



STATE OF NEW JERSEY
Board of Public Utilities
Two Gateway Center, Suite 801
Newark, NJ 07102
www.nj.gov/bpu/

AUDITS

IN THE MATTER OF THE AUDIT OF AFFILIATED)
TRANSACTIONS BETWEEN ROCKLAND ELECTRIC)
COMPANY, ORANGE AND ROCKLAND UTILITES AND)
CON EDISON AND ITS AFFILIATES AND A)
MANAGEMENT AUDIT OF ROCKLAND ELECTRIC)
COMPANY, PURSUANT TO N.J.S.A. 48:2-16.4, 48:3-49,)
48:3-55, 48:3-56, 48:3-58 AND N.J.A.C. 14:3-12.1 -12.4,)
14:4-5 ET. SEQ.)

ORDER OF APPROVAL

DOCKET NO. EA08080560

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BY THE BOARD:

At its agenda meeting of December 8, 2008, the New Jersey Board of Public Utilities ("Board" or "BPU") authorized staff of the Audits Division ("Staff") to initiate: (1) an audit of the affiliated transactions between Rockland Electric Company ("Rockland" or "Company"), Orange and Rockland Utilities ("O&R") and Con Edison Inc. ("Con Ed") and its affiliates; and (2) a Management Audit of Rockland. The Board also authorized Staff to send a request for proposals ("RFP") to the five pre-approved management consulting firms under State Term Contract T2482.

In accordance with the RFP, three bid proposals were submitted to the Board's Division of Audits by January 23, 2009 from NorthStar Consulting Group, PMC Management Consultants ("PMC") and Schumaker and Company. The bid proposals were subsequently forwarded to the Evaluation Committee for review and analysis. The Evaluation Committee consisted of staff members from the Division of Audits (2), the Division of Energy (2), and Counsel's Office (1).

At its April 3, 2009 agenda meeting, the Board approved the Evaluation Committee's recommendation of PMC to perform the audits at a not-to-exceed cost of \$477,000. On April 27, 2009, the Board authorized President Fox to execute the Consulting Agreement with PMC.

This assignment was conducted in two concurrent phases. Phase I concentrated on Rockland's compliance with the Electric Discount and Energy Competition Act ("EDECA"), its electric procurement strategies, and the impact of the Company's retail and wholesale transactions with its affiliates. Phase II included a comprehensive management audit of Rockland's major organizational areas other than those identified in Phase I. Phase II included an examination of executive management, corporate governance, organizational structure, strategic planning, finance, accounting and property records, distribution and operation management, human resources, customer services and external relations and support services.

At the Board meeting on May 12, 2010, the PMC Final Audit Report ("Final Report") was accepted "for filing purposes only," and interested parties were provided with the opportunity to file comments on the report. The Final Report consisted of two volumes and an executive summary. By this Order, the Board determines whether to accept the conclusions of the Final Report and direct implementation of its recommendations, and whether to direct Staff to release the remaining fees to PMC.

BACKGROUND

As stated above, the audits were conducted in two concurrent phases. PMC had conducted the initial EDECA compliance review in 2000, and reviewed the 2003 EDECA report as part of its current review. Phase II required PMC to determine whether there was an absence of conflicts of interest, and whether the corporate goals and objectives were being appropriately implemented. During the course of the audits, Rockland responded to 329 separate data requests, many with multiple parts. Forty-five (45) individual interviews were conducted with Company personnel. Staff was present for all interviews and reviewed PMC's working papers during the conduct of the audit. PMC found no significant compliance issues with Rockland.

PMC found that Rockland is a well run organization that benefits from the large reserve of talent in the corporate family of Con Ed. Con Ed and O&R handle all of the support functions. Rockland is a financial and legal entity that has no operating employees. Rockland has no competitive businesses. According to PMC, little has changed at Rockland from previous audits other than the implementation of previous recommendations. The Final Report included the following recommendations:

- PMC proposes that the Joint Operating Agreement between O&R and Rockland be periodically reviewed by O&R and a formal opinion of the applicability of the inter-company transactions be formally attested.
- PMC found that Rockland's capital costs are generally insulated from non-utility operations because Rockland does not engage in non-utility operations. PMC recommended the following guidelines in the event that Rockland establishes non-utility operations in the future:
 - 1) Adherence to proper cost assignment between entities followed by internal audits of the cost assignment results.
 - 2) Performance of Cost of Service Studies by Rockland; and
 - 3) Annual reporting of capital costs between the entities to the BPU.

