the availability of discounts of rates or other charges or fees, rebates, or waivers of terms and conditions of any products and/or services provided by the electric and/or gas public utility to the taking of any products and/or services from its PUHC or a related competitive business segment of its public utility holding company.

2. Summary of Audit Activities

This section prohibits the utility from tying the provision of goods and/or services, discounts, rebates or waivers to the taking of products and/or services from its PUHC RCBS. The criteria that Liberty employed in examining utility performance with respect to this standard were:

- Regular customer communications should not directly or indirectly indicate that the availability of or the conditions associated with taking any utility service have any connection to the taking of service from an affiliate.
- The utility compliance plan should offer employees explicit instructions with respect to avoiding direct or implied statements that tying is necessary for securing utility services or advantageous with respect to the terms and conditions applicable to utility service.

Liberty reviewed utility customer communications, including information provided to customers inquiring about Energy Choice, utility bill inserts, advertising, and the Company website for any representation or implication with respect to tying the taking of goods or services from a PUHC

⁴³ DR #80.



RCBS to the provision of utility services. Liberty also reviewed the utility's compliance plan to ensure that the action of tying utility products and/or services to the taking of products and/or services from an affiliate is specifically prohibited.

3. Findings

The RECO Compliance Plan addresses the tying of products or services provided by a utility. RECO specifically states that it does not tie the provision of any products and/or services provided by RECO, or the availability of discounts or waivers, to the taking of any products or services from RECO and/or O&R or a subsidiary of RECO and/or O&R.⁴⁴ General Principle (ii) of the Revised O&R Standards of Competitive Conduct states in part:⁴⁵

The Delivery Company [Rockland] will not provide services to its marketing affiliates or customers of its marketing affiliates on preferential terms, nor represent that such terms are available, exclusively to customers who purchase goods or services from, or sell goods or services to, an affiliate of the Delivery Company. The Delivery Company will not purchase goods or services on preferential terms offered only to suppliers who purchase goods or services from, or sell goods or services to an affiliate of the Delivery Company. The Delivery Company will not represent to any customer, supplier, or third party that an advantage may accrue to such customer, supplier, or third party in the use of the Delivery Company's services as a result of that customer, supplier, or third party dealing with any affiliate.

Where the Standards of Competitive Conduct prohibit the precluded behavior with regard to dealings with any affiliate, the Compliance Plan specifies only RECO, O&R, or a subsidiary of those two organizations. Solutions and Communications, which are non-utility subsidiaries of CEI, market their services "throughout the Northeast," according to www.conedison.com, which is the Con Ed website. Because unregulated, affiliated companies offer to provide competitive services in the State of New Jersey, RECO's Compliance Plan should be amended to include an expanded and more correct definition of a holding company RCBS.

RECO has limited potential for engaging in the activity proscribed by this section of the Standards. None of the small number of New Jersey retail customers of the two CEI RCBSs operating in the state lie within RECO's service territory, which makes them ineligible for RECO utility services.

4. Conclusions

- a. RECO's Compliance Plan and Standards of Competitive Conduct generally preclude the tying of utility products and/or services to the taking of goods and services from an affiliate, but fail to adopt a proper definition of what constitutes a holding company RCBS.**

⁴⁴ DR #8.

⁴⁵ DR #8.



When these two documents are taken together, as RECO intends, the Company clearly prohibits the referenced activity. The Compliance Plan should clearly state that the prohibition applies to all CEI affiliates, rather than just identifying RECO, O&R, and their subsidiaries.

5. Recommendations

- 4. Amend the RECO Compliance Plan to clearly prohibit tying activity to any RCBSs of O&R or CEI that serves in-state customers, whether or not in the RECO's New Jersey utility service territory.**

L. Customer Assignments

1. Statement of Applicable Requirements

Section 14:4-5.3(l) of the Standards provides that:

An electric and/or gas public utility shall not assign customers to which it currently provides products and/or services to any related competitive business segments of its public utility holding company, whether by default, direct assignment, option or by any other means, unless that means is equally available to all competitors on a non-discriminatory basis.

2. Summary of Audit Activities

This provision prohibits a public utility from discriminating in favor of RCBSs of its holding company when assigning customers. The criteria that Liberty employed in examining utility compliance with this requirement were:

- The utility compliance plan should adequately inform employees about their obligations under this section
- In the event that any customer assignments took place during the audit period, there should be clear and convincing evidence that there was no discrimination against competitors in making such assignments.

Liberty reviewed the utility compliance plan. Then, Liberty sought to identify all cases where the utility may have assigned customers to any party, affiliated or not, during the audit period. Liberty would use this information to determine whether the utility engaged in any activity covered by the requirements imposed by this section of the Standards. Liberty would then identify and carry out any test activities considered appropriate in examining testing compliance with those requirements.

3. Findings

O&R/RECO stated that it did not make any assignments of customers to any party during the audit period.⁴⁶ As such, no testing was required.

⁴⁶ DR #81.



4. Conclusions

- a. RECO engaged in no activity concerning which the requirements of Standards Section 14:4-5.3(l) would apply during the audit period.

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

M. Customer Enrollment, Marketing, and Business Development

1. Statement of Applicable Requirements

Section 14:4-5.3(m) of the Standards provides that:

Except as otherwise provided by these standards, an electric and/or gas public utility shall not provide any assistance, aid or services to its PUHC or related competitive business segment of the PUHC if related to customer enrollment, marketing, or business development unless offered to all competitors on a non-discriminatory basis.

2. Summary of Audit Activities

The section lists the following examples of assistance to the PUHC or to an RCBS of the PUHC:

- Providing leads
- Soliciting business
- Acquiring information on behalf of the PUHC or an RCBS of the PUHC
- Sharing market analysis reports or other types of proprietary reports
- Sharing customer usage or end-use equipment information
- Requesting authorization from its customer to pass on customer information exclusively
- Representing or implying that the utility speaks on behalf of the RCBS or that the customer will receive preferential treatment as a consequence of conducting business with the RCBS
- Representing or implying that the RCBS speaks on behalf of the public utility.

These provisions prohibit a public utility from assisting its holding company or the RCBSs of its holding company in customer enrollment, marketing, and business development. Liberty reviewed the utility's compliance plan for adherence to these provisions. In addition, Liberty reviewed business plans, customer service representative training, information recipients, marketing materials, bill inserts, customer and competitor complaints, and information acquisition and dissemination. This review was to ensure that the utility was not participating in any prohibited activity involving its holding company or holding company RCBSs.

The criteria that Liberty employed in examining compliance with this standard were:

- The utility compliance plan should adequately address the requirements of this provision of the Standards



- There should exist controls adequate for assuring compliance with the requirements of this provision of the Standards.

3. Findings

Liberty made several requests of RECO about the activities of its RCBS and the RCBSs of its PUHC, CEI, including business plans. RECO's responses typically cited the inapplicability of the requests. RECO did not make the business plans available, but it did provide some summary information about activities in New Jersey. The Company also made senior management personnel from the four RCBSs of CEI (including the president of communications, vice president and director of solutions, and a director of energy and development) available for interviews about their companies' activities in New Jersey. Liberty found that the value of the interviews was necessarily reduced by the lack of access to business plans.

Liberty found that RECO, O&R, and the CEI non-regulated companies did not have active competitive business in RECO's service territory during the audit period. Absent such activities, there would be little opportunity for RECO to provide RCBSs of the PUHC with special advantages of the type described in this provision of the Standards.

4. Conclusions

- RECO and its affiliates, CEI's RCBSs and O&R's other subsidiaries, had no audit-period activities that would make the application of this subsection of the standards likely.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

N. Customer Advice or Assistance

1. Statement of Applicable Requirements

Section 14:4-5.3(n) of the Standards provides that:

Provided it is in compliance with these standards, and subject to the provisions of N.J.A.C. 14:4-5.4(g), an electric and/or gas public utility may offer or provide customers advice or assistance with regard to a related competitive business segment of its public utility holding company and/or other product and/or service providers upon the unsolicited request of the customer, so long as such advice or assistance is provided with regard to other competitors on a non-discriminatory basis.



2. Summary of Audit Activities

These provisions assure equal treatment of all providers of goods and services offered by an RCBS of the PUHC, and that the public is made aware of the existence of alternative suppliers of utility-related products and services or of products and services of any related competitive business segment of its holding company. Liberty applied the following criteria in examining performance under this standard:

- Regular customer communications should not offer advice or assistance about any RCBS of its holding company.
- The utility compliance plan should offer employees explicit instructions that: (a) limit them to providing such advice or assistance to cases where it is solicited by customers, and (b) instruct them that such advice must be provided with regard to other competitors on a non-discriminatory basis.

Liberty reviewed the utility's website, materials that it provides in response to customer inquiries about Energy Choice, and the compliance plan with regard to this portion of the Standards.

3. Findings

Liberty asked RECO for all information provided to customers inquiring about the Energy Choice program, and for the list of product and/or service providers that the utility offers in response to a customer request. However, RECO did not respond to these requests until after the completion of Liberty's draft audit report.⁴⁷

RECO's website, which is accessed at www.oru.com,⁴⁸ offers information separately for New Jersey residential customers and business customers. A list of licensed third-party suppliers is available through a link on the website under "Shopping for Savings – Step by Step Guide." The website directs customer to either an on-line "Contact Us" form or to a toll-free telephone number to request an Energy Choice enrollment guide, which includes the customer's average monthly kWh usage.

RECO's website lists two suppliers for service to commercial and industrial customer, Select Energy, Inc. and Strategic Energy Inc.; no suppliers are shown for residential customers because there are none operating the RECO service area.

A link to www.njenergychoice.com, as well as a toll free number to New Jersey Energy Choice Hotline, appears in the "Shopping for Savings – Questions & Answers" section of the website. The New Jersey Energy Choice link provides no information on the program; instead, customers are directed to contact their local utility. There are no links to the New Jersey Board of Public Utilities. There are no references to unregulated affiliates on the RECO website, however the "About O&R" section contains a link to CEI.

⁴⁷ DRs #109 and 110.

⁴⁸ The website can also be reached through a link at www.conedison.com. Searches under other logical domain names (reco.com, rocklandelectric.com, and rockland.com) either were unsuccessful or went to unrelated sites.



4. Conclusions

a. The RECO website provides a listing of alternative electric suppliers.

Although the RECO website indicates that the alternate electric suppliers listed meet the requirements of the NJBPU, there is no link provided to the Board's website.

b. The RECO website provides no references to unregulated affiliated companies; however, the website does contain a link to Con Ed.

CEI's unregulated affiliates Solutions, which offers energy management services throughout the Northeast, and Communications, which offers telecommunications solutions throughout the Northeast, are selections on the Con Ed home page.

c. The lack of a timely RECO response to data requests seeking information about what it tells customers with respect to energy choice made it impossible to test compliance with the requirements of Sections 14:4-5.3(n), as well as 14:4-5.4(c), (f), and (g).

RECO did provide the requested information, but only after Liberty had completed its draft audit report.

5. Recommendations

5. Include in the RECO website section "Shopping for Savings" a link to the BPU website.

6. Verify that RECO's regular communications with customers do not make representations of the type prohibited by Sections 14:4-5.3(n).

Liberty could not do so because it received information requested from Rockland only after completion of the draft audit report.

O. Posting Discounts, Rebates, and Waivers

1. Statement of Applicable Requirements

Section 14:4-5.3(o) of the Standards provides that:

If a discount, rebate, or other waiver of any charge, penalty, or fee associated with products and/or services provided by an electric and/or gas public utility is offered to its PUHC or a related competitive business segment of its public utility holding company, the electric an/or gas public utility shall provide the following information within 24 hours of the time of the transaction, via a public posting:

- 1. The name of its PUHC or related competitive business segment of its public utility holding company involved in the transaction;*



2. *The rate charged;*
3. *The maximum rate;*
4. *The time period for which the discount, rebate, or waiver applies;*
5. *The quantities involved in the transaction;*
6. *The delivery points involved in the transaction;*
7. *Any conditions or requirements applicable to the discount, rebate or waiver, and a documentation of the cost differential underlying the discount as required in (d) or (e) above; and*
8. *Procedures by which a non-affiliated entity may request a comparable offer.*

2. Summary of Audit Activities

These provisions ensure that the details of any discount, rebate, or other waiver of any charge provided by a utility to RCBSs of its PUHC are made available by a public posting to non-affiliated entities. The posting must include information on how a non-affiliate can request a comparable offer.

The criteria that Liberty used to examine performance under this standard were:

- The utility compliance plan should offer employees explicit instructions that address compliance with this provision
- Any discounts, rebates, or waivers offered should be posted as required.

Liberty asked for information about any discounts, rebates or waivers offered by the utility. Liberty requested copies of any posting required to comply with this section, and also searched the Company's website for any relevant postings.

Liberty also reviewed the utility compliance plan to examine the Company's intended method of complying with this section of the Standards.

3. Findings

RECO stated that the Company has offered no discounts, rebates or waivers to any customer, including its PUHC or an RCBS of its PUHC, during the audit period.⁴⁹

The Company's Revised Standards of Competitive Conduct state that "the availability of certain discounts and discretionary waivers must be posted on Orange and Rockland's and RECO's [Rockland's] website." The Compliance Plan also references the Company's Affiliate Relations Conditions, which provide that Rockland must contemporaneously offer to all similarly situated non-affiliate merchants, any discount or special arrangement that Rockland offers to its affiliate or customer of its affiliate. Although the Compliance Plan does not specify what information is to be publicly posted, the Revised Standards of Competitive Conduct state that Rockland "will post on its website the information that the Commission requires a utility to file in association with providing a discount or negotiated rate or special arrangement..."

⁴⁹ DRs #72 and 73.



Consistent with the Company's statement that it offered no such discounts or special arrangements, there were no public postings of any type on the Rockland or Con Ed websites.

4. Conclusions

- a. Liberty found no evidence that Rockland offered a discount or waiver to any RCBS of CEI during the audit period to which Section 14:4-5.3(o) would apply.**
- b. The procedures detailed in Rockland's Compliance Plan meet the requirements of this Standard.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

P. Information Retention for Discounts, Rebates, and Waivers

1. Statement of Applicable Requirements

Section 14:4-5.3(p) of the Standards provides that:

An electric and/or gas public utility that provides its PUHC or a related competitive business segment of its public utility holding company a discounted rate, rebate, or other waiver of a charge, penalty or fee associated with services offered by the electric and/or gas public utility shall maintain, in compliance with N.J.A.C. 14:4-5.2 or longer if required by another government agency, for each billing period, the following information:

The standard goes on to recite seven categories of information that must be retained.

2. Summary of Audit Activities

These provisions ensure that the utility maintain adequate documentation regarding details of any discount, rebate, or other waiver of any charge provided by a utility to its PUHC or to RCBSs of its PUHC.

Liberty's criteria and audit activities were the same as those set forth for Section 14:4-5.3(o).

3. Findings

Liberty's findings are the same as those set forth for Section 14:4-5.3(o).

4. Conclusions

- a. Liberty found no evidence that Rockland offered a discount or waiver to any RCBS of CEI during the audit period to which Section 14:4-5.3(p) would apply.**



5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

Q. Compliance With FERC Record Keeping Requirements

1. Statement of Applicable Requirements

Section 14:4-5.3(q) of the Standards provides that:

All records maintained pursuant to the standards in (o) and (p) above shall also conform to FERC rules where applicable.

2. Summary of Audit Activities

This provision requires that records maintained regarding discounts, waivers and rebates offered by a utility to its PUHC or to an RCBS of its RCBS conform to FERC rules. Liberty's audit activities were the same as those set forth for Section 14:4-5.3(o).

3. Findings

RECO offered no audit-period discounts, rebates, or waivers to any customer, including its PUHC or an RCBS of its PUHC; therefore, Section 14:4-5.3(q) was not applicable.

4. Conclusions

- a. Liberty found no evidence that Rockland offered a discount or waiver to any RCBS of CEI during the audit period to which Section 14:4-5.3(q) would apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.



III. Information Disclosure Standards (14:4-5.4)

Section 14:4-5.4 of the Standards applies to interactions between a utility and an RCBS of its holding company or the holding company itself if it offers or provides competitive services to retail customers in New Jersey. These standards do not, however, apply in cases where an internal RCBS exists within the utility itself and where there are transactions between the utility and such an RCBS. Separate standards, which are addressed in Chapter V of this report, apply to interactions between utilities and their internal RCBSs.

