

## I. EXECUTIVE SUMMARY

### A. AUDIT SCOPE AND OBJECTIVES

The overall objective of the audit is to assist the Board in assessing the extent to which the competitive services offerings of PSE&G and its affiliates are in compliance with the Electric Discount and Energy Competition Act (the Act) and the Board's Affiliate Relations, Fair Competition and Accounting Standards (the Standards). To accomplish this objective, the audit (1) examined the practices, programs and methodologies employed by PSE&G to comply with the Standards and (2) examined PSE&G's cost allocation and accounting procedures to determine if any competitive services offerings are being subsidized by the ratepayers.

The basis for the audit project work plan was the Request For Proposal (RFP) prepared by the BPU. This RFP provided direction as to the scope of the project and the specifics of this audit. Our team developed much of its work plan based on the attachments to the RFP, the information provided by PSE&G at the pre-bid conference, and other public information. Specific areas that were addressed include:

- Cross subsidization between utility and non-utility segments.
- Separation of utility and non-utility organizations.
- Effects on ratepayers of the use of utility assets in the provision of non-safety related competitive services.
- Effects on utility workers.
- The effect of utility practices on the market for such services.
- Overall compliance with the Act and the Standards.
- Reasonableness of lump sum charges or service contract rates.
- Time and material charges encountered in the competitive environment.
- Determination as to whether other services offered by the utility are competitive.

### B. PROJECT TEAM

In order to staff a project of this complexity and with such a short schedule, a team consisting of three firms was assembled to address all of the issues. Vantage Consulting, Inc., NorthStar Consulting Group, Inc. and Mitchell & Titus, LLP (collectively referred to as the Audit Team) collaborated on the project. Exhibit I-1 lists the name, firm, and areas of responsibility for each member of the Audit Team.



Mitchell & Titus LLP



---

**Competitive Service and Affiliate Compliance Audit of PSE&G**

**Exhibit I-1  
Audit Team**

<b>Name</b>	<b>Firm</b>	<b>Areas of Responsibility</b>
Walt Drabinski	Vantage	Project Manager, Chapters 1, 2, and 4
Michael Allen	NorthStar	Project Manager, Chapters 1, 3, and 5
Douglas Bennett	NorthStar	Chapters 3 (Sunburst) and 5
Chuck Buechel	Vantage	Chapters 2 and 4
Mark Fowler	Vantage	Chapter 3 (Holdings)
Martha King	Vantage	Chapter 3 (Holdings)
Dawn Francis	NorthStar	Chapters 3 and 5
Darrell Smith	NorthStar	Chapter 3 (Appliance Service Business)
Wesley Garland	Mitchell & Titus	Chapter 4 (SAP Audit)
Chris Brown	Mitchell & Titus	Chapter 4 (SAP Audit)
Bob Wilkinson	Vantage	Chapter 4 (SAP Audit)
Marie Davidson	Vantage	Chapter 4 (Intercompany Transactions)
Cynthia Holste	Vantage	Chapter 2 (Compensation)
Hayley Downey	Vantage	Administration and Editing

**C. SUMMARY OF FINDINGS**

**CHAPTER II: INFRASTRUCTURE ISSUES**

Chapter II of the report addresses the current organization, the placement and organization of Affiliate Compliance, and changes in compensation practices as a result of the reorganization of PSE&G. PSE&G has undergone a major reorganization during the last ten months. It has effectively been broken into three separate companies. PSE&G, the utility where distribution, transmission, customer service, appliance services, and meter reading and billing reside; PSEG Power, a Limited Liability Company where all of the nuclear, fossil, and trading activities and assets reside; and PSEG Service Corporation (Service Company,) where shared services are located. A fourth major subsidiary of Public Service Enterprise Group, PSEG Energy Holdings, was in existence prior to the reorganization of PSE&G.

The transfer of personnel from PSE&G to PSEG Power took place at the end of 1999, while the transfer of assets to PSEG Power took place on August 21, 2000 in order to meet the final BPU Decisions. It should be noted that the final development of this company must wait until a number of legal challenges are exhausted.

The Service Company was formed late in 1999 and employees changed payroll in December 1999. However the final approval of this organization is under consideration by the BPU at this time.

Our team held numerous discussions with PSE&G management regarding the location and structure of the affiliate compliance group as well as the formality of affiliate compliance procedures. Currently, responsibility for affiliate compliance rests with the Chief Compliance Officer/General Counsel of PSE&G and his staff. The legal department was undergoing a reorganization at the time of the audit and it is expected that a partner level attorney will have day to day responsibility for compliance issues after the reorganization. It is not clear at this time what resources will be available on a permanent basis as part of this compliance group. In addition to having concerns about the size and responsibility of the affiliate compliance group, we also have raised concerns in Chapter V about the comprehensiveness of the compliance plan itself.

One specific objective of the audit was to assess changes in the compensation program to determine if it accurately reflects the size of the new utility. After the spin-off of PSEG Power and PSEG Services, the utility is at 70 percent of its former staffing and has a reduction in assets of almost \$2.6 billion. Our compensation expert determined that job positions were being accurately reassessed and compensation levels were adjusted appropriately.

### **CHAPTER III: COMPETITIVE SERVICES**

Chapter III includes an assessment of each competitive service offered by the competitive business segments of PSE&G and PSEG. The competitive services include those services deemed competitive services by the Act or the Board and as well as other services that are or may be subject to the Standards. The competitive services addressed include the following:

- Electric generation service offered through PSEG Power.
- Testing, equipment overhaul and repair, and maintenance, offered through SERVCO, an operating division of PSEG Power.
- Mechanical contracting and energy services offered through PSEG Energy Technologies, an operating company within PSEG Holdings.
- Appliance repair offered through PSE&G.
- Metering and billing, offered through Sunburst Customer Solutions, part of PSE&G.
- A variety of other competitive services offered by PSE&G.

### **PSEG Power and SERVCO**

Power generation, a competitive