- Rockland should analyze and develop estimates of improvements to its distribution system reliability performance indices, the magnitude of potential customer cost reductions, and any other quantifiable financial and operational benefits that may be realized by the Company from the Smart Grid Project.
- Rockland should review and update the Distribution Planning Criteria document, and provide an effective date as well as the date of the most recent revision(s).

Rockland should compile all applicable work procedures into a Rockland specific document. This would avert any confusion regarding which Con Ed or O&R work procedures and practices (or portions thereof) apply to Rockland.

- Rockland should implement the projects listed in the first five-year portion of the 15-year electric delivery planning study, and continue to monitor and update project priorities for the second and third five-year segments. PMC notes that the projects included for the first five-year segment are reliability driven and critical to bringing electric system conditions up to current planning criteria levels. The projects proposed for the second and third five-year segments are important to maintain reliability but are also assigned to address customer growth.
- Rockland should assure that sufficient resources are made immediately available to complete and implement all recommendations contained in the Internal Task Force Report titled "Self Assessment of Internal Controls Associated with the Procurement and Management of Contractor Services" as expeditiously as possible.

Rockland should compile its standardized contractor inspection procedures and forms into a field inspection program manual in order to document the processes and assure they are uniformly understood and implemented. PMC lists several items that should be contained in the Field Inspection Manual.

The Comments and Responses

Following a request for an extension of time to file comments, the Division of Rate Counsel ("Rate Counsel") filed comments on the Final Report on July 6, 2010. Subsequently, on August 19, 2010, Rockland submitted a response to Rate Counsel's July 6, 2010 comments. A summary of the filed comments and Staff's recommendations is set forth below.

Rate Counsel, in its letter to the Board dated July 6, 2010, opined that the written report itself appears to lack sufficient detail to explain the audit and procedures used in coming up with the recommendations, citing several examples where Rate Counsel believed that PMC did not expound on how it arrived at a given conclusion. Staff acknowledged that the written report is not as detailed as some similar reports submitted to the Board by different consultants. However, Staff did not agree that the report should be rejected since the overall findings made by PMC respond to the RFP. Rather, Staff deemed it more appropriate to address and clarify Rate Counsel's concerns based upon Staff's oversight of the audit process and participation at the interviews conducted by PMC, as well as the response submitted by Rockland dated August 13, 2010. Staff suggests that any requirement for additional supportive and background material in the report would only serve to delay the implementation of the recommendations in the Final Report.

The following is a summary of Rate Counsel's comments, Rockland's responses, and where appropriate, clarifications based upon Staff's participation in the audit process.

EDECA AUDIT REPORT

Sections B.1, B.2, B.3

Rate Counsel viewed the term "N/A" in the tables of EDECA standards as unintelligible noting that the term had not been defined in the report. As PMC explained to Staff and Rockland, the term "N/A" has the customary meaning of "Not Applicable." Rate Counsel also questioned why Section B.2.5 is denoted as in "Compliance for 2000 and 2009 but denoted as "N/A" for 2003. Section B.2.5 is regarding "Provision of Information Concerning Unaffiliated Suppliers." Rockland did not have any unaffiliated suppliers in 2000, 2003 or 2009. Since no unaffiliated suppliers were present during any of these years, Staff concludes that the usage of the terms "compliant" and "N/A" by different consultants performing audits during those periods have the same meaning.

Section B.4

Rate Counsel stated that no foundation was provided for PMC's conclusion that BPU oversight of the BGS auction process provides assurances of compliance with the Affiliate Standards. Rate Counsel further asserts that the Final Report does not mention whether PMC examined Rockland's transactions with Con Edison Solutions (an affiliated third party supplier of retail electric service and energy audits), does not contain any findings or conclusions as to whether Rockland's affiliate transactions with Con Edison Solutions are compliant with the Board's Affiliate Standards, nor is there a discussion on the structural safeguards that are in place at either the parent company level or at Rockland to prevent abuses in dealing with third party affiliates.

Rockland asserts that a review of the Board's oversight procedures with respect to the BGS auction process, which process is supervised by the Board, carried out by an auction expert and in which Rate Counsel actively participates, was not contemplated as part of the scope of this audit. Staff concurs with Rockland on this area of the audit. With respect to Con Edison Solutions, Rockland asserts that Rate Counsel's criticism is misguided. Rockland notes that Con Edison Solutions does not provide any services directly or indirectly to Rockland. Rather, Con Edison Solutions is a third party supplier that has minimal market share in Rockland's territory. Rockland notes, and the Board Staff confirms, that PMC interviewed the Rockland "Director – Retail Access" at length and determined that Rockland's limited involvement with Con Edison Solutions complies with the Board's Affiliate Standards. Rockland further noted the structural safeguards referred to by Rate Counsel may be seen on the charts on pages 9-11 and the discussion on pages 30-42 of the affiliate relations audit report. Staff reviewed the working papers at the Company to confirm that no transactions took place during the audit period.