A. Providing Customer Proprietary Information

1. Statement of Applicable Requirements

Section 14:4-5.4(a) of the Standards provides that:

An electric and/or gas utility may provide individual proprietary information to its PUHC or a related competitive business segment of its public holding company only with the prior affirmative customer written consent or as otherwise authorized by the Board and only if it is provided to unaffiliated entities on a non-discriminatory basis.

2. Summary of Audit Activities

These provisions provide protection to both customers and competitors by preventing affiliate exploitation of information and data generated by the public utility. The holding company and its RCBSs could gain competitive advantage by:

- Inappropriately sharing of customer specific information
- Using information gained through the operation of the utility system to gain competitive advantage in identifying market opportunities or problems
- Using non-public information provided to the public utility by unaffiliated suppliers to gain competitive advantage
- Inappropriately using or exclusively exchanging proprietary data to preclude unaffiliated suppliers from obtaining information available to the PUHC and its related competitive business segment.

The criteria that Liberty applied in examining performance under this standard were:

- The utility should have adequate methods for controlling the release of customer information in accord with the standard
- The utility compliance plan should adequately address employee obligations under this standard.

In its initial review of customer proprietary information, Liberty sought via data requests and interviews to determine if the utility released customer proprietary information to either a holding company or RCBS during the audit period. Liberty then sought to determine if customer proprietary information that had been released was pursuant to written customer authorization or



otherwise approved by the Board. Liberty also requested information regarding any formal or informal complaints concerning the use or release of customer proprietary information that occurred during the audit period.

Liberty also reviewed utility customer service processes to ensure that adequate methods existed to control access and protect customer proprietary information from inappropriate disclosure or access. In particular, Liberty reviewed training material for customer service personnel and customer service personnel aids, along with controls on access to customer information.

3. Findings

Rockland stated that it did not release any unauthorized customer proprietary information to either the PUHC or related competitive business segment, or to any other group, during the audit period.⁵⁰ Orange & Rockland stated that it did not release customer proprietary information to anyone on any basis other than customer consent.⁵¹ The Company also added that it had not requested Board authorization to release customer proprietary information using alternative release methods.⁵² No such authority had been requested because there were no customers participating in retail residential choice in the retail electric company's service area. RECO did not receive any formal or informal customer complaints related to release of customer proprietary information.⁵³

O&R told Liberty that they provided four months of training to their customer service employees.⁵⁴ Due to limited information provided by O&R, Liberty was unable to determine whether O&R's customer service training was adequate concerning the treatment of customer proprietary information.

4. Conclusions

- a. RECO complied with the Standards limiting the release of customer proprietary information to cases of prior, written authorization.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

B. Providing Other Non-Public Information

1. Statement of Applicable Requirements

Section 14:4-5.4(b) of the Standards provides that:

⁵⁰ DR #115.

⁵¹ DR #125.

⁵² DR #114.

⁵³ DR #125.

⁵⁴ DR #117.



An electric and/or gas public utility shall make available non-customer specific non-public information acquired as a result of operating the public utility's distribution system, including information about an electric and/or gas public utility's natural gas or electricity purchases, sales, or operations or about an electric and/or gas public utility's gas-related goods or services, electricity-related goods or services, to a related competitive business segment of its public utility holding company only if the electric and/or gas public utility makes such information available, via a public posting, to all other service providers on a non-discriminatory basis, and keeps the information open to public inspection.

- 1. An electric or gas public utility is permitted to exchange proprietary information on an exclusive basis with its PUHC or a related competitive business segment of its public utility holding company, provided it is necessary to exchange this information in the provision of the corporate support service permitted by N.J.A.C. 14.4-5.5(i) and (j).*
- 2. The PUHC's or related competitive business segment's use of such proprietary information is limited to its use in conjunction with the permitted corporate support services, and is not permitted for other use.*

2. Summary of Audit Activities

These provisions provide protection to competitors by preventing affiliate exploitation of information and data generated by the public utility. The PUHC and the related competitive business segments could gain competitive advantage in the following manner:

- Utilizing information gathered through the operation of the utility system to gain competitive advantage in identifying market opportunities or problems
- Inappropriate use or exclusive exchange of proprietary data to preclude unaffiliated suppliers from obtaining information available to the PUHC and its related competitive business segment.

The criteria that Liberty applied in examining performance under this standard were:

- The utility compliance plan should adequately address employee obligations under this standard
- Any release of covered information should meet the posting and continuous availability requirements of the standard.

Liberty sought to determine if the holding company or a holding company RCBS received non-customer-specific information acquired by the utility in the operation of its distribution system, and whether it was then made available to other service providers via a public posting. To the extent that non-specific customer information resides on a website that is publicly accessible by competitors, Liberty believes that the Company would meet the requirements of the standard. Liberty reviewed the utility's planning processes to determine if this non-specific information was acquired by any RCBS during the planning process, and reviewed the Company's practices concerning the use of non-specific customer information.



As to the exclusive exchange of proprietary information between the utility and its holding company or an holding company RCBS necessary for corporate support services, Liberty sought to identify whether such information had been exchanged. To the extent that such data are required for the provision of support service pursuant to and permitted by N.J.A.C. 14.4-5.5(i) and (j) then it would meet the requirement.

3. Findings

RECO does not have a related competitive business segment operating in its certified territory and stated that no customer participates in customer choice in its territory.⁵⁵ Therefore, RECO and O&R do not provide access to non-customer specific information to either its PUHC or related competitive business segments. Without an active related competitive business segment within its certified territory, CEI affiliates cannot gain competitive advantage through the exchange of this information. Thus, RECO is not required to provide access to non-customer specific information gained through the operation of its distribution system with competitors.

4. Conclusions

- a. RECO made no release during the audit period of information covered by Section 14:4-5.4(b).**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

C. Providing Lists of Generation or Gas Service Providers

1. Statement of Applicable Requirements

Section 14:4-5.4(c) of the Standards provides that:

When an electric and/or gas public utility makes available a list of electric generation and/or gas service suppliers (suppliers), said list shall only contain those suppliers who are duly licensed by the Board and comply with the electric and/or gas public utility's Board-approved tariff to operate on its distribution system. Said list shall be maintained in alphabetical order, and not highlight or otherwise promote any particular supplier.

2. Summary of Audit Activities

This provision limits utility-provided lists of competitive suppliers of electric generation and gas service to those licensed by the Board and it precludes any form of emphasis on a particular supplier on such lists. The criteria that Liberty applied in evaluating utility performance under this standard were:

- Supplier lists should contain all those licensed by the Board and only those licensed

⁵⁵ DR #114.



- There should be no emphasis by location or print and other identification features on any supplier on the list
- The utility compliance plan should adequately address the release requirements of this provision.

Sections 14:4-5.3(n), 14:4-5.4(c), 14:4-5.4(f), and 14:4-5.4(g) are related. Liberty's audit activities were the same as those set forth for Section 14:4-5.3(n).

3. Findings

Liberty's findings are the same as those set forth for Section 14:4-5.3(n).

4. Conclusions

Liberty's conclusions are the same as those set forth for Section 14:4-5.3(n).

5. Recommendations

Liberty's recommendations are the same as those set forth for Section 14:4-5.3(n).

D. Providing Affiliates Information Concerning Unaffiliated Suppliers

1. Statement of Applicable Requirements

Section 14:4-5.4(d) of the Standards provides that:

An electric and/or gas public utility may provide non-public information and data which have been received from unaffiliated suppliers to its PUHC or a related competitive business segment of its public utility holding company or other non-affiliated entities only if the electric and/or gas public utility first obtains written affirmative authorization to do so from said unaffiliated supplier.

2. Summary of Audit Activities

This provision provides protection to competitors by preventing exploitation of confidential non-public information and data provided by an unaffiliated supplier to the utility. The PUHC and related competitive business segments could gain competitive advantage by:

- Using non-public information provided to the public utility by unaffiliated suppliers to improve the PUHC's and related competitive business segment's understanding of market conditions
- Restricting the use of non-public information provided by an unaffiliated supplier to only the PUHC or related competitive business segment.

Liberty applied the following criteria in examining this provision of the Standards:



- Non-public information and data received from unaffiliated suppliers by the electric or gas public utility can be provided to either the PUHC or RCBS only if the public utility is authorized by the non-affiliated supplier to release the information.
- There should have been no provision of information received from unaffiliated suppliers absent written permission
- The utility compliance plan should adequately address the release requirements of this provision.

Liberty first determined if non-affiliated information and data are shared by the utility with the holding company or any holding company RCBS. If the information and data were shared with the PUHC or RCBS, then Liberty would then review the unaffiliated supplier's written authorization for release of the information. To the extent that a signed release was provided, Liberty would then consider this provision met.

3. Findings

Liberty asked for information from O&R on whether it requested information and/or data from unaffiliated suppliers that was ultimately shared with its PUHC and related competitive business segments. The Company responded that neither RECO nor O&R requested any non-public confidential information from unaffiliated suppliers. Therefore no information was made public.⁵⁶

4. Conclusions

- a. During the audit period, RECO engaged in no activity covered by this provision of the Standards.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

E. Soliciting Release of Information Concerning Unaffiliated Suppliers

1. Statement of Applicable Requirements

Section 14:4-5.4(e) of the Standards provides that:

An electric and/or gas public utility shall not solicit the release of such information exclusively to its PUHC or a related competitive business of its public utility holding company in an effort to keep such information from other unaffiliated entities.

⁵⁶ DRs #148-150.



2. Summary of Audit Activities

This provision provides protection to competitors by preventing a utility from requesting asymmetric access to information requested from unaffiliated suppliers. The PUHC and related competitive business segments could gain competitive advantage in the following manner:

- A utility could provide the PUHC and related competitive business segment an opportunity to limit access to competitively sensitive information.
- Restricting the use of non-public information provided by unaffiliated suppliers to only the PUHC or RCBS.

Liberty first determined if non-affiliated information and data are shared by the utility with its holding company or holding company RCBS. If so, Liberty would then determine if the information and data were provided to other suppliers pursuant to the requirements of this provision. The solicitation could not be exclusively for the holding company or holding company RCBS in an effort to prevent distribution to nonaffiliated suppliers. To the extent there were any such solicitations, Liberty would review each to determine if it were designed to limit the information distribution.

3. Findings

Liberty requested information from O&R about whether it solicited non-public data or information from unaffiliated suppliers within its certified territory.⁵⁷ The Company responded that neither RECO nor O&R requested such information.

4. Conclusions

- a. During the audit period, RECO engaged in no activity covered by this provision of the Standards.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

F. Highlighting Affiliates in Lists of Providers

1. Statement of Applicable Requirements

Section 14:4-5.4(f) of the Standards provides that:

Except upon request by a customer or as authorized in (c) above or otherwise by the Board, an electric and/or gas public utility shall not provide its customers with any list of product and/or service providers, which highlights or otherwise identifies its PUHC or a related competitive business segment of its public utility

⁵⁷ DRs #148-150.



holding company, regardless of whether such list also includes the names of unaffiliated entities.

2. Summary of Audit Activities

Sections 14:4-5.3(n), 14:4-5.4(c), 14:4-5.4(f), and 14:4-5.4(g) are related. Liberty's audit activities were the same as those set forth for Section 14:4-5.3(n).

3. Findings

Liberty's findings are the same as those set forth for Section 14:4-5.3(n).

4. Conclusions

Liberty's conclusions are the same as those set forth for Section 14:4-5.3(n).

5. Recommendations

Liberty's recommendations are the same as those set forth for Section 14:4-5.3(n).

G. Supplementing Information About Affiliated Providers

1. Statement of Applicable Requirements

Section 14:4-5.4(g) of the Standards provides that:

If a customer requests information about any affiliated product and/or service provider, the electric and/or gas public utility may acknowledge that such affiliated product and/or service provider exists, but shall provide no additional information unless it provides a list of all providers of gas-related, electricity-related, or other utility-related products and/or services in business in its service territory, including the related competitive business segment of its public utility holding company.

- 1. Any such list shall include all suppliers licensed by the Board.*
- 2. Where maintaining such list would be unduly burdensome due to the number of service providers, the electric and/or gas public utility shall not provide a list and may direct the customer to a generally available listing of service providers, for example, the Board, the telephone directory or Internet.*

2. Summary of Audit Activities

Sections 14:4-5.3(n), 14:4-5.4(c), 14:4-5.4(f), and 14:4-5.4(g) are related. Liberty's audit activities were the same as those set forth for Section 14:4-5.3(n).



3. Findings

Liberty's findings are the same as those set forth for Section 14:4-5.3(n).

4. Conclusions

Liberty's conclusions are the same as those set forth for Section 14:4-5.3(n).

5. Recommendations

Liberty's recommendations are the same as those set forth for Section 14:4-5.3(n).

H. Record Keeping Concerning Transactions With Affiliates

1. Statement of Applicable Requirements

Section 14:4-5.4(h) of the Standards provides that:

An electric and/or gas public utility shall maintain complete and accurate records, documenting all tariffed and non-tariffed transactions with its PUHC and a related competitive business segment of its public utility holding company, including but not limited to, all waivers of tariffed or contract provisions.

2. Summary of Audit Activities

These provisions require that a utility keeps complete and accurate records of all transactions it has with its holding companies and related RCBSs. During transaction testing, and during other work sessions as well, Liberty reviewed the available documentation for numerous transactions between the utility and its affiliates. In addition, Liberty requested all contracts between the regulated and unregulated affiliates and reviewed the contracts it received.

The criteria Liberty applied in examining performance under this standard are set forth in the chapter of this report that addresses transaction testing.

3. Findings

According to O&R, it does not provide any services to CEI's unregulated subsidiaries, and no costs are charged, assigned or allocated.⁵⁸ Liberty confirmed in interviews with O&R personnel that it had no transactions with Solutions, Development, or Energy.⁵⁹

⁵⁸ DR #2.

⁵⁹ Interview with O&R personnel, January 28, 2003.



4. Conclusions

- a. Since RECO/O&R had no transactions with RCBSs of the holding company, the provisions of Section 14:4-5.4(h) regarding recordkeeping do not apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

I. Record Retention Requirements For Transactions With Affiliates

1. Statement of Applicable Requirements

Section 14:4-5.4(i) of the Standards provides that:

An electric and/or gas public utility shall maintain such records in compliance with the time frame required by N.J.A.C. 14:5-5.2 or longer if another government agency so requires.

2. Summary of Audit Activities

These provisions require that the records of transactions between the utility and its holding company or holding company RCBSs be maintained in accordance with the time frame specified in N.J.A.C. 14:5-5.2.

Liberty sought to identify the company policy with respect to document retention.

3. Findings

According to O&R, it does not provide any services to CEI's unregulated subsidiaries, and no costs are charged, assigned or allocated.⁶⁰ Liberty confirmed in interviews with O&R personnel that it had no transactions with Solutions, Development, or Energy.⁶¹

4. Conclusions

- a. Since RECO/O&R had no transactions with RCBSs of the holding company, the provisions of Section 14:4-5.4(i) regarding record retention do not apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁶⁰ DR #2.

⁶¹ Interview with O&R personnel, January 28, 2003.



J. Inspection of Records

1. Statement of Applicable Requirements

Section 14:4-5.4(j) of the Standards provides that:

An electric and/or gas public utility shall make such records available for Board and/or RA review upon 72 hours' notice, or at a time mutually agreeable to the electric and/or gas public utility and the Board and/or RA.

2. Summary of Audit Activities

These provisions require that transaction records be made available for BPU and RA review upon 72 hours notice. During conduct of its audit, Liberty sought access to records and documents pertaining to transactions involving the utility, holding company, and holding company RCBSs.

3. Findings

Liberty found that the companies were able to produce transaction records and documents as required during the audit.

4. Conclusions

- a. RECO/O&R was in compliance with Section 14:4-5.4(j) insofar as supporting reasonable audit time frames.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

K. Bid and Contract Records

1. Statement of Applicable Requirements

Section 14:4-5.4(k) of the Standards provides that:

An electric and/or gas public utility shall maintain a record of all contracts and related bids for the provision of work, products and/or services to and from the electric and/or gas public utility to and from the PUHC or related competitive business segments of its public utility holding company in compliance with N.J.A.C. 14:5-5.2 or longer if another government agency so requires.



2. Summary of Audit Activities

These provisions require that the utility maintain records of all contracts with the holding company and holding company RCBSs in accordance with N.J.A.C. 14:5-5.2.

During transaction testing, and during other work sessions as well, Liberty reviewed the available documentation for numerous transactions between the utility and its affiliates. In addition, Liberty requested all contracts between the regulated and unregulated affiliates and reviewed any contracts that it received.

3. Findings

According to O&R, it does not provide any services to CEI's unregulated subsidiaries, and no costs are charged, assigned or allocated.⁶² Liberty confirmed in interviews with O&R personnel that it had no transactions or contracts with Solutions, Development, or Energy.⁶³

4. Conclusions

- a. **Since RECO/O&R had no transactions with RCBSs of the holding company, the provisions of Section 14:4-5.4(k) regarding recordkeeping do not apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁶² DR #2.

⁶³ Interview with O&R personnel, January 28, 2003.



IV. Separation Standards (14:4-5.5)

Section 14:4-5.5 of the Standards applies to interactions between a utility and an RCBS of its holding company or the holding company itself if it offers or provides competitive services to retail customers in New Jersey. These standards do not, however, apply in cases where an internal RCBS exists within the utility itself and where there are transactions between the utility and such an RCBS. Separate standards, which are addressed in Chapter V of this report, apply to interactions between utilities and their internal RCBSs.

A. Separate Corporate Entities

1. *Statement of Applicable Requirements*

Section 14:4-5.5(a) of the Standards provides that:

An electric and/or gas public utility, its PUHC and related competitive business segments of its public utility holding company shall be separate corporate entities.

2. *Summary of Audit Activities*

These provisions require that the utility, its PUHC, and the non-regulated RCBSs of the holding company be separate corporate entities. The criterion that Liberty employed in examining compliance with this standard was:

- The utility should exist as a legal entity that is separate and distinct from its holding company and any RCBS of its holding company.

Liberty considered relevant filings with the Securities and Exchange Commission, organization charts, a variety of data requests and interview results to assess whether there existed the required corporate separation between the utility, on the one hand, and any holding company or holding company RCBSs, on the other hand.

3. *Findings*

Liberty found RECO, O&R, and CEI's non-utility subsidiaries to be separate and distinct companies and legal entities.

4. *Conclusions*

- a. **O&R/RECO's structure and operation complied with this provision of the standards during the audit period.**

5. *Recommendations*

Liberty has no recommendations regarding the requirements of this standard.



B. Separate Books and Records

1. Statement of Applicable Requirements

Section 14:4-5.5(b) of the Standards provides that:

An electric and/or gas public utility and related competitive business segments of its public utility holding company shall keep separate books and records.

2. Summary of Audit Activities

This provision requires that the holding company keep separate books and records for the regulated utility and for its non-regulated affiliates. The criterion that Liberty applied in examining compliance with this standard was:

- Whether the utility books and records are fully separate and distinct from those of the holding company and any holding company RCBS.

Liberty reviewed the accounting systems and a sample of the accounting records for O&R.

3. Findings

Liberty interviewed O&R accounting personnel to gain an understanding of the utility's accounting system and structure. Liberty reviewed a RECO Trial Balance Report and RECO's financial statements for the periods ending December 31, 2001 and June 30, 2002.

4. Conclusions

- a. CEI complies with Section 5.5(b) of the Standards.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

C. Conformity of Books and Records with USOA

1. Statement of Applicable Requirements

Section 14:4-5.5(c) of the Standards provides that:

Electric and/or gas public utilities' books and records shall be kept in accordance with applicable Uniform System of Accounts (USOA).

2. Summary of Audit Activities

Liberty obtained and reviewed the Uniform System of Accounts and the O&R chart of accounts. Liberty then compared the chart of accounts with the Uniform System of Accounts on a random



sample basis. Liberty did conduct an overall review of compliance, and, during its transaction testing work, which is addressed later in Section IV.I of this the report, did seek to determine whether affiliate transaction record keeping demonstrated substantial compliance with all USOA requirements applicable to the transactions being tested and the documents being examined as part of that testing

3. Findings

Liberty obtained and reviewed the Uniform System of Accounts and met with O&R accounting staff to develop an understanding of the O&R account structure and chart of accounts. Liberty then compared the O&R chart of accounts with the USOA on a random sample basis.

The O&R chart of accounts uses 22 digits conveying data in eight informational categories. The third segment of these 22 digits, consisting of 6 digits, corresponds to the USOA. While the USOA requires only three to four of these 6 digits, the additional digits provide more detailed information for use by O&R.

4. Conclusions

- a. O&R complies with Section 5.5(c) of the Standards.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

D. Availability of Books and Records for Board Examination

1. Statement of Applicable Requirements

Section 14:4-5.5(d) of the Standards provides that:

The books and records of its PUHC or a related competitive business segment of an electric and/or gas public utility's holding company engaged in transactions, interactions and relations with the electric or gas public utility shall be open for examination by the Board.

2. Summary of Audit Activities

This provision requires that the utility's holding company provide access to its books and records and to those of its non-regulated RCBSs. During the conduct of its audit, Liberty sought access to a host of records and documents pertaining to the utility, the utility holding company, and the holding company RCBSs. The criterion that Liberty applied in examining compliance with this standard was:

- Whether all requests for information necessary to verify compliance with the standards subject to this audit produced substantially complete responses.



3. Findings

As is noted throughout this report, RECO took an unduly restrictive view of the scope of the Standards and of this audit. That view made audit activities substantially more cumbersome, difficult, and inefficient that Liberty was led to believe would be the case before this audit was commissioned.

4. Conclusions

- a. RECO's view of the scope of the Standards and this audit, with which Liberty disagrees, made auditing its compliance with the Standards difficult and it prevented Liberty from performing a number of other validation activities that it was able to perform in auditing the other three New Jersey electric utilities.**

5. Recommendations

- 7. Revise Company policy to permit access to affiliate books and records as necessary to verify compliance with the Standards.**

E. Sharing of Space, Services, and Equipment

1. Statement of Applicable Requirements

Section 14:4-5.5(e) of the Standards provides that:

An electric and/or gas public utility shall not share office space, office equipment, services, and systems with a related competitive business segment of its public utility holding company, except to the extent appropriate to perform shared corporate support functions permitted under this subsection or as follows:

- 1. An electric and/or gas public utility may access the computer or information systems of a competitive related business segment of its PUHC or allow a related competitive business segment of its PUHC to access its computer or information systems, for purposes of the sharing of computer hardware and software systems and may share office space, office equipment, services and systems, provided adequate system protections are in place to prevent the accessing of information or data between the utility and its affiliate(s) which would be in violation of these standards.*
 - i. Prevention of unauthorized access to computer and information systems must be specifically addressed as part of an electric and/or gas public utility's compliance plan submitted pursuant to N.J.A.C. 14:4-5.7(b).*



2. Summary of Audit Activities

These provisions allow a utility and an RCBS of its PUHC to share office space, office equipment, services and systems only if:

- It is required as part of providing permitted shared corporate support functions, or
- Adequate system protections are in place to prevent accessing of data that would violate the Standards.

Despite what it appears to be on first review, the effect of the two bulleted exceptions is generally to allow shared space, services, systems, and equipment, provided that security against data exchange is adequate. Given the breadth of this exception, Liberty applied the following criterion in examining performance under this standard:

- Whether, in cases where sharing is done, adequate measures are taken to prevent inappropriate information exchange.

Liberty requested information regarding the sharing of Information Technology services between the utility, its holding company, and holding company RCBSs. Liberty conducted an in-depth interview with personnel from the Information Technology Department and followed up with several data requests. In addition, Liberty reviewed the listing of data bases and policies and procedures pertaining to IT security and data base access.

3. Findings

Liberty requested information regarding the sharing of Information Technology services between RECO, O&R, CECONY, and CEI.

Liberty requested a list of the major databases used by CEI and its subsidiaries that CEI believe must be protected as required by the Standards. CECONY and O&R have separate computer systems, as do the non-regulated affiliates.⁶⁴

CEI provided Liberty with a list of four such databases that contain financial and customer-specific information:⁶⁵

- Walker (owned by O&R, with access by certain O&R finance/accounting and specific CECONY departments)
- Customer Information Management System (owned by O&R, with access by certain O&R departments and CECONY IT)
- General Accounting (owned by CECONY, with access by certain CECONY departments)
- CIS (owned by CECONY, with access by specific CECONY departments and O&R administrative services).

According to the Company, no third parties were allowed temporary access to the above data.

⁶⁴ Work session, December 11, 2002.

⁶⁵ DR #93.



CEI also provided Liberty with a copy of its corporate policy statement regarding computer data security, dated June 2000.⁶⁶ Liberty found that these guidelines for computer security and data integrity made no mention of the Standards. They were in essence very general, and assigned the primarily responsibility for designing security measures to the IT department.

4. Conclusions

- a. Existing practices to prevent information sharing described in the Standards are not sufficient to ensure compliance.**
- b. Prohibited sharing of information would have had little impact on New Jersey customers.**

As discussed above in Section I.F, Liberty found that CEI's RCBS are now relatively inactive in New Jersey. This means that there is little likelihood that impermissible sharing of RECO's information about its customers, if it had occurred, would have harmed competitors in New Jersey. If, however, there is greater competition in New Jersey in the future, then RECO might have information that would be useful to CEI's RCBSs, and accordingly, steps should be taken to prevent those RCBSs from having access to RECO's information about customers not allowed by the Standards.

5. Recommendations

- 8. Strengthen IT security policies and procedures to address the information exchange provisions of Section 14:4-5.5(e).**

The policies and standards should specifically cite and explain the requirements of the Standards, and address how compliance with them will be assured.

F. Authorized Joint Products and Services

1. Statement of Applicable Requirements

Section 14:4-5.5(f) of the Standards provides that:

Subsection (e) above does not preclude an electric and/or gas public utility from offering a joint product and/or service, provided such joint product and/or service is authorized by the Board and is available to all non-affiliated product and/or service providers on the same terms and conditions, for example, joint billing services.

⁶⁶ DR #94.



2. Summary of Audit Activities

The purpose of the provisions is to ensure that any joint products and/or services offered by the utility are offered to non-affiliated providers on the same terms and conditions. The criterion that Liberty applied in examining performance under this standard was:

- In the event that any utility offered products or services jointly with a holding company RCBS, whether they were offered to non-affiliated providers on the same basis.

Liberty reviewed the utility's tariffs to determine whether the Company had any competitive products and services. In addition, Liberty asked whether the utility offered any competitive services, and gathered information on the product offerings of the RCBSs who provide services at retail in New Jersey.

3. Findings

Liberty found that RECO offers no services that are like those offered by the RCBSs of CEI, nor did it discover any joint services or products offered by the electric utility and another CEI company. In response to a request for documents, RECO stated that neither RECO "nor its affiliates provide competitive services in RECO's service territory."⁶⁷ While two CEI RCBSs do provide retail services in New Jersey but outside of RECO's service territory, as discussed elsewhere in this report, the facts that the services are provided outside of the service territory, and that none of them are like the services that RECO provides (RECO provides no gas, engineering, and communications services), creates no apparent opportunities for joint products or services between RECO and any CEI RCBS.

4. Conclusions

- a. There were no joint product or service offerings by RECO and any RCBS of its holding company during the audit period; therefore the provisions of Section 14:4-5.5(f) have not been relevant to RECO.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

G. Joint Purchases

1. Statement of Applicable Requirements

Section 14:4-5.5(g) of the Standards provides that:

⁶⁷ DR #2.



An electric and/or gas public utility and its PUHC or related competitive business segments of its public utility holding company may make joint purchases of products and/or services, but not those associated with merchant functions.

2. Summary of Audit Activities

This provision of the standards confirms the general permissibility of joint purchases, which Liberty addresses in the next ensuing section of this audit report. However, the provision also imposes a strict prohibition against joint purchases that relate to the merchant function. Liberty applied the following criterion in examining performance under this standard:

- The utility may not make merchant-function related purchases jointly with a holding company or holding company RCBS.

Liberty requested copies of all joint purchasing agreements that included both the regulated utility and a holding company or holding company RCBS.

3. Findings

In response to document requests about joint purchasing agreements, RECO stated that the discovery request was not applicable to RECO, since neither RECO nor its affiliates provide competitive services in RECO's service territory.⁶⁸ The Company also stated "that there have been no asset transfers, asset leases, asset rental, employee transfers, employees loaned, shared employees, and goods and services provided between Orange and Rockland/RECO and Solutions, Energy, or Development, respectively" as an indication of the lack of relationship between the companies.⁶⁹

Liberty also reviewed data provided by RECO, which indicated that the RCBSs of CEI provide no merchant functions in RECO's service territory; therefore, by definition there would have been no reason to make joint purchases of products or services having to do with a merchant function performed by an RCBS of CEI.⁷⁰

In its role as provider of shared services, CECONY does make joint purchases or engage in certain agreements on behalf of O&R/RECO and the non-regulated subsidiaries of CEI. Examples include PCs and EPRI fees. These joint purchases are not, however, related to merchant functions.

4. Conclusions

- a. There were no merchant product or service offerings by a RECO RCBS or any RCBS of its holding company during the audit period; therefore, the provisions of Section 14:4-5.5(g) have not been relevant to RECO.**

⁶⁸ DR #44.

⁶⁹ DR #26.

⁷⁰ DRs #112 and 113.



5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

H. Pricing and Reporting of Joint Purchases

1. Statement of Applicable Requirements

Section 14:4-5.5(h) of the Standards provides that:

The electric and/or gas public utility must insure that all such joint purchases are priced, reported, and conducted in a manner that permits clear identification of the electric and/or gas public utility's portions and its PUHC or the related business segment's portion of such purchases, and that direct costs of the joint purchase(s) as well as the indirect purchasing costs are apportioned between the electric and/or gas public utility and the related competitive business segment of the public utility holding company in direct proportion to the relative amounts of the purchased products(s) and/or services(s) received and/or utilized, respectively, in accordance with these standards and other applicable Board allocation and reporting rules.

2. Summary of Audit Activities

The purpose of these provisions is to ensure, for all joint purchases, proper record keeping, pricing, and assignment of direct and indirect costs between the utility and the RCBS. The provision's two principal requirements include the ability to segregate the utility portion of joint purchases and the allocation of both the direct and indirect costs of purchases to the utility on the basis of its portion of the purchases. Therefore, Liberty applied the following criteria in examining performance under this standard:

- Whether recordkeeping and reporting of jointly made purchases provides for accurate identification and segregation of the utility portion of purchases made through common efforts
- Whether the costs that the utility pays for purchases made through common efforts are in strict proportion to the amounts purchased for its use.

Liberty conducted interviews to learn about the procurement process within the service company and the utility. During transaction testing, Liberty examined the means for allocating the costs of common purchasing.

3. Findings

Liberty requested a list of all joint purchasing agreements that included both the regulated utility and an unregulated affiliate of the parent. RECO did not provide any information regarding joint purchases in response to this request.⁷¹ However, during transaction testing, Liberty questioned CEI

⁷¹ DR #44.



employees about joint purchases made by O&R or CECONY. CEI indicated that joint purchases among O&R and other CEI affiliates were limited. The Company stated that there are a few cases where CECONY negotiated overall master agreements (for PCs, *e.g.*), and the affiliates placed orders directly under separate purchase orders. In cases where the company was unable to obtain split invoices from the vendor (such as EPRI or the Edison Electric Institute), CECONY separated the charges itself.⁷²

During transaction testing, Liberty selected two joint purchases for further examination. The purpose of the testing was to determine whether the charges to the utility were consistent with the amount of product or service used, and to establish whether CEI kept adequate records of how such charges were determined. As part of each review, Liberty examined the invoice, the relevant contract, agreement or purchase order, and any supporting documentation and worksheets that indicated the basis for separating these charges between O&R, CECONY, and applicable CEI affiliates.

Due to the limited number of joint purchases identified, Liberty had few possibilities from which to choose for transaction testing. Liberty selected two joint purchases of R&D services for 2001 by CEI, because they were the most likely to contain judgments about the proportion of charges relevant to a given affiliate (rather than simple per unit calculations as for PCs). The two purchases tested were membership dues to the Edison Electric Institute (EEI) and fees to EPRI to fund research and development activities.

Liberty found that in the case of the Edison Electric Institute, the total amount of yearly fees paid by CEI was lower than the total would have been had O&R and CECONY been assessed separately (\$947,000 versus \$965,000). The total fee paid by CEI was allocated to CECONY and O&R in proportion to what individual fees would have been (specified by EEI) had they been contracted for separately (rather than at 6.5 percent in this case). Liberty found this approach to pricing on the basis of use to be an appropriate one, and O&R received a charge of \$157,983. Liberty found the documentation supporting the determination of charges to be adequate, and reviewed the settlement of the charges on the accounting system to verify that the appropriate costs were actually charged.

With respect to EPRI, Liberty found that fees for projects from which both O&R and CECONY would benefit were clearly identified on supporting company documentation. Since these projects are considered part of shared services, O&R was assessed 6.5 percent of the associated fees for 2001. Since they were part of the shared service allocation made monthly, Liberty could not review the separate settlement of this transaction.