Section C.1 Purchasing

Rate Counsel stated that PMC adequately explained Rockland's policies and procedures for procuring goods and services but failed to provide any summary of its review of actual transactions to determine whether and to what extent Rockland is correctly following its own protocol as well as the extent to which Rockland's goods and services are procured competitively.

Rockland asserts that Rate Counsel's criticism is unwarranted given the Final Report's detailed description of the Company's purchasing policies coupled with the fact that there were no material findings, nor recommendations in this area. Staff notes that the Final Report includes five pages describing the Company's procurement and purchasing procedures, and indicates that those procedures are sound and ensure that pricing is non-discriminatory and does not exceed market rates. Staff believes the Final Report adequately addresses the requirements of the RFP.

Section D Affiliate Relationships and Section G Affiliate Cost Allocation Methodologies

Rate Counsel criticizes PMC for not describing the Joint Operating Agreement ("JOA") between Rockland and O&R, and states that there is no evidence in the Final Report to demonstrate that the auditors critically evaluated Rockland's charges under the agreement or to explain how many of O&R's charges to Rockland are via direct billing as opposed to ratios of revenues and customer counts. Rate Counsel further criticizes the Final Report for not expressing an opinion on whether the revenue or the customer count ratios produce an equitable sharing of costs.

Rockland maintains these criticisms are particularly unwarranted as the JOA has been reviewed and approved by the Board, and the JOA and the various charges allocated are routinely reviewed in the context of Rockland's base rate cases, to which Rate Counsel is an active party. Rockland notes that the most recent base rate case concluded in May 2010. Staff concurs with Rockland's assessment of this area of the Final Report. Staff notes that PMC's Final Report includes a recommendation that the Joint Operating Agreement between O&R and Rockland should be periodically reviewed by O&R and a formal opinion of the applicability of the inter-company transactions should be formally attested. Moreover, as acknowledged by Rockland in its August 19, 2010 comments, the JOA and its cost allocation methodologies may be investigated by any party in the Company's next base rate case.

Section E.5 Non-Utility Generator (NUG) Transactions and Section E.6 Non-Utility Generator Mitigation Efforts

Rate Counsel claims these two sections of the Final Report are incomprehensible. Rate Counsel notes that PMC never states whether Rockland has NUG contracts, and the Final Report refers to only two O&R NUG transactions. Rate Counsel asserts that if Rockland has NUG contracts, PMC should have analyzed and reported on the specific circumstances of each contract and should have explained in detail Rockland's specific mitigation efforts and formed an opinion as to the effectiveness of those efforts based upon the examination of evidence.

Rockland asserts that Rate Counsel's criticisms are unwarranted. Rockland notes that its July 1, 2010 Company Specific Filing in the current BGS proceeding¹ (in which Rate Counsel is an active participant) shows that the one remaining NUG contract applicable to Rockland is the West Point Hydro contract which is referred to on page 28 of the PMC Final Report on Affiliate Relations. Rockland notes that this is a very small (i.e. less than 1 MW) hydro facility. Rockland also asserts that the bottom line is that Rockland has no NUG issue. Given the small amount of the single Rockland NUG contract, Staff believes the PMC audit and Final Report sufficiently addressed this area.

¹I/M/O the Provision of Basic Generation Service for the Period Beginning June 1, 2011, BPU Docket No. ER10040287.

MANAGEMENT AUDIT REPORT

I.B.1 Composition of the Board of Directors

Rate Counsel states that there is no support provided for PMC's conclusion that the O&R Board of Directors advocates on behalf of Rockland. Rockland asserts that there is no suggestion that any of the Board of Directors' members are anything other than very well qualified. Further, it is unclear to Rockland how the interests of O&R and Rockland necessarily differ, particularly given the fact that Rockland has no operating employees. PMC's Final Report clearly reviews in detail the qualifications of the three (3) member board including a resume summary. The member board is composed of the Chairman of the Board of Con Ed, the CEO of O&R, and an independent local businessman. It was clear to Staff from statements made by the independent local businessman on the Board of Directors that it was independent of any parent control and that all stakeholders are represented in a responsible manner.

I.D.2 Executive Compensation

Rate Counsel notes that PMC mentions that CEI retains Mercer Consulting to compare CEI executive compensation to that of 20 peer companies. A Towers Perrin database of executive compensation paid by other utilities is also used. Rate Counsel argues that PMC does not state how CEI executives compare with these peer companies or with the Towers Perrin database of other utility executives, nor does PMC offer any recommendations on executive compensation.