Specific accounting policies and procedures regarding the treatment of joint purchases are not covered by the Company's corporate accounting policies, nor are they addressed in the Compliance Plan.

As discussed more fully in Section 5.5(i) on shared services, the indirect costs of purchasing, *i.e.*, the cost of the purchasing department, are part of shared administrative services provided by CECONY and allocated between O&R and CECONY. There is no direct relationship between

⁷² Work session, December 11, 2002.



the dollar amount of purchases by either utility and the amount allocated to it for the purchasing department. To the extent that any non-regulated affiliate uses purchasing services, it is billed for these on a direct charge basis, however any such charges are not made on a fully-allocated cost basis.

4. Conclusions

- a. There were adequate recordkeeping practices and appropriate pricing for joint purchases during the audit period.**
- b. The way that CECONY imposes charges for procurement management does not apportion costs as required by the Standards, and creates a potential for cross subsidization.**

5. Recommendations

- 9. Introduce a method by which indirect costs for joint purchases are properly assigned.**

The number and amount of joint purchases has been small. Therefore, it would be appropriate to use an estimate of indirect costs to be assigned, provided that the Company can provide a basis for concluding that such an estimate is substantially accurate.

I. Shared Services

1. Background

There are a large number of shared administrative services provided by CECONY. This part of the report is organized into subsections that include additional background and detailed findings on the topic of shared services.

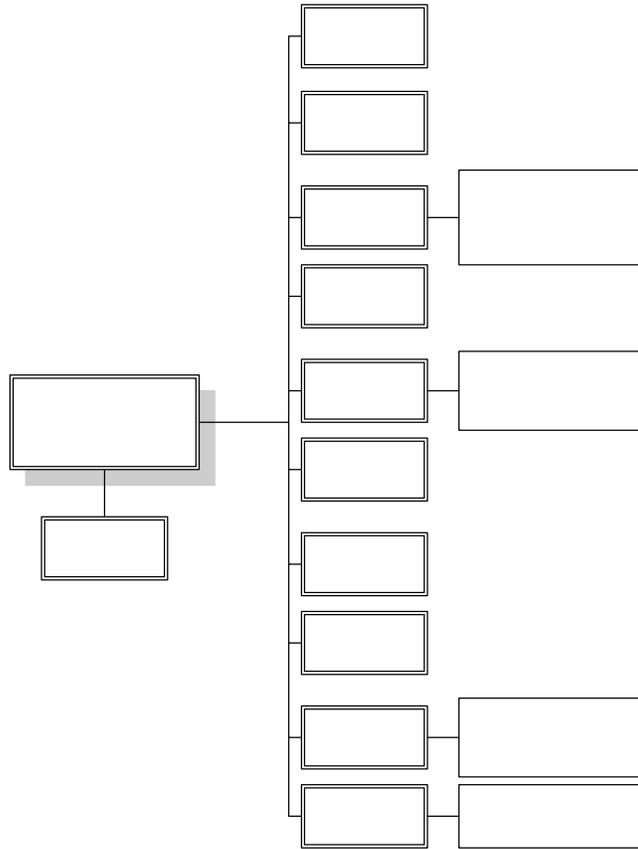
The requirements of the Standards applicable to shared services, which are discussed below, essentially disallow cross-subsidization. The findings in each shared area begin with a list of specific criteria that Liberty employed in assessing the Company's adherence to that requirement.

Organizational Structure

CECONY is neither solely nor primarily a service company, but rather an electric utility company that serves the New York City metropolitan area. Nevertheless, it provides substantial amounts of administrative support services, which are allocated between O&R and CECONY. Support services are also directly charged to CEI and to CEI's non-utility subsidiaries, which include two entities that offer and provide retail services to customers in New Jersey. CEI's costs are in turn allocated to CECONY, O&R and the unregulated subsidiaries.



An overview of CECONY is depicted below:⁷³



CECONY's administrative support services for O&R include:⁷⁴

- Finance
- Human Resources
- Information Resources
- Legal
- Logistics
- Office of the CEO and Office of the Secretary
- Public Affairs
- Transmission and Distribution
- Annual Meeting Fees
- Annual Report Fees
- Informational Advertising Fees
- Insurance Premiums
- Trustee Fees

⁷³ Material provided with October 18, 2002 letter to Liberty.

⁷⁴ Material included with October 18, 2002 letter to Liberty, GAP-040.



Information Technology

The Information Technology (“IT”) function represents one of the largest shared services activities, and was a particular focus of Liberty during the audit. The Information Resources Department of CEI consists of five major units:

- Application Services – provides corporation data and information resources, provides and maintain applications software, and facilitates change of business practices and processes through technology;
- Information Technology Planning – designs and plans information systems and communications infrastructure, architecture, and standards, and identifies emerging technologies;
- Special Projects – supports IT projects requiring cross-departmental coordination;
- Technology Services – provides design, implementation, maintenance, and technical support in the areas of data, visual communications, equipment and infrastructure; on-site technical support; LAN/WAN support; contract administration for hardware and services; WEB services; and voice communication support;
- Operations Support – plans and coordinates finances, budget, personnel and EEO.

For 2002, the budgeted costs for IT services performed by CECONY are \$44.9 million and \$14 million for those performed by O&R.⁷⁵

Shared Service Billing and Transaction Volumes

CECONY does not bill RECO directly; rather costs are charged to O&R, which in turn allocates them to RECO and Pike Electric. O&R allocates costs between Pike Electric and RECO through a FERC approved Power Supply Agreement for electric production and transmission costs and through a Joint Operating Agreement for all of its customer and administrative expenses.⁷⁶

The Competitive Opportunities Settlement Agreement with the New York Public Service Commission (“NYPSC”) set forth the method for allocation of shared administrative costs between O&R and CECONY applicable during the audit period. The allocation to O&R is based on the average of the following measures:⁷⁷

- The ratio of O&R’s net plant to total CECONY and O&R net plant
- The ratio of O&R’s payroll to total CECONY and O&R payroll
- The ratio of O&R’s gross margin to total CECONY and O&R gross margin

From January 2001 through March 2002, O&R received 6.5 percent of the cost of the shared services provided by CECONY. According to O&R, the strict application of the formula would not have yielded 6.5 percent; rather, the figure was one set by the NYPSC in a rate agreement.⁷⁸ With the expiration of the rate agreement in March, the percentage rose as of April 2002 to 7.2

⁷⁵ DR #86.

⁷⁶ DR #1. The Joint Operating Agreement is an evergreen contract effective since 1976.

⁷⁷ Material included with October 18, 2002 letter to Liberty, GAP-040.

⁷⁸ Work session, October 31, 2002.



percent, which does reflect application of the formula.⁷⁹ In calculating the formula, CECONY excludes the portion of payroll in CECONY and O&R that relates to shared services provided by each, since reportedly the intent of the calculation is to reflect operating payroll.⁸⁰

A limited number of shared services (cash receipts processing, print shop, rubber goods testing, as well as a portion of information resources) are performed by O&R and billed to CECONY; these costs are then allocated along with the costs of shared services performed by CECONY.

CECONY allocates its shared administrative service costs between itself and O&R based on budgeted, rather than actual, costs for the year.⁸¹ Estimates for shared services costs that will be direct charged to CEI or the unregulated affiliates are removed from that budget. CECONY then bills one-twelfth of the total yearly budget allocation to O&R each month through November, and costs are true-up to actual costs in December (and reflect actual rather estimated charges for services for CEI or the unregulated affiliates).⁸² Thus, any residuals between actual and budgeted costs are allocated to O&R at the same percent that applied during the rest of the year.

CECONY also pays, on O&R's behalf, for "extraordinary" items not otherwise included in the administrative support services allocation.⁸³ CECONY bills these to O&R each month as direct charges on a dollar for dollar basis. These extraordinary costs include miscellaneous administrative and general ("A&G") expenses such as outside training, membership fees for professional organization, and postage, as well as information resources capital equipment and software licenses.

O&R, in turn, charges CECONY each month for the actual costs of the shared services functions that it performs. To the extent that O&R provides any other services to CECONY other than those considered shared administrative services, the costs are to be direct billed to CECONY each month based on O&R's "internal accounting procedures."⁸⁴ For accounting purposes, CECONY's receivable from O&R is offset by CECONY's payable to O&R, and the difference is settled by a cash payment.

O&R provided to Liberty the amount of shared services charges allocated to O&R from CECONY, total O&R billings to CECONY, and the direct charges from CECONY to O&R for each month in the audit period.⁸⁵ That information is summarized below:

⁷⁹ Work session, October 31, 2002; calculations provided in DR #76.

⁸⁰ Work session, December 11, 2002. In calculating the formula for 2002 (which is based on year 2001 data), CECONY also excluded the labor costs associated with the Indian Point power plant; according to CEI, the plant had been divested but some labor costs remained in CECONY payroll for a portion of the year.

⁸¹ These estimates also include budgeted amounts for services performed by O&R.

⁸² Material included with October 18, 2002 letter to Liberty, GAP-040. Liberty found during transaction testing that the reconciliation continues into the next January if actual costs are not finalized when the December bill is created.

⁸³ O&R was also direct charged minimal amounts (a few hundred dollars per month) for other non-administrative work at fully loaded rates.

⁸⁴ Material included with October 18, 2002 letter to Liberty and GAP-040. Liberty was provided with no information on these procedures. According to a sample bill from O&R to CECONY for February 2002, there were legal costs and stores costs charged from O&R to CECONY during the month.

⁸⁵ Material included with October 18, 2002 letter to Liberty, "Summary of Allocation Costs."



Charges between CECONY and O&R

	CECONY Allocated Shared Services	O&R Billings to CECONY	CECONY Direct Charges to O&R	Net CECONY Billing to O&R
Total 2001	\$9,192,000	(\$10,886,901)	\$4,397,813	\$2,703,910
First half 2002	\$4,566,000	(\$5,765,456)	\$2,360,217	\$1,160,760

CECONY also provides goods and services to unregulated subsidiaries. For example, Energy and Development buy IT services and legal services, and Communications buys A&G services.⁸⁶ Not all affiliates buy all services, however, since they typically have their own administrative support staff (and each has a separate accounting system). The following costs are incurred by CECONY and billed to each non-utility affiliate:⁸⁷

- The salary of CECONY officers who serve as directors of the unregulated affiliates are billed to these affiliates based upon percentage of the officer’s time expended
- Corporate support services, such as auditing, law, tax and treasury, are billed to each affiliate based on the actual time spent by each employee
- Non-corporate services, such as Central Operations and Customer Service must be evidenced by a written contract and filed with the NYPSC. If these services are provided, they are billed to the unregulated affiliates at the higher of the employees fully loaded cost plus 10 percent or the price CECONY would charge a third party for those services.
- From time to time CECONY pays for certain general expenses on behalf of an unregulated subsidiary (legal fees, audit fees, etc.); these costs are accumulated in a separate billing order and charged to the affiliate monthly on a dollar for dollar basis
- CECONY pays the cost of medical, dental and other employee benefits on behalf of the affiliates. These are billed to the unregulated subsidiaries at cost plus a 2 percent administrative fee.

Salary and labor-related expenses incurred by CECONY in support of unregulated affiliates are directly assigned and billed to them each month based on “full cost allocation methods.”⁸⁸ According to Company accounting procedures, these direct costs include salaries as well as loaders for fringe benefits (pensions, health benefits, payroll taxes), office space, corporate office supplies and expenses (18.66 percent in 2002) and A&G.⁸⁹

CECONY also provides non-administrative types of services to its affiliates. For example, Communications uses CECONY for construction activities (reportedly a tariffed service).⁹⁰ For

⁸⁶ Telephone interview with representatives of CEI’s unregulated affiliates, October 31, 2002.

⁸⁷ Material included with October 18, 2002 letter to Liberty.

⁸⁸ Material included with October 18, 2002 letter to Liberty, GAP-008.

⁸⁹ Per DR #74, the office space loader is applied only for officers, however the Company clarified that it was applied to all employees who perform services for O&R, CEI or any unregulated subsidiary in DR #138. The Company uses a market rate per square foot. The 2002 office supplies and expenses loader is calculated as the ratio of total A&G salaries (PSC Account 92000) and office supplies and expenses (PSC Account 92100) for 2001. In practice, CECONY applies no A&G loader. The fringe benefit loader was negative 14.22 percent for 2002.

⁹⁰ Telephone interview with representatives of CEI’s unregulated affiliates, October 31, 2002.



certain non-regulated affiliate transactions (and third party transactions) where a comparable market price exists, CECONY uses a different fringe benefit loader. Instead of the negative 14.22 percent fringe loader for 2002 used for shared services (the loader is negative because of a large credit for pensions), CECONY used 34.08 percent (which doesn't reflect the pension credit). In these instances, CECONY also adds a 10 percent profit loader.⁹¹

Similarly, an unregulated affiliate may provide management, construction, engineering, or similar contract services to CECONY. Provision of such services must be pursuant to written contracts filed with the NYPSB. Any such costs are to be billed to CECONY in accordance with the affiliate's internal procedures.⁹²

The Company provided to Liberty a summary of administrative and general charges from CECONY to each unregulated subsidiary during the audit period.⁹³ This information is summarized below:

Charges from CECONY to Unregulated Affiliates

	Con Ed Development	Con Ed Commun.	Con Ed Energy	Con Ed Solutions
Total 2001	\$583,013	\$665,839	\$535,091	\$1,196,289
First half 2002	\$348,742	\$382,828	\$394,462	\$632,608

CECONY also provides some of these same services, plus others, to the holding company, CEI. Costs that are allocated to CEI from CECONY, as well as other costs incurred by CEI, are in turn allocated back to CECONY and O&R and to the unregulated subsidiaries. All charges from CECONY to CEI are direct charged. The services provided by CECONY to CEI include:⁹⁴

- Auditing
- Corporate Accounting
- Corporate Planning
- Employee Relations
- Legal
- Office of the Secretary
- Public Affairs
- Tax
- Treasury (including financial and investor services, operation, real estate and risk management)
- All other applicable company organizations

Each month, CECONY bills CEI for the following:⁹⁵

⁹¹ DRs #74 and 141, and work session, October 31, 2001. It is not clear what non-administrative services were charged during the audit period.

⁹² Material included with October 18, 2002 letter to Liberty, GAP-008. Liberty was provided with no information on these services.

⁹³ Material included with October 18, 2002 letter to Liberty, "Summary of Allocation Costs."

⁹⁴ Material included with October 18, 2002 letter to Liberty, GAP-006.

⁹⁵ Material included with October 18, 2002 letter to Liberty.



- Fully costed salary and labor rates of CECONY officers who serve as officers of CEI (billed as a percentage of officer's time)
- Actual time billed for support services from departments such as auditing, corporate accounting, etc.
- Corporate services performed by the Investor Services Department
- Board of Trustee and Committee meeting expenses
- Corporate Planning Department
- Annual shareholder's meeting and annual report expenses
- Other A&G expenses under work orders set up specifically for CEI (miscellaneous A&G and Times Square 2000 costs)
- Employee benefits to extent CEI employees participate in CECONY programs; these are billed to CEI at cost plus a 2 percent administrative fee (these charges are generally inapplicable, because CEI has no employees).

According to the Company's procedures, CEI's use of CECONY's accounts receivable, accounts payable, and treasury operations services were assumed to be minimal, and CECONY does not charge CEI for these services.⁹⁶

Salary and labor-related expenses incurred by CECONY in support of CEI activities are directly assigned and billed to CEI each month based on "full cost allocation methods."⁹⁷ According to the Company's accounting procedures, it applies fringe benefit, office space, office supplies and expenses, and A&G loaders to derive a fully loaded rate for these billings.⁹⁸

In addition to the costs incurred by CECONY on its behalf, CEI incurs certain direct costs related to day-to-day operations of the holding company, including bank fees, dividend account services, and other administrative fees paid directly by CEI. These fees are allocated to subsidiaries along with the charges from CECONY using a three-factor formula, which is updated annually.⁹⁹ The percentage of CEI costs allocated to each subsidiary is the arithmetical average of the following three percentages:

- Percentage of the subsidiary's total payroll dollars to the total consolidated payroll dollars
- Percentage of the subsidiary's operating revenues to the total consolidated gross margin
- Percentage of the subsidiary's average net book value of tangible assets to the consolidated average net book value of tangible assets.

Of the costs either transferred to CEI from CECONY or directly incurred by CEI, there are certain costs that do not benefit the subsidiaries; these remain at the holding company and do not get allocated. These include costs related to the failed merger with Northeast Utilities ("NU") and costs relating to CEI's investment in Pantellos, a software application. While the Pantellos system assets are retained on CEI's books, the maintenance costs associated with the system are allocated to its current users, which consist of O&R and CECONY.¹⁰⁰

⁹⁶ Material included with October 18, 2002 letter to Liberty, GAP-006

⁹⁷ Material included with October 18, 2002 letter to Liberty, GAP-006.

⁹⁸ Material included with October 18, 2002 letter to Liberty, GAP-006 Exhibit A.

⁹⁹ Material included with October 18, 2002 letter to Liberty and GAP-006.

¹⁰⁰ Work session, October 31, 2002.



The Company provided information about the percentage of CEI costs allocated to affiliates. As an example, for the month of April 2002, the following percentages and dollars of CEI costs were allocated to the subsidiaries:

CEI Charges Allocated to Subsidiaries – April 2002

	Percentage Allocated	Total Dollars
CECONY	89.88	\$441,837
Con Ed Solutions	0.66	3,245
Con Ed Development	1.90	9,342
Con Ed Energy	0.39	1,918
Con Ed Communications	0.31	1,524
O&R	6.86	33,730
Total	100.00	\$491,695

The Company also provided the amount of total charges allocated to CEI from CECONY, direct costs incurred by CEI, and CEI costs allocated to subsidiaries during the audit period.¹⁰¹ Charges to O&R from CEI amounted to \$829,026 in 2001 and \$255,137 for the first half of 2002.

Allocation of CEI Costs to O&R¹⁰²

	Total CEI Dollars Allocated	Dollars Allocated to O&R
Total 2001	\$11,997,480	\$829,026
First half 2002	\$3,719,181	\$255,137

In a typical month, charges allocated to the subsidiaries by CEI ranged between \$500-900,000. However, during June 2001, CEI incurred costs of \$3.1 million for a corporate branding campaign, which increased the costs allocated to the subsidiaries to the month to nearly \$4 million.

2. Shared Service Requirements

Section 14:4-5.5(i) of the Standards provides that:

An electric and/or gas public utility, its public utility holding company and related competitive business segments, or separate business segments of the public utility holding company created solely to perform corporate support services may share joint corporate oversight, governance, support systems and personnel. Any shared support shall be priced, reported and conducted in accordance with N.J.A.C. 14:4-5.4 and this section, respectively, set forth herein, as well as other applicable Board pricing and reporting requirements.

¹⁰¹ Material included with October 18, 2002 letter to Liberty, “Summary of Allocation Costs.”

¹⁰² Material included with October 18, 2002 letter to Liberty, “Summary of Allocation Costs.”



In addition, Section 14:4-5.5(j) of the Standards require that the joint utilization permitted above shall not:

.....create significant opportunities for cross-subsidization of a related competitive business segment of the public utility holding company.

These provisions allow shared support services but require that the shared support:

- Be priced and conducted in accordance with the Standards
- Not create the opportunity for cross-subsidization.

CECONY has a set of Corporate Accounting Procedures that set forth the methods for accounting for transactions between CECONY and O&R, between CECONY and the unregulated affiliates, and between CECONY and CEI. According to the Company, these procedures have been in effect and unchanged since 2000.¹⁰³ Corporate Accounting has the responsibility for maintaining these procedures.¹⁰⁴

As noted earlier, the NYPSC agreement sets forth the method for allocation of shared administrative costs between O&R and CECONY applicable during the audit period.

3. Audit Activities

Liberty's goal was to determine if CEI's methods of capturing costs, pricing services, and charging for shared services resulted in cross-subsidization of non-regulated affiliates. Liberty conducted interviews to learn about the organization structure, the shared services functions, and the processes used to capture costs and charge them to the benefiting entities.

Liberty also issued many data requests to help understand the functions provided by CECONY and O&R, the cost of those functions, and their allocation methods. In addition, Liberty tested transactions between CECONY and O&R, CECONY and CEI, and CECONY and non-regulated affiliates. Liberty chose transaction types to test in a manner that ensured all transaction types would be tested and that services representing large amounts of costs would be included in testing.

4. Findings, Conclusions, and Recommendations

Clarity/Completeness of Governing Documents and Procedures

Liberty applied the following evaluation criteria in examining the clarity and completeness of governing documents and procedures:

- 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 the NJ standards.

¹⁰³ October 18, 2002 letter to Liberty. The policies provided to Liberty were dated from 1997 to 1999.

¹⁰⁴ Material included with October 18, 2002 letter to Liberty.



The Company's Corporate Accounting Policies are the primary documents governing the pricing of services by CECONY, as well as the allocation of CEI costs. While these documents provide general guidance, they do not provide specific details about day-to-day procedures required to implement these policies. This shortcoming is discussed more fully in connection with transaction testing.

The Company's policies state that CECONY uses fully-loaded costs to price shared administrative services to non-regulated affiliates and to CEI. Costs for shared administrative services are directly charged to these entities using a standard rate that includes salaries, fringe benefits, an office supplies and expense loader, an office space loader, and an A&G loader. If the Company in fact charged its services this way, it would arguably be in accord with the Standards. However, the Company told Liberty it does not have an A&G rate that it adds to direct labor charges, and that the policy should be revised because it has never been used.¹⁰⁵

The Company's accounting policies are also out of date. These documents indicate that certain finance, information resources, legal, human resources, logistics, and transmission and distribution shared service functions were actually performed by O&R. O&R clarified during a work session that this portion of the policies was obsolete.¹⁰⁶ During 1999, some shared services employees still remained at O&R; they have since been transferred to CECONY. The Company clarified during a work session that gross receipts taxes are no longer applied to extraordinary items.¹⁰⁷ This practice was discontinued after 1999, but is still reflected in the policies. They do not spell out how costs for shared administrative services are to be estimated for the year 2001 or 2002; they provide only an example for year 2000 using year 1999 costs.

Conclusions: Clarity/Completeness of Governing Documents and Procedures

- a. **While CECONY's written corporate accounting policies for charging services to unregulated affiliates appear to conform to the Standards on their face, they do not in practice.**
- b. **CECONY has not sufficiently documented its methods for implementing the accounting policies.**

Recommendations: Clarity/Completeness of Governing Documents and Procedures

10. **Update the corporate accounting policies regarding the distribution of costs between companies and conform them to the Standards; develop a clear and consistent set of methods for implementing these policies.**

Adequacy of Data Collection, Analysis, Pricing Calculation Systems and Organizations

Liberty applied the following evaluation criteria in its examination of this area:

¹⁰⁵ DRs #74 and 139.

¹⁰⁶ Work session, December 11, 2002.

¹⁰⁷ Work session, December 11, 2002.



- There should be systems that have the capability to perform all required cost collection and price calculation work
- The systems should be routinely and consistently used
- The Company should use adequate means to periodically test the accuracy of the systems
- There should be adequate resources for operating the systems
- The systems should minimize error potential.

One important way that Liberty assessed the Company’s pricing systems was by means of transaction testing. The primary purpose of Liberty’s transaction testing was to determine whether the Company was executing the methods it had documented for charging out its costs. To obtain a representative sample, Liberty selected charges, both directly charged and allocated, from different months over the audit period. Liberty reviewed transactions between CECONY and O&R, CECONY and CEI (along with subsequent allocation out to affiliates), and between CECONY and a non-utility affiliate. During testing, Liberty also sought to determine whether the documentation trail was reasonably complete and whether standard rates and allocation factors were correctly calculated and applied.

Liberty’s tested transactions are summarized below:

Transaction Testing of CECONY and CEI Charges

Type of Charge	Flow of Charges	Month	Amount
<i>Allocated Charge:</i>			
Reconciliation of shared R&D:	CECONY to O&R	Year 2001	
In-house R&D (6.5%)			\$114,676
EPRI fees (6.5%)			187,456
Reconciliation of shared IT costs:		Year 2001	1,749,823
<i>Direct Charges:</i>			
Microsoft software support	CECONY to O&R	Mar. 2002	2,239
(pass-through)			
Lanar Systems	CECONY to O&R	Mar. 2002	15,408
(pass-through)			
EEI fees	CECONY to O&R	Year 2001	157,983
(joint purchase)			
Corporate branding	CECONY to CEI	June 2001	3,316,042
Legal charges	CECONY to CEI	Mar. 2001	18,825
NU merger costs			



(retained at parent)	CECONY to CEI	July 2001	376,664
Legal charges	CECONY to Development	Mar. 2001	29,925

The allocated amount of shared administrative services billed to O&R each month is based on a yearly budget, so Liberty could not conduct tests on individual cost center charges each month per se. Instead, Liberty tested the amount of shared services for R&D (including EPRI fees) and for IT that was charged to O&R for the entire year 2001 (which involves reconciling between budgeted amounts and actual costs). Liberty also reviewed the Company's calculations supporting the 7.2 percent allocation instituted beginning in April 2002.¹⁰⁸

Liberty reviewed information in the CECONY accounting system regarding total labor and non-labor costs associated with in-house R&D efforts for 2001 (\$1.764 million). Liberty reviewed the calculation of common EPRI program charges (projects that benefit both O&R and CECONY are considered part of shared services) that totaled \$2.884 million (done on separate worksheets). These actual costs were then included as part of year-end reconciliation between actual and budgeted shared administrative services. O&R's share for R&D was reconciled to be \$302,132 (6.5 percent in 2001).

Liberty then reviewed the reconciliation of shared IT charges totaling \$26.9 million in 2001, of which O&R's share should be \$1.75 million. Liberty requested backup documentation from the Company to verify that any IT charges billed to non-regulated affiliates or CEI had been removed from the total remaining charges allocated between O&R and CECONY. The Company found that it had not removed the costs for IT charged to non-regulated affiliates (\$126,083 for year 2001) in its reconciliation. The Company stated that it would true up and provide a credit to O&R for its overpayments.¹⁰⁹

Liberty also tested direct charges from CECONY to O&R for costs that pertain exclusively to O&R and are not considered part of shared administrative services. Liberty tested an invoice for Microsoft software support and one for charges from LANAR Systems. In both cases, Liberty reviewed the supporting invoices, and verified that the correct portion of the invoice was assigned to O&R and billed to O&R in the CECONY accounting system. Since CECONY and O&R have separate computer accounting systems, Liberty could not view the concomitant settlements in O&R's system. Liberty also tested joint purchases made by CECONY including EEI fees, a portion of which were in turn direct charged to O&R; this is discussed more fully in Section 5.5(h).

Liberty next tested charges from CECONY to CEI. Liberty reviewed charges for legal costs and for \$3.136 million in corporate branding costs (apparently accumulated over a three-year period but not previously charged out). Liberty reviewed the journal entries that indicated the charges were made to CEI. Liberty also reviewed the calculation of the standard rates for legal services, and established that the fringe benefit, office space, and office supplies and expenses loaders

¹⁰⁸ DR #76.

¹⁰⁹ DR #130. IT charges to affiliates for the year 2002 of \$142,191 were also not reconciled properly. O&R will receive a credit of 6.5 percent of the charges for year 2001 and 7.2 percent of the charges for 2002.



were applied (no A&G loader was applied). Liberty also reviewed monthly CEI bills allocating charges to all affiliates, and reviewed the calculation used to develop the allocation percentages used. In a separate transaction test, Liberty verified that costs retained by the parent (NU merger costs) were actually retained at CEI and not allocated.

CECONY also provides certain services to unregulated affiliates. Therefore Liberty tested a charge for legal services for March 2001 from CECONY to Con Ed Development to verify that the charges were based on the same hourly rate as that used to charge CEI for the same services. Since Development has a separate accounting system, Liberty could not view the settlement of the transaction, only the billing from CECONY. Liberty asked the Company to provide documentation that verified that these direct charges were removed from the legal services portion of shared administrative services later allocated between CECONY and O&R.

The Company responded that it did not properly credit the flow of charges to other affiliates in its reconciliation. The implication was that mistake was not only for the specific charge tested, but for all administrative expenses charged to affiliates. CECONY stated that its accounting research team was currently performing reconciliations and would determine the amount of credit that is due to O&R.¹¹⁰

Liberty expected to test an example of charges for shared services performed by O&R that are billed to CECONY (and in turn allocated between O&R and CECONY). O&R was not able to provide information about such costs at a detailed enough level for Liberty to select and test a transaction (O&R could only produce summary-level reports). Liberty therefore reviewed nothing directly in O&R's accounting system. CECONY also did not provide information about non-shared service activities performed for unregulated affiliates, and Liberty was unable to test any transactions. However, since sales of such non-administrative services to O&R were minimal, there would be little opportunity for cross-subsidization for those services.

There was evidence that procedures were not well understood throughout the organization. As an example, Liberty asked for information about loaders applied to standard rates. The Company provided a sample of a standard rate without an office expense loader, and stated that this loader was used only for officers; this response was in direct contrast to its accounting policies.¹¹¹ During transaction testing, Liberty found that this overhead was being applied for legal services. The Company later clarified that indeed the office space loader was used for all employees.¹¹²

Conclusions: Adequacy of Data Collection, Analysis, Pricing Calculation Systems and Organizations

- a. CECONY does not have sufficient control over the procedures and systems used to accomplish the required data collection, analysis, and pricing calculations necessary to support charging for shared services.**

¹¹⁰ DR #134. The Company was unclear in its response whether this mistake occurred in the year 2002 as well.

¹¹¹ DR #74.

¹¹² DR #138.



- b. CECONY does not have adequate detailed documentation that explains the day-to-day implementation of its corporate accounting policies.**
- c. The procedures in place do not minimize the potential for error; the dollar impact of the shortcomings in the CECONY process is not known, and may be much more significant than that uncovered during testing.**

Recommendations: Adequacy of Data Collection, Analysis, Pricing Calculation Systems and Organizations

- 11. Improve existing procedures to strengthen control over the data collection, analysis and pricing calculation for shared services.**
- 12. Conduct an examination by Internal Audit to validate that data collection, analysis and pricing of shared services are done accurately and consistently.**
- 13. Conduct an examination of all shared administrative services costs for the years 2001 and 2002 to determine the extent of errors similar to those uncovered during transaction testing, make necessary corrections, and validate the accuracy and completeness of administrative services costs.**

Cost Charging Methods (e.g., use of general allocators versus direct charging)

Liberty employed the following criteria in examining this area:

- General allocators should not be used in cases where they cannot be shown to have a direct and representative relationship to the entities and factors that cause costs to be expended
- General allocators should be tailored to the cost causation factors; *i.e.*, over-reliance upon a single simplistic formula is not favored
- General allocators should not be used where there are reasonably efficient alternatives, such as direct charging, that would be demonstrably more effective in assuring that utility customers do not subsidize non-utility operations
- There should be adequate time reporting procedures to assure that costs directly attributable to a given affiliate are charged to that affiliate.

Standard rates used for direct charging these entities include salaries, benefits, an office supplies and expense loader, and an office space loader. These rates do not, however, include the indirect costs of all other shared services. As an example, a non-regulated affiliate charged for a CECONY lawyer would not reflect the cost of payroll processing, IT services, human resources, etc., that are associated with that employee. Instead, those costs remain as part of the total remaining shared service costs allocated between O&R and CECONY. Although the Company's accounting policies state that it uses such an A&G loader, it in fact does not and never has. As a result, the regulated utilities are cross-subsidizing a portion of the indirect costs associated with direct charges to the unregulated affiliates. The same is true of all direct charges from CECONY to CEI. CECONY should develop and institute an A&G loader for all direct charges to unregulated affiliates and CEI.



Liberty is concerned that the unregulated affiliates may make more use of CECONY shared administrative services than is reflected in direct charges to them. One way to determine this would be to conduct a time study of all the CECONY departments that provide shared services to determine if affiliates make a standard, recurring and difficult to segregate used of these services. The results of this study could then be reconciled to the amount of administrative-type services that the non-regulated affiliate performs for itself, in order to determine that the affiliates are not relying on CECONY services through unrecorded activities.

CECONY has the most simplistic form of allocation of all four New Jersey electric utilities – it simply charges a flat percentage of shared administrative costs to O&R. The percentage allocated to O&R was approved by the NYPSC. According to O&R personnel, the percentage was meant to represent an overall balance, rather than being accurate for each given category of shared services costs.¹¹³ For example, O&R may use much more than 7.2 percent of a given service (such as IT), but less than 7.2 percent of another. Liberty is not aware of any analysis undertaken by the Company to identify whether the cost have been fairly apportioned between O&R and CECONY. However, any improvements in an allocation formula are likely to produce relatively small effects on the cost actually borne by RECO.