PMC's Final Report indicates that compensation philosophy is designed to attract and retain key executives. PMC noted that the base pay portion of executive compensation is designed for competitive positioning defined as the median of the peer group top five executives. The second component of executive compensation is a pay for performance program with short and long term aspects. Awards under the annual incentive plan are based on achieving financial and operational objectives that favor the Company's business. The longer-term portion of the program is over a three year period. PMC noted that in 2008, the CEO of O&R received the second highest award of the top five executives. Staff believes PMC adequately addressed Rockland's basis for determining executive compensation. The reasonableness of executive compensation is an issue which would be reviewed in the context of a base rate case.

I.F.1 Outside Financial Auditors

Rate Counsel criticized PMC for not making a finding regarding the reasonableness of the outside financial auditor fees. PMC provides a breakdown of the outside auditor fees for 2007 and 2008. Pursuant to the RFP, PMC was required to assess the independence of Rockland's auditors and the appropriateness of committee structures, which includes the Audit Committee. PMC's findings on these two areas are discussed at pages 8 and 9 of the Management Audit Report. The RFP did not require a determination regarding the reasonableness of outside financial auditor fees. Staff notes that the reasonableness of such fees would be the subject of discussion in Rockland's base rate proceedings.

I.I.1 Non-compliance with FERC Rules concerning interlocking positions

Rate Counsel asserts that PMC auditors never offer an opinion or findings as to the reasonableness of Rockland's request to the FERC for a waiver of the FERC rules prohibiting certain interlocking officers and directors. In this particular circumstance, the interlocking position was held by the Chief Financial Officer (CFO) of CEI while also serving as a director for

several of Con Ed's unregulated affiliates. O&R provided the consultant with a completed and filed FERC form 561 covering this interlocking position. Rockland notes that as a result of PMC's recommendation during the course of the audit, a new CFO, who holds no position with Con Ed's unregulated affiliates, was appointed for O&R and Rockland. Therefore, Staff has concluded that this point is moot.

II.B.2 Capital Budget Process

Rate Counsel asserts that PMC never discusses Rockland's budget variance reporting procedures. Nor does PMC state its findings regarding the accuracy and reliability of Rockland's capital budgets and the ability of Rockland to adhere to approved capital budgets.

Staff notes that section II.B of the RFP requires PMC to make an assessment of the resources among regulated and non-regulated affiliates. The PMC finding in Section II.B.2 indicates that the Capital Budget process provides for resources to Maintain and Expand the System and explains the Company's Capital Budget Process. Staff believes PMC has addressed the RFP requirement with respect to the assessment of resources among regulated and non-regulated affiliates.

II.C.1 Affiliate Charges

Rate Counsel maintains that PMC has not offered analyses, findings or conclusions as to whether the JOA results in a fair allocation of costs to Rockland. The Company notes that the JOA and its cost allocations have been reviewed and accepted by the Board. Rockland further notes that the cost allocation methodologies have been investigated in numerous Rockland rate cases, to which Rate Counsel has been an active party. Rockland asserts, and the Staff concurs, that PMC has accomplished the audit objective of validating that Rockland is properly implementing the terms of the Board approved JOA.

II.D Contracts with Affiliates

Rate Counsel asserts that no quantitative analysis was provided in this area of the Final Report. Rockland notes that no quantitative analysis was included for the simple reason that, aside from the JOA that already has been discussed, Rockland does not have any contracts with affiliates. Staff believes all related affiliate issues have been adequately addressed in paragraphs II.D.1 through II.D.3 of the Final Report.

II.E Internal Controls

Rate Counsel believes that PMC did not make an independent review of CEI's and O&R's internal controls. According to the Final Report, PMC reviewed CEI's Sarbanes-Oxley (SOX) report and supporting documents in accordance with CEI's internal audit procedures. The Company notes that the SOX report is timely (June, 2009) and was prepared by PricewaterhouseCooper ("PWC"), an eminently qualified outside auditor. Staff agrees with Rockland that the review of these documents constituted an adequate review of this audit area.

VI.D.1 Write-offs by Rockland

Rate Counsel has concerns about PMC's reliance on PWC's report as the basis for its conclusion regarding write-offs. Rockland asserts that PWC is a well qualified (Big 4) outside auditor, and PMC's reliance on PWC's report is reasonable. Rockland further asserts that Rate Counsel had ample opportunity to review Rockland's uncollectible levels in its recently

concluded base rate case. The RFP requests the consultant assess the quantified or potential impact of write-offs by Rockland, O&R and CEI and its affiliates on Rockland. In section VI.D.I, PMC concluded that write-offs by Rockland, O&R and CEI and its affiliates had little impact to no impact on Rockland. Staff agrees with Rockland that the review of the PWC documents constitutes an adequate review of this area. Moreover, as noted by Rockland, Rate Counsel was provided ample opportunity to review Rockland's write-off levels in the recent base rate case.