The allocation of CEI costs among the subsidiaries is based on a three-factor formula based on payroll, operating revenues, and net book values. Although it has not been established that this formula is necessarily equitable, Liberty believes that it is likely to produce reasonably equitable results. For example, the non-regulated affiliates in total are roughly half the size of O&R (based on assets). As indicated on an earlier chart, the non-regulated affiliates received a total of 3.26 percent of CEI costs, while O&R received 6.86 percent. Finding a better formula would arguably produce a relatively small effect.

Conclusions: Cost Charging Methods

- a. CECONY's standard rates for shared administrative services to non-regulated affiliates and to CEI result in cross-subsidization by failing to include an A&G loader.**
- b. The formula used to allocate shared administrative services between CECONY and O&R is not perfect, but improved allocation methods are likely to result in only modest changes to RECO.**
- c. CEI's method for allocating its costs produces reasonably equitable results.**

Recommendations: Cost Charging Methods

- 14. Develop and institute an A&G loader to be included in standard rates used for direct charges to non-regulated affiliates and CEI.**
- 15. Provide for a systematic review of unrecorded usage of CECONY shared administrative services by the non-regulated affiliates.**

¹¹³ Work session, December 11, 2002.



Overhead Pools

Liberty applied the following evaluation criteria in examining this area:

- Overhead pools should be designed to add only costs properly associated with the underlying direct costs
- Where different activities require demonstrably different types or levels of overhead or support activity, distinct pools or percentages of the same pool should be developed
- Overhead rates should be uniformly and consistently applied to all activities to which they logically apply
- There should exist sound documentation to support the calculation of all overhead rates.

Liberty reviewed the Company's supporting calculations of the fringe benefit and office supplies and expense loader, which is applied to direct charges from CECONY to non-regulated affiliates and CEI.¹¹⁴ The office supplies and expenses loader is calculated as the ratio of total A&G salaries (PSC Account 92000) and office supplies and expenses (PSC Account 92100) for the prior year, *i.e.*, dollars of supplies and expenses per dollar of A&G salaries. For the transactions that Liberty reviewed for direct charges from CECONY to CEI and to an unregulated affiliate, both loaders had been properly applied.

Liberty reviewed the supporting documentation for the office space loader, which consisted of a list of market rates in the boroughs of New York prepared by the Company's real estate department. The \$27 per square foot office space loader is merely the arithmetic average of these market rates. The Company stated that it uses a market rate per square foot, rather than the true costs of facilities; the Irving Place building has been owned for over 100 years and would not reflect the true cost of office space in Manhattan.¹¹⁵ Therefore, CECONY charges affiliates and CEI for costs in excess of those that it actually incurs. For the transactions that Liberty reviewed for direct charges from CECONY to CEI and to an unregulated affiliate, this loader had been properly applied.

Although the Company's procedures state that an A&G loader is to be applied to all CECONY charges to unregulated affiliates and CEI, the Company had reportedly never done so. This issue was addressed previously in the *Cost Charging Methods* portion of this section of his report.

Conclusions: Overhead Pools

- a. The fringe benefit and office and supplies expense loaders were properly calculated and applied.**
- b. The office space loader for charges to non-utility affiliates exceeds actual costs.**

Recommendations: Overhead Pools

Liberty has no recommendations in this area.

¹¹⁴ DR #74.

¹¹⁵ DR #138.



Pricing (e.g., using and reconciling budget-based pricing)

The evaluation criteria that Liberty applied in examining this area were:

- Where budgets are used to develop prices, they should bear a reasonable relationship to experience and to final future results, subject to the effects of significant, unforeseen contingencies;
- Where prices based on budgets are used, there should be a reconciliation both to final costs and to ultimate actual usage of the service involved.

CECONY allocates its shared administrative service costs to O&R on the basis of budgeted, rather than actual, costs for the year. Estimates for shared services costs that will be direct charged to CEI or the unregulated affiliates are to be removed from that budget. CECONY then bills one-twelfth of the total yearly budget allocation to O&R each month through November, and costs are trued-up to actual costs in December. The actual direct charges for services to CEI or the unregulated affiliates are to be reconciled.

To the extent that too much or too little had been charged to O&R during year, the difference is reconciled at the same percentage that applied during the rest of the year (*i.e.*, 6.5 percent for 2001). There is nothing inherently incorrect about using this process to reconcile budgets to actual costs for shared administrative services charged to O&R, assuming it is executed correctly. This also assumes that an appropriate A&G loader is included in the standard rate used to charge CEI and the non-regulated affiliate, however.

CECONY allocates its shared administrative service costs to CEI and the non regulated affiliates based upon actual costs. The CAABS system is linked to the payroll system so that employees' actual salary is charged to the affiliates. However, overhead rates are based upon prior year actual costs. These rates are updated annually, but any difference between prior year actual and current costs are not reconciled.

Conclusions: Pricing

- a. The process for year-end reconciliation of budgeted to actual costs for shared services allocated between O&R and CECONY is sound, if properly executed.**
- b. CECONY does not reconcile the actual cost for services provided by it to CEI or to the unregulated affiliates, and any shortfalls are born by the regulated utilities.**

Recommendations: Pricing

- 16. Reconcile the standard rate to actual costs for shared services directly charged to unregulated affiliates and CEI.**

Parent Cost Retention

Of the costs either transferred to CEI from CECONY or directly incurred by CEI, there are certain costs that do not benefit the subsidiaries; these remain at the holding company and do not



get allocated. These include cost related to the failed merger with Northeast Utilities (“NU”) and costs relating to CEI’s investment in Pantellos, a software application.

Conclusions: Parent Cost Retention

- a. Liberty concludes that cost retention by CEI does not represent a vehicle for cross-subsidization.**

Recommendations: Cost Retention

Liberty has no recommendations regarding this topic.

J. Protection of Confidential and Market Information

1. Statement of Applicable Requirements

Section 14:4-5.5(j) of the Standards provides that:

Such joint utilization shall not allow or provide a means for the transfer of confidential customer or market information from the electric and/or gas public utility to a related competitive business segment of its public utility holding company in violation of these standards, create the opportunity for preferential treatment or unfair competitive advantage, lead to customer confusion, or create significant opportunities for cross-subsidization of a related competitive business segment of the public utility holding company.

2. Summary of Audit Activities

This provision prohibits the utility from sharing confidential customer and market information with the holding company and related competitive business segments. The purpose of this prohibition is to prevent opportunities for cross-subsidies, customer confusion, and unfair competitive advantage. Cross-subsidies and unfair market advantages could occur in ways such as the following:

- Identification of new market opportunities
- Information concerning strategic direction of the company
- Acquiring market sensitive and related information
- Providing an opportunity for customer confusion between the identity of the utility and its PUHC and/or its RCBS

This provision addresses the transfer of both customer and market information. A number of other provisions in the Standards address the protection of customer information. Liberty addresses the sufficiency of those protective efforts in connection with its discussion of those standards. Therefore, the focus of audit activities here was marketing.

The criteria that Liberty employed in examining performance under this provision were:



- Whether adequate steps are taken to prevent the transfer of protected information during planning activities
- Whether the utility compliance plan adequately addresses responsibilities imposed by this provision of the Standards.

Through the use of data requests and interviews, Liberty reviewed and analyzed the planning process at the utility and holding company as it relates to this provision of the standards. Liberty sought to determine whether competitive sensitive information was shared during the planning cycle, and what controls were in place to ensure that competitive sensitive information generated at the utility was not used by affiliates.

As its initial step, Liberty reviewed the utility's compliance plan and its procedures for complying with the Standard. Then through the use of data requests and interviews, Liberty attempted to identify opportunities in joint processes between the utility and its PUHC and/or RCBS where inappropriate sharing of information could occur. Liberty then reviewed and analyzed select processes to ensure that adequate controls were in place to protect competitively sensitive information. To assess the controls, Liberty reviewed the information flows, the granularity of the information, who had access, and how was it used. Because of the amount of data and its competitive sensitivity, particular emphasis was placed on the planning process at the utility and the PUHC.

Liberty first identified the group or groups responsible for planning at the utility and holding company, then sought to determine the type of information and the granularity of the information provided by the utility to the holding company. Liberty then attempted to determine how information was protected as it moved through the planning process. Liberty reviewed the internal controls to determine whether they were adequate to limit the dissemination of the information among the various affiliates during high level planning sessions.

3. Findings

Initially, O&R contended that neither it nor its affiliates provide competitive services within its service territory, so it did not respond to the data request regarding this standard.¹¹⁶ Liberty identified the group or groups responsible for planning at Orange and Rockland.¹¹⁷ At RECO, the Corporate Policy Committee is responsible for high-level business planning, financial forecasting and budgeting.¹¹⁸

Liberty requested information about how RECO retains ownership and control of disaggregated and competitively sensitive information that is used to create its business plan, and whether O&R planning practices limit access to its competitively sensitive information. RECO said that proposed corporate budgets and financial reports are provided on a consolidated basis, and discussed with CEI, and that this information is never shared with unregulated affiliates. The Company also indicated that O&R does not share any customer usage data or competitively

¹¹⁶ DR #23.

¹¹⁷ DR #123.

¹¹⁸ DR #123.



financial information with any affiliate. O&R maintains separate billing systems and financial records from affiliates and only O&R authorized personnel have access to these records.¹¹⁹

RECO does not have any related competitive business segments operating within its territory that could take advantage of confidential information gained during the operation of the electric utility.¹²⁰

4. Conclusions

- a. RECO was in compliance with this provision of the Standards during the audit period.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

K. Use of Utility Name and Logo

1. Statement of Applicable Requirements

Section 14.4-5.5(k) of the Standards provides that:

A related competitive business segment of a public utility holding company shall not trade upon, promote, or advertise its relationship with the electric and or gas public utility, nor use the electric and/or gas public utility's name and/or logo in any circulated material, including, but not limited to, hard copy, correspondence, business cards, faxes, electronic mail, electronic or hardcopy advertising or marketing materials, unless it discloses clearly and conspicuously or in audible language that:

- 1. The PUHC or related competitive business segment of the public utility holding company "is not the same company as [LDC's NAME HERE], the electric and/or gas public utility";*
- 2. The PUHC or related competitive business segment of the public utility holding company is not regulated by the Board; and*
- 3. "You do not have to buy [RELATED COMPETITIVE BUSINESS SEGMENT'S NAME HERE] products in order to continue to receive quality regulated services from the electric and/or gas public utility."*

2. Summary of Audit Activities

These provisions address how a holding company RCBS may promote itself, particularly if it shares a similar name or logo with the regulated utility. A holding company RCBS may not use its connection with the utility to promote itself, nor may it use the utility's name or logo in any

¹¹⁹ DR #153, 154 and 155.

¹²⁰ DR #17.



form of communication, unless it clearly and conspicuously provides the required disclaimer. The disclaimer is required only with regard to the use of the utility's name or logo in New Jersey.

Liberty requested information concerning the use of logos, trademarks and service marks, in order to determine whether there was any shared use of the utility name or logo, and, if so, whether the required disclaimer was prominently displayed. Liberty requested copies of utility and affiliate logos, trademarks and service marks and details of where the marks were used.

Liberty also reviewed the websites and utility compliance plan for adherence to these standards.

3. Findings

The O&R website shows only the O&R logo, a stylized combination of the letters "O" and "R." The single reference to Con Ed, in the "About O&R" section, shows a text link and no logo or identifying mark. There are no references to any affiliates; in fact, the utility names (Rockland Electric and Pike Electric) are not mentioned; instead, customers access the appropriate company by selecting the state of residence.

The CEI homepage shows the Con Ed logo, a stylized "C" surrounding a stylized "E." O&R's website may be accessed by a link to the O&R homepage. The RCBSs are also shown on the CEI website, and may be accessed by a link. The Solutions and Communications affiliates each have their own logo and identifying marks, neither of which is similar to either Con Ed's or O&R's. Neither homepage has any reference to utility affiliates. Because there are no references among the affiliated companies' websites to other affiliates, the disclaimer required under the Standards is not necessary.

RECO did not respond to Liberty's data requests until after the draft report; therefore Liberty could not determine what the marketing materials say that may be relevant to this provision.

4. Conclusions

- a. Liberty cannot definitively determine whether affiliates reference RECO by name or through use of shared marks in marketing materials.**

Liberty believes it would be unlikely that the O&R logo would be used in materials for Solutions or Communications, given the differences in the logos and marks used on the respective website homepages.

- b. The O&R and Con Ed websites meet the Standards in terms of not trading on the utility name or sharing marks or logos without a disclaimer.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.



L. Non-New Jersey Use of Utility Name and Logo

Section 14.4-5.5(l) of the Standards provides that:

The requirement of the name and/or logo disclaimer set forth in (k) above is limited to the use of the name and/or logo in New Jersey.

This section of the standards does not provide a conduct standard that is auditable. It merely narrows the restrictions imposed by standard Section 14:4-5.5(k).

M. Promising or Implying Preferred Treatment

1. Statement of Applicable Requirements

Section 14:4-5.5(m) of the Standards provides that:

An electric and/or gas public utility, through actions or words, shall not represent that, as a result of its PUHC or a related competitive business segment of the public utility holding company's relationship with the electric and/or gas public utility, its affiliate(s) will receive any different treatment than other product and/or service providers.

2. Summary of Audit Activities

The requirements of this section are similar to those of Sections 14:4-5.3(a) and (c). Liberty's audit activities were the same as those set forth for Sections 14:4-5.3(a) and (c).

3. Findings

Liberty's findings are the same as those set forth for Sections 14:4-5.3(a) and (c).

4. Conclusions

Liberty's conclusions are the same as those set forth for Sections 14:4-5.3(a) and (c).

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

N. Use of Utility Advertising Space

1. Statement of Applicable Requirements

Section 14:4-5.5(n) of the Standards provides that:



An electric and/or gas public utility shall not offer or provide to its PUHC or a related competitive business segment of its public utility holding company advertising space in the electric and/or gas public utility's billing envelope(s) or any other form of electric and/or gas public utility's written communication to its customers unless it provides access to all other unaffiliated services providers on the same terms and conditions.

2. Summary of Audit Activities

These provisions prohibit joint marketing activities between the utility and an RCBS of its holding company. The utility may not promote the holding company RCBS in its billing envelope or in other written communication unless competitors are offered the same opportunity. Liberty applied the following criterion in examining performance under this standard:

- If space is provided to an RCBS in any written communications to utility customers, it must be similarly provided to others.

Liberty requested information about all joint marketing activities pertaining to compliance with these provisions of the Standards. Liberty also requested a copy of all inserts included with utility bills during the audit period. Liberty also reviewed the utility compliance plan with regard to this section of the Standards.

3. Findings

The Company stated that neither O&R nor RECO has engaged in any joint marketing, promotional, or advertising activities with Con Edison Solutions, Con Edison Energy, or Con Edison Development.¹²¹ RECO stated the Company did not utilize any bill inserts relating to the competitive services offered by Solutions, Energy, or Development; it did not, however, provide copies of bill inserts.¹²²

4. Conclusions

- a. RECO represented that it did not provide its affiliates advertising space in its bill inserts, although the Company did not timely provide copies for verification.**

5. Recommendations

Liberty has no recommendations regarding this requirement of the standard.

O. Joint Advertising or Marketing

1. Statement of Applicable Requirements

Section 14:4-5.5(o) of the Standards provides that:

¹²¹ DR #47.

¹²² DR #48.



An electric and/or gas public utility shall not participate in joint advertising or joint marketing activities with its PUHC or related competitive business segment of its public utility holding company which activities include, but are not limited to, joint sales calls, through joint call centers or otherwise, or joint proposals (including responses to requests for proposals) to existing or potential customers.

- 1. The prohibition in (o) above notwithstanding, at a customer's unsolicited request, an electric and/or gas public utility may participate, on a nondiscriminatory basis, in non-sales meetings with its PUHC or a related competitive business segment of its public utility holding company or any other market participant to discuss technical or operational subjects regarding the electric and/or gas public utility's provision of distribution service to the customer;*
- 2. Except as otherwise provided for by these standards, an electric and/or gas public utility shall not participate in any joint business activity(ies) with its PUHC or a related competitive business segment of its public utility holding company which includes, but is not limited to, advertising, sales, marketing, communications and correspondence with any existing or potential customer;*
- 3. An electric and/or gas public utility shall not participate jointly with its PUHC or a related competitive business segment of the PUHC in trade shows, conferences, or other information or marketing events held in New Jersey; and*
- 4. An electric and/or gas public utility shall not subsidize costs, fees, or payments with its PUHC or related competitive business segments of its public utility holding company associated with research and development activities or investment in advanced technology research.*

2. Summary of Audit Activities

These provisions prohibit joint marketing activities or the joint funding or support of research and development activities between the utility and an RCBS of its PUHC. Joint advertising or marketing activities between the utility and the PUHC RCBS are prohibited, including (but not limited to):

- Joint sales calls
- Joint call centers
- Joint proposals or responses to RFPs
- Joint advertising, marketing, communications, or correspondence
- Joint participation in trade shows, conferences, or other information or marketing events held in New Jersey
- Joint business activities

The utility may, at the customer's unsolicited request, participate in non-sales meetings with its PUHC RCBS in order to discuss technical or operational subjects regarding the provision of distribution services, provided the same participation is offered on a nondiscriminatory basis to



competitors. Subsidization by the utility of R&D costs, fees, or payments with the PUHC RCBS is prohibited.

Liberty applied the following criteria in examining performance under this standard:

- Except in the case of unsolicited customer requests, the utility should not engage in any of the proscribed joint marketing and sales activities
- The utility should not participate with its holding company or a holding company RCBS in joint funding of research and development activities in a manner that fails to assign a proper share of the costs to the holding company or holding company RCBS.

Liberty requested information on all joint marketing, promotional, and advertising programs that benefited both regulated and competitive services; in particular, Liberty also asked about sharing of space at trade shows. Liberty also requested information on practices and policies for utility participation in non-sales meetings with affiliates or non-affiliates. Liberty has also reviewed the utility compliance plan for its procedures regarding this section of the Standards.

Liberty also interviewed utility personnel and requested information on the amount of research and development and advanced technology expenditures by the utility and the PUHC or a PUHC RCBS. Support costs for the Electric Power Research Institute (EPRI) are considered R&D costs for the purposes of this audit. As part of Liberty's transaction testing, Liberty tested a transaction involving payment of EPRI charges.

3. Findings

Joint Marketing

The Company stated that neither O&R nor RECO has engaged in any joint marketing, promotional, or advertising activities with Con Edison, Con Edison Energy, or Con Edison Development.¹²³ The Company also stated that neither O&R nor RECO participated in non-sales meetings with any affiliates in order to discuss customer technological or operational subjects regarding the provision of distribution service. However, the utility's Retail Access department participates in communications meetings with energy services companies at least twice a year to discuss the developing deregulated market, and to answer any questions that they may have in participating in retail choice.¹²⁴

R&D

CEI told Liberty that only certain R&D costs are considered part of shared services to be allocated between CECONY and O&R: costs for the R&D administrative function at CECONY, and EPRI fees associated with transmission, distribution, and manufactured gas plant projects. Historically, CECONY had been very active in research, and the New York Commission, as part of its ruling on the merger, specified that CEI could not share all of its costs for research with O&R (such as nuclear programs).

¹²³ DR #47.

¹²⁴ DR #145.



According to CEI, for the 18-month period, the cost allocation to O&R from CECONY (both R&D department costs and EPRI fees) was \$447,000. RECO paid 30 percent of the total R&D shared services costs allocated to O&R from CECONY, or \$134,000.¹²⁵ During the same period, CEI spent \$19.873 million for R&D and EPRI. During transaction testing, Liberty reviewed the charges for shared R&D for 2001, as discussed more fully in Section 5.5(h). Of \$14.5 million in total CEI R&D costs for the year 2001, \$4.8 million (roughly \$1.8 million in R&D department administrative costs and \$2.9 million in EPRI fees) were included in shared services that were allocated between CECONY and O&R.

According to CEI, unregulated subsidiaries are only billed for specific EPRI programs for which they may benefit. However, RECO was unaware of any specific policies, procedure, or guidelines addressing when non-regulated affiliates pay for R&D costs. Reportedly, the unregulated subsidiaries are supporting one EPRI program related to distribution resources (\$50,000 in 2002). During the audit period, CEI has also invested approximately \$500,000 in advanced technology, including an investment with Ambient Corporation. The original expense was all charged exclusively to CECONY, and RECO was not charged for any of the dollars charged to CECONY because it is not considered a shared services R&D expense.¹²⁶

4. Conclusions

- a. RECO represented that it had not engaged in any joint marketing programs with Solutions, Communications or Development and that it had not participated in any non-sales meetings regarding customer technological or operational subjects.**
- b. RECO does not appear to be subsidizing research and development activities or advanced technology funding with its affiliates.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

P. Joint Employees

1. Statement of Applicable Requirements

Section 14:4-5.5(p) of the Standards provides that:

Except as permitted in (i) and (j) above, an electric and/or gas public utility and its PUHC or related competitive business segments of its public utility holding company which are engaged in offering merchant functions and/or electric related services or gas related services shall not employ the same employees or otherwise retain, with or without compensation, as employees, independent contractors, consultants, or otherwise.

¹²⁵ DR #67.

¹²⁶ DR #67.



1. *Other than shared administration and overheads, employees of the competitive services business unit of the public utility holding company shall not also be involved in the provision of non-competitive utility and safety services, and the competitive services are provided utilizing separate assets than those utilized to provide non-competitive utility and safety services.*

2. Summary of Audit Activities

The criteria that Liberty employed in examining performance under this provision were:

- Whether any employee of a holding company RCBS was provided to the utility as an employee, consultant, or independent contractor for the performance of non-competitive utility and safety services.
- Whether there was any sharing of employees between the utility and a holding company RCBS engaged in the merchant function.

Liberty requested and analyzed information from the utility identifying which, if any, employees of affiliates (other than a service company and the holding company) provide non-competitive utility and safety services.

3. Findings

O&R and CECONY perform various non-competitive services in accordance with the provisions of their respective tariffs.¹²⁷ O&R stated that, to the best of its knowledge, during the audit period, it did not employ the same employees or outside contractors as were employed by the PUHC or an RCBS engaged in merchant functions or electric/gas-related services.¹²⁸

4. Conclusions

- a. **O&R/RECO was in compliance with this section of the Standards during the audit period.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

Q. Common Directors and Officers

1. Statement of Applicable Requirements

Section 14:4-5.5(q) of the Standards provides that:

¹²⁷ DR #151.

¹²⁸ DR #152.



An electric and/or gas public utility and the PUHC or related competitive business segments of its public utility holding company shall not have the same persons serving on the Board of Directors as corporate officers, except for the following circumstances:

- 1. In instances when these standards are applicable to public utility holding companies, any board member or corporate officer may serve on the holding company and with either the electric and/or gas public utility or a related competitive business segment of the public utility holding company, but not both the electric and/or gas public utility holding company and a related competitive business segment of the public utility holding company.*
- 2. Where the electric and/or gas public utility is a multi-state utility, is not a member of a holding company structure, and assumes the corporate governance functions for the related competitive business segments, the prohibition against any board member or corporate officer of the electric and/or gas public utility also serving as a board member or corporate officer of a related competitive business segment shall only apply to related competitive business segments operating within New Jersey.*
 - i. In the case of shared directors and officers, a corporate officer from the electric and/or gas public utility and holding company shall verify, subject to Board approval, in the electric and/or gas public utility's compliance plan required pursuant to N.J.A.C. 14:4-5.7(a) through (e), the adequacy of the specific mechanisms and procedures in place to ensure that the electric and/or gas public utility is not utilizing shared officers and directors in violation of the Act or these standards.*

These provisions prohibit the occurrence of common Directors and Officers between a utility and any related competitive business segment of the utility's holding company.

2. Summary of Audit Activities

Liberty requested a list of Directors and Officers for each company in addition to asking for any information on any position changes that were made during the audit period¹²⁹.

3. Findings

The following are the instances of common officers and/or directors between the utility and an RCBS of the utility's holding company:

Robert P. Stelben served as a Director at both Solutions and Communications and also served as Treasurer of Rockland Electric Company.

¹²⁹ DR#65.



Stephen B. Bram served as Chairman of the Board of Directors at Solutions and also served as Director and President of Rockland Electric Company.

4. Conclusions

- a. RECO and O&R are not in compliance with Section 14:4-5.5(q) of the Standards, as there exist instances where individuals served as a Director and/or an Officer for both a utility and an RCBS of the utility's holding company.**

5. Recommendations

- 17. Reposition the duties of individuals who serve as a Director and/or an Officer for both a utility and a related competitive business segment of the utility's holding company so that RECO and O&R are in compliance with the standard.**

R. Employee Transfers

1. Statement of Applicable Requirements

Section 14:4-5.5(r) of the Standards provides that:

All employee transfers between an electric and/or gas public utility and its PUHC or related competitive business segments of its public utility holding company providing or offering competitive services to retail customers in New Jersey which are engaged in offering merchant functions and/or electric related services or gas related services shall be consistent with following provisions:

- 1. The electric and/or gas public utility shall make a public posting of all employee transfers within three working days.*
- 2. An electric and/or gas public utility shall track and report annually to the Board all employee transfers between the electric and/or gas public utility and such related competitive business segments of its public utility holding company.*
- 3. Once an employee of an electric and/or gas public utility is transferred to such related competitive business segment of its public utility holding company, said employee may not return to the electric and/or gas public utility for a period of one year, unless the related competitive business segment of the public utility holding company to which the employee is transferred goes out of business or is acquired by a non-affiliated company during the one-year period.*
- 4. In the event that an employee is returned to the electric and/or gas public utility, such employee cannot be transferred for employment by a related competitive business segment of the public utility holding company which is engaged in offering merchant functions and/or electric-related services or gas-related services for a period of one year.*



2. Summary of Audit Activities

These provisions limit the competitive impact on unaffiliated suppliers of public utility employee movement from or to the PUHC or a related competitive business segment. To the extent that transfers occur, the provision makes them transparent to regulators and competitors. These limitations prevent PUHCs and related competitive business segments from gaining competitive advantage through inappropriate transferring of employees to or from the public utility. Advantages could be gained in the following manners:

- Frequent transfer of employees with special expertise or knowledge
- Joint use of employees with special expertise and/or knowledge
- Transferring employees utilizing knowledge or transporting information gained at the electric utility for the benefit of the PUHC or related competitive business sector or vice versa.

Liberty sought to determine if employee transfers from the utility to a holding company or holding company RCBS occurred during the audit period. If there were any, Liberty would then ascertain whether the utility had publicly posted the information within the three working day period. Liberty proceeded to determine if a transferring employee was provided proper instructions on the employee's use of retained information. Liberty also sought to determine if the utility made any required annual filing of employee transfer information with the Board.

In addition, Liberty sought to determine whether any employee that did transfer from the utility to the holding company or holding company RCBS and vice-versa met the one-year requirement on transferring back to the previously held job at the affected entity. As a part of this evaluation Liberty determined whether employees were properly instructed on confidential, competitively-restricted information prior to and after the transfer. Liberty also evaluated whether equipment, files, and other related paper were transferred or retained by the utility or a transferring employee.

If there were any, Liberty then intended to ascertain whether O&R/RECO had publicly posted the information within a three working day period. In addition, Liberty would determine whether any employee that did transfer from the public utility to the PUHC and vice-versa met the one-year restriction prior to transferring back to the previously-held job at the affected entity. Liberty would also determine if RECO had filed its annual report with the Board during the audit period.

3. Findings

Liberty sought to determine if employee transfers from O&R (RECO has no employees of its own) to the PUHC or related competitive business segments occurred during the audit period. RECO reported that there had been no employee transfers during the audit period from the utility to either the PUHC or a related competitive business.¹³⁰ Similarly, O&R has not transferred any employees with less than one year in their job. As such, reporting and posting requirements under the Standard are not applicable.

¹³⁰ DRs #13 and 14.



RECO does have in place a procedure to report employee transfers from or to its PUHC or related competitive business within the three working days as required by the Standards.

4. Conclusions

- a. RECO and O&R are in compliance with the employee transfer provisions of Section 14:4-5.5(r).**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

S. Use of Utility Information After Employment Transfers

1. Statement of Applicable Requirements

Section 14:4-5.5(s) of the Standards provides that:

Employees transferring from an electric and/or gas public utility to a related competitive business segment of the public utility holding company are expressly prohibited from using any information gained from the electric and/or gas public utility to the benefit of the related competitive business segment of the public utility holding company or to the detriment of other unaffiliated product and/or service providers.

- 1. Any electric and/or gas public utility employee hired by a related competitive business segment of the public utility holding company shall not remove or otherwise provide information to said affiliate which said related competitive business segment of the public utility holding company would otherwise be precluded from having pursuant to these standards.*
- 2. An electric and/or gas public utility shall not make temporary or intermittent assignments, or rotations to related competitive business segments of its public utility holding company.*

2. Summary of Audit Activities

The first provision prohibits inappropriate use of utility information by transferred employees. The second prohibits rotations that would have the effect of making such information available without permanent transfer.

As a threshold matter, Liberty first sought to determine if employee transfers from the utility occurred during the audit period. Liberty reviewed utility employment practices, and analyzed severance or exit procedures used when an employee transfers to an affiliated company. Liberty also inquired whether any public utility employees were provided temporary or intermittent jobs with the holding company or holding company RCBS. Liberty also reviewed the utility



compliance plan and conducted interviews concerning temporary assignments, transfers, and rotations with human resources personnel.

3. Findings

Liberty determined that no employee transfers took place during the audit period; therefore, Liberty had no occasion to perform an examination of compliance with the first portion of this standard.¹³¹ There was no occasion during the audit period for RECO business information to be made available through employee transfers or rotations.¹³²

4. Conclusions

- a. The lack of employee transfers during the audit period means that there was no occasion for inappropriate transfer of information proscribed by this section.**
- a. There were no prohibited temporary assignments or rotations during the audit period.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

T. Service Transfers

1. Statement of Applicable Requirements

Section 14:4-5.5(t) of the Standards provides that:

All transfers of services not prohibited by these standards shall be subject to the following provisions:

- 1. Transfers from the electric and/or gas public utility to a related competitive business segment of its public utility holding company of services produced, purchased or developed for sale on the open market by the electric and/or gas public utility will be priced at no less than the fair market value.*
- 2. Transfers from a related competitive business segment of the public utility holding company to the electric and/or gas public utility of services produced, purchased or developed for sale on the open market by the related competitive business segment of the public utility holding company shall be priced at no more than fair market value.*
- 3. Prices for services regulated by a state or Federal agency shall be deemed to be the fair market value.*
- 4. Services produced, purchased or developed for sale on the open market by the electric and/or gas public utility shall be provided to related*

¹³¹ DRs #13 and 14.

¹³² DR #146.



competitive business segments of its public utility holding company and unaffiliated company(ies) on a nondiscriminatory basis, except as otherwise required or permitted by these standards or applicable law.

5. *Transfers of services not produced, purchased or developed for sale on the open market by the electric and/or gas public utility from the electric and/or gas public utility to related competitive business segments of its public utility holding company shall be priced at fully allocated cost.*
6. *Transfers of services not produced, purchased or developed for sale on the open market by a regulated competitive business segment of the public utility holding company from that related competitive business segment of the public utility holding company to the electric and/or gas public utility shall be priced at the lower of fully allocated cost or fair market value.*

These provisions require that:

- “Open market” services the utility provides to an RCBS of the PUHC are priced at no less than fair market value and are provided on a nondiscriminatory basis. Note that regulated services are at fair market value.
- “Open market” services an RCBS of the PUHC provides to the utility are priced at no more than fair market value. Note that regulated services are at fair market value.
- “Non-open” market services the utility provides to an RCBS of the PUHC are priced at fully allocated cost.
- “Non-open” market services an RCBS of the PUHC provides to the utility are priced at the lower of fully allocated cost or fair market value.

2. Summary of Audit Activities

During interviews and document reviews, Liberty sought information about any transactions between O&R and affiliates in order to determine if those transactions violated the pricing rules of this section of the Standards.

3. Findings

O&R does not provide any services to CEI’s unregulated subsidiaries, and no costs are charged, assigned or allocated.¹³³ O&R informed Liberty during a working session that there were no services provided by the unregulated affiliates to O&R during the audit period.¹³⁴ Thus, no testing was required.

4. Conclusions

- a. **O&R provides no services, produced for sale on the open market or not, to unregulated affiliates.**

¹³³ DR #2.

¹³⁴ Work session December 11, 2002. O&R did clarify that it provided “single bill” service for ConEd Solutions, but it did the same for other ESCOs in New York; there is no fee for this service, as set forth by the New York Commission.