VI.F.1 Rockland's capital costs and non-utility operations

Rate Counsel criticizes PMC's conclusion that Rockland's capital costs are insulated from non-utility operations based upon the finding that Rockland does not engage in any non-utility operations. Rate Counsel argues that PMC fails to recognize that Rockland obtains its equity capital from its parent company CEI which has non-utility operations.

Rockland asserts that an investigation of the non-utility operations of CEI is improper and plainly outside the scope of this audit. In section VI.E.I, PMC noted that a review of the most recent base rate case at the time of the audit, Docket No. ER06060483, revealed no discussion of negative effects on Rockland's cost of capital by diversifying activities. As discussed earlier herein, PMC offered some recommendations in the event that Rockland establishes any non-utility operations in the future.

VII.B Accounts receivable

Rate Counsel criticizes PMC for relying on the SOX summary reports and for failing to conduct its own analysis. The RFP required PMC to review the processes for receiving and securing accounts receivable. As stated in section VII.B.I of the Phase II Final Report, PMC reviewed the SOX summary reports provided by PWC, project status reports and various control deficiency reports. There were 8 total control deficiencies noted. PMC believes that these deficiencies were not material and were being addressed by management. Staff agrees with Rockland that the review of these documents constituted an adequate review of this audit area.

VII.C Payroll.

Rate Counsel states that PMC did not conduct an independent analysis of Rockland's payroll accounting procedures to determine if there are adequate payroll cost controls and whether payroll costs under the JOA are fairly assigned and allocated to Rockland. Rockland notes that the Company has no employees and the Company's payroll is covered under the provisions of the JOA. Section VII.C.I of the Phase II Final Report confirms that payroll is performed by O&R and that all charges made to Rockland are done in accordance with the JOA.

DISCUSSION AND FINDING

Upon careful review of the Final Report, the comments received, and Staff's clarifications, the Board FINDS that the Final Report sufficiently satisfies the requirements of the RFP. Accordingly, the Board HEREBY ACCEPTS the Final Report submitted by PMC. The Board HEREBY ORDERS Rockland to implement all recommendations in PMC's Final Report. Specifically, the Board HEREBY DIRECTS Staff, with Rockland's assistance, to formulate detailed implementation plans for all recommendations within 45 days from the date of this Order. Rockland shall implement all recommendations as soon as possible and not later than one year from the date of this Order. Furthermore, the Board HEREBY DIRECTS Rockland to file quarterly reports to the Division of Audits, by the fifteenth day of the month following the

conclusion of each calendar quarter, regarding the status of all recommendations. The Division of Audits shall monitor, evaluate, and modify, as necessary, the implementation of the recommendations.

Finally, the Board HEREBY ORDERS, consistent with the terms of the Agreement for Consulting Services with PMC, that the final hold back of fees in the amount of \$47,700 be released to PMC.

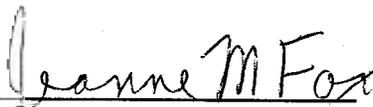
The recommendations of the Final Report shall not be dispositive of issues raised in any other proceeding before this Board.

DATED: 11/10/10

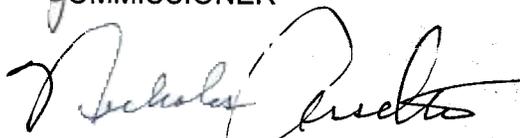
BOARD OF PUBLIC UTILITIES
BY:



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PRESIDENT



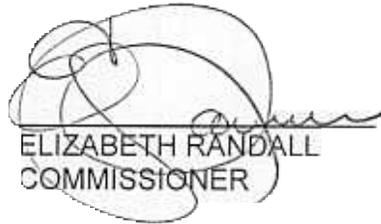
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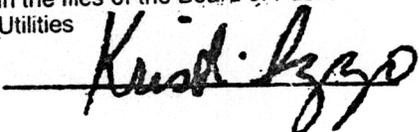


ELIZABETH RANDALL
COMMISSIONER

ATTEST:

KRISTI IZZO
SECRETARY

I HEREBY CERTIFY that the within document is a true copy of the original in the files of the Board of Public Utilities



Rockland Electric Company Management Audit
Docket No. EA08080560

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