5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

U. Utility Asset Transfers

1. Statement of Applicable Requirements

Section 14:4-5.5(u) of the Standards provide that:

All transfers, leases, rentals, licenses, easements or other encumbrances of utility assets to a PUHC or related competitive business segments of a PUHC not prohibited by these standards shall be subject to the following pricing provisions, consistent with all other applicable Board rules:

- 1. Transfers, leases, rentals, licenses, easements or other encumbrances of utility assets from the electric and/or gas public utility to a related competitive business segment of its public utility holding company shall be recorded at fair market value or book value as determined by the Board.*
- 2. Transfers, leases, rentals, licenses, easements or other encumbrances of assets from a related competitive business segment of the public utility holding company to the electric and/or gas public utility shall be recorded at the lesser of book value or fair market value.*

These provisions address the pricing of assets transferred between affiliates, and generally require asymmetric pricing:

- Transfers from the utility to a PUHC RCBS are to be priced and recorded at fair market value or book value as determined by the Board.
- Transfers from a PUHC RCBS to the utility are to be priced at the *lesser* of book or fair market value.

2. Summary of Audit Activities

As a threshold matter, Liberty formally asked O&R if there had been any transactions of the type covered by this section of the Standards during the audit period.

3. Findings

The Company responded that there have been no asset transfers, asset leases, or asset rentals provided between O&R/RECO and Solutions, Energy, or Development, respectively.¹³⁵ RECO stated that, since no transfers, leases or rentals were made, no Board approvals were sought or issued.¹³⁶ According to Con Ed, there were also no transfers of intellectual property between RECO and CEI during the audit period.¹³⁷

¹³⁵ DR #17.

¹³⁶ DR #61.

¹³⁷ DR #68.



During a working session at RECO and CECONY, the Company stated that there were no transfers of assets, rentals, licenses, leases, easements or other encumbrances between O&R and CEI's unregulated affiliates during the audit period. The Company confirmed this statement in response to a data request.¹³⁸ Therefore, no testing was required.

RECO's Compliance Plan refers to Section 2(b) of the Affiliate Relations Conditions with regard to the transfer of utility assets:¹³⁹

For all assets other than generating stations, transfers of assets from the Delivery Company [Rockland] to an unregulated affiliate shall be at the higher of book value net of deferred Federal income taxes or fair market value... Transfers of assets from an unregulated affiliate to the Delivery Company shall be on a basis not to exceed fair market value.

Liberty found that the Compliance Plan does not reflect the Standards with regard to the transfer of assets from an unregulated affiliate to the utility. The Standards require that the transfer be made at the *lesser* of book or fair market value in that instance, *not* on a basis not to exceed fair market value.

4. Conclusions

- a. Liberty has found no evidence of any transfer of assets from RECO or O&R to an affiliated competitive business segment or vice versa.**
- b. RECO's Compliance Plan regarding the transfer of assets from a PUHC RCBS to the utility do not accurately reflect the Standards.**

5. Recommendations

- 18. Revise the Compliance Plan to incorporate the requirements of Section 14:4-5.5(u)(2) with regard to the transfer of assets from a PUHC RCBS to the utility.**

¹³⁸ Work session December 11, 2002.

¹³⁹ DR #8.



V. Utility Competitive Business Segments (14:4-5.6)

Section 14:4-5.6 of the Standards applies in cases where a public utility offers competitive products or services itself or through an RCBS of the utility.

A. Review and Approval of Competitive Services

1. Statement of Applicable Requirements

Sections 14:4-5.6(a) through (y) of the Standards relate to competitive products and/or services offered by a utility or related competitive business segment of a utility.

2. Summary of Audit Activities

Liberty first questioned whether RECO or O&R offered competitive products or services either itself or through an RCBS. Had either offered such competitive products or services, Liberty would have investigated further the compliance with the standards of Section 14:5.6.

3. Findings

According to RECO's Compliance Plan, neither O&R through any business venture nor any of its subsidiaries provide or offer to provide competitive services to retail customers in New Jersey.¹⁴⁰ The Company later confirmed that RECO did not offer any competitive services.¹⁴¹ O&R added that neither it nor RECO had an RCBS.¹⁴² As such, no further audit activities regarding the provisions of Section 14:4-5.6 were required.

4. Conclusions

- a. **During the audit period, O&R and RECO engaged in no activity to which the requirements of Standards Sections 14:4-5.6(a) through (v) would apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of these standards.

¹⁴⁰ DR #8.

¹⁴¹ DR #69.

¹⁴² DR #81.



VI. Prior Audit Recommendations

A. Background

The scope of Liberty's audit included an examination of the utility's efforts to implement any recommendations that arose from the prior competitive services audit. Recommendation IV.B(1) from the 2000 PMC-WGA audit of RECO stated as follows: Formalize and test employee understanding of the information disclosure rules. The Board ordered the implementation of this recommendation on February 8, 2002.

B. Summary of Audit Activities

Liberty submitted data requests asking RECO to address the status of any approved and "on hold" recommendations from the 2000 Audit. Liberty reviewed the responses to ensure that any actions taken fulfilled both the letter and the spirit of the recommendation. Liberty also reviewed the RECO Compliance plan and related documents.

C. Recommendation IV.B(1) - Formalize and test employee understanding of the information disclosure rules.

1. Findings

In a letter to the Board dated February 28, 2002, RECO indicated that it proposed to comply with the recommendation by taking the following steps:

- Place the Revised O&R Standards of Competitive Conduct on the O&R Intranet Site by no later than March 15, 2002. The O&R Intranet site is available only to employees of O&R.
- Distribute copies of the Revised O&R Standards of Competitive Conduct to all O&R employees via interoffice mail, along with a plain language explanation of these two documents, by March 29, 2002.
- Place an article in *Currents*, the weekly O&R employee newsletter, by no later than March 15, 2002, drawing employees' attention to the Revised O&R Standards of Competitive Conduct and the fact that this document has been placed on the O&R Intranet Site.
- Obtain "wet signatures" from O&R employees to evidence that they have read and understood the Revised O&R Standards of Competitive Conduct.

The letter further stated that O&R's Ethics Officer meets with all employees during the course of a year in order to discuss O&R's ethical policies. RECO proposed that the Revised O&R Standards of Competitive Conduct be included in these meetings. The Company proposed to obtain signatures from current O&R employees during these meetings, and from new employees during orientation. The O&R Ethics Officer would maintain these signatures.

The referenced letter does not indicate that the proposals noted have been made part of the RECO Compliance Plan.



RECO stated that two employees had made multiple presentations in May and June 2002 about the Revised O&R Standards of Competitive Conduct to various employee groups of O&R (who perform services for RECO, which has no employees of its own). These presentations took place at various Company locations (Spring Valley, Middletown, Pearl River HQ, Blooming Grove), and included customer service employees and O&R's Corporate Planning Committee (senior management including O&R's CEO and president).¹⁴³

Each employee attending received a copy of the O&R Standards of Competitive Conduct and each signed an acknowledgement that the Standards had been read and understood. Attending employees were also informed that they could contact designated specialists on the standards directly if they had any follow up questions.

These standards generally parallel the New Jersey Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements. The acknowledgement signed by each attending employee provided RECO an effective mechanism to identify which employees received and understood the training.

2. Conclusions

- a. RECO undertook reasonable efforts to ensure that employees in general, and service employees and senior management in particular, were made familiar with the O&R Standards of Competitive Conduct**
- b. It does not appear that the Standards training has not formally been made a part of any new employee orientation program, or that the training has been required of any employees who did not attend in May or June, 2002.**
- c. There is also no confirmation that the proposals from the letter were instituted.**

3. Recommendations

- 19. Make training in the O&R Standards of Competitive Conduct mandatory for all new employees.**
- 20. Include routinely scheduled, mandatory refresher training that is appropriate to the nature and extent of employee involvement in activities affected by the Standards.**
- 21. Confirm the permanent implementation of the proposals related to employee understanding of information disclosure rules as set forth in the February 28, 2002 letter to the Board in the compliance plan.**

¹⁴³ DR #19.



VII. Financial Relationships between Utilities and their Non-Regulated Affiliates

A. Background

There are three elements of the Standards that address the topic of financial relationships between utilities and their affiliates:

- Subsection 14:4-5.5 (p) (1) is concerned with the use of utility assets to provide competitive services. This raises the issue of whether the sources and uses of funds by affiliates of a utility are appropriately separated from the utility.
- To the extent that the common or the interrelated provision of financing constitutes a service that is shared for purposes of subsection 14:4-5.5 (j), there is a question that bears scrutiny as to the means of acquisition, sources, and uses of funds and whether there is a significant opportunity for cross-subsidization or unfair competitive advantage.
- The nature of any common means of acquisition, sources, and uses of funds is relevant in determining whether there have been any encumbrances of utility assets under subsection 14:4-5.5 (u).

The Board's request for proposals for this audit makes clear at Section 1.2 also includes matters that bear on this line of audit inquiry:

The Contractor will offer its expert opinion, based on appropriate methodology, as to whether there is a strict separation and allocation of each utility's revenues, costs, assets, risks, and functions, between the utility's electric and/or gas distribution operations and its related competitive business segments. The audits will also determine whether there is (1) cross subsidization between utility and non-utility segments within a public utility or holding company; (2) whether the separation of utility and non-utility organizations is reasonable based upon the Board's affiliate relation and fair competition standards.

The question of financial risk and separation of the utility from the risks of affiliates has become an important one. Current events in the electric-utility industry underscore the importance of financial relationships among affiliates. First, the major credit-rating agencies have changed their position on holding-company financial relationships in the past few years, resulting in a stance that all entities in a holding-company structure influence the credit of the others, including utility companies. On the heels of this new method for judging holding company credit are widely-known troubles in the wholesale electric-power market during the past two years, including many wholesale generators who are affiliates of utilities.

Two of the more extreme cases of holding companies and their subsidiaries affecting a utility company are CenterPoint Energy (formerly Reliant) and Xcel Energy. Severe cash flow and liquidity problems at the unregulated business units have caused credit downgrades at both the holding company and affiliated utility company levels. The holding companies were also temporarily shut out of the commercial paper and banking markets, and were unable to raise funds for utility operations due to the risk from other holding company entities.



In Liberty's experience, the financial relationships between utilities and their non-regulated affiliates can have significant costs for the utilities. Liberty believes that a full examination of financial risk separation thus requires a baseline review of the financial relationships among the New Jersey utilities, their holding companies, and affiliates.

B. Summary of Audit Activities

Liberty focused on the following activities in conducting a diagnostic review of financial risk separation:

- a) A review of public financial documents, especially SEC documents, to determine a general structure of corporate relationships;
- b) A review of rating agency reports and credit documents provided by the companies;
- c) Interviews with the Treasurer and their treasury management staff regarding the following issues:
 1. Cash Flow and Projections – Holding company, utility, and other subsidiaries cash flow and projections.
 2. Dividends – For the holding company and each major subsidiary, a review of dividend policies and actual dividends paid.
 3. Cash Management and money pools, if applicable – Review of participants, operations, debt instruments, credit, and restrictions.
 4. Permanent Financing – Review of the holding company, utility and other subsidiaries equity, preferred stock and debt issuances. Review of credit support provided, including guarantees, support agreements, etc.
 5. Credit Management – Review of credit ratings and trends, with discussion of key credit influences, and a discussion of the impact of current markets and changing credit criteria.
 6. Risk management and monitoring – Review of high-level corporate risk management policy, limitations and monitoring.
- d) Follow-up data requests to the interviews to provide clarification and documentation to selected key issues.

The criteria that Liberty applied in auditing this area were:

- Whether a utility's financial relationships (direct and indirect) with the holding company and all affiliates harm or have the significant potential to harm the utility or its ability to provide utility services
- Whether any transfers of financial value within the holding company family have produced fair compensation for any utility asset transfer or encumbrance.

C. Findings

Utility Financial Summary

In 2001 CECONY provided over 90 percent of CEI's earnings, O&R provided about 6 percent, and the four non-utility businesses less than 2 percent.¹⁴⁴

¹⁴⁴ Standard and Poor's Research: Consolidated Edison, April 19, 2002.



CEI does not operate a money pool to facilitate the daily cash needs of the holding company and its subsidiaries. According to CEI, the New York Public Service Commission does not allow utilities and unregulated affiliates to participate in the same money pool.¹⁴⁵ Short-term funds requirements for RECO would be arranged specifically for the company through bank borrowing.

CEI as a whole is expecting to spend \$6 billion during the five-year period from 2002-2006, as the electric distribution system is upgraded in the New York City. This program and budget includes upgrades to the RECO distribution system.¹⁴⁶

RECO is currently in a cash positive position, and CEI does not anticipate the need for RECO to borrow in the near future.¹⁴⁷ O&R supports its short-term liquidity with a \$100 million dollar commercial paper program. The O&R commercial paper program is backed by a matching revolving credit facility.¹⁴⁸

RECO has significant deferrals, which are forecasted to exceed \$100 million by July 31, 2003, associated with RECO's provision of basic generation service to its customers. RECO has proposed that securitization bonds be sold to fund the deferrals. RECO has suspended its dividend to O&R in order to alleviate the potential cash shortfall. CEI Treasury management expected to resume the RECO dividend following the end of the deferral period.¹⁴⁹

CEI's target for O&R and RECO is an "A+" credit rating level for secured debt. Generally, this rating target equates to a capital structure target of about 50 percent equity and 50 percent debt for each company. CEI also tries to preserve access to an "A1P1" commercial paper rating for O&R, in order to maintain access to inexpensive short-term funds during more troubled financial times. Currently, RECO has only a single series of first mortgage bonds outstanding. The principal amount of the A+ rated bonds is \$20 million.¹⁵⁰

CEI Financial Risk Factors

The credit ratings and ratings rationale for the debt securities of holding companies and their subsidiaries can provide indicators of the financial risks in the holding company family. In light of this, Liberty reviewed rating agency reports for CEI, O&R and the holding company family for the past few years.

Standard and Poor's and Moody's each rate the RECO first mortgage bonds at the 'A+' level, and O&R's corporate credit rating at the same level. Both rating agencies agree that O&R's strong business profile stems from a supportive regulatory environment and the relatively conservative strategic focus on transmission and distribution businesses. Standard and Poor's notes:

¹⁴⁵ Interview with CEI Treasury personnel, December 18, 2002.

¹⁴⁶ Interview with CEI Treasury personnel, December 18, 2002.

¹⁴⁷ Interview with CEI Treasury personnel, December 18, 2002.

¹⁴⁸ Fitch Ratings, ORU, April 29, 2002

¹⁴⁹ Interview with CEI Treasury personnel, December 18, 2002

¹⁵⁰ Interview with CEI Treasury personnel, December 18, 2002.



*Although parent CEI has been developing nonregulated businesses, most significantly in power generation in the Northeast, Standard and Poor's expects these activities to be conservatively funded, and that they will continue to account for a small percentage of consolidated cash flows and capital commitments. ... CEI's unregulated subsidiaries are currently an inconsequential part of its asset base and cash flow. Nonregulated ventures include about 1,300 megawatts of merchant power plants under construction in the northeastern U.S., and plans to provide a back-up telecommunications network in New York City. Although the plan is to expand these businesses over time, they will remain a small contributor to overall cash flow.*¹⁵¹

The volatility and risk involved with electric marketing and trading operations has caused many companies to monitor and attempt to limit corporate exposure to extreme market price volatility and the poor credit of trading counterparties. According to CEI Treasury personnel, CEI has established a Corporate Risk Oversight Committee. Reporting to this committee are two risk management sub-committees, one for regulated operations and one for unregulated businesses.

The risk management committees set guidelines for and monitor CEI's risk management guidelines and trading activities. CEI emphasizes that the company does not take positions in the market, and that trading activities are limited to supporting electric and gas supply requirements.

CEI also monitors and limits the credit risk exposure to trading counterparties. CEI uses the corporate credit rating assigned by the major rating agencies, and adds internally-generated information. CEI requires all trading partners to carry an investment-grade rating. If a trading counterparty falls below investment grade, CEI requires that collateral be posted by the counterparty.¹⁵²

D. Conclusions

a. RECO is not currently exposed to significant risk from CEI's non-utility businesses.

The non-utility businesses of CEI are currently of very small size relative to the magnitude CEI's utility businesses. As a result, RECO is exposed to very little risk by these unregulated activities. Future growth in CEI's unregulated activities could eventually pose some level of risk to RECO, but the current level of unregulated activity would need to be multiplied by several times.

E. Recommendations

Liberty has no recommendations in this area.

¹⁵¹ Standard and Poor's Research: Orange and Rockland Utilities, April 24, 2002.

¹⁵² Interview with CEI Treasury personnel, December 18, 2002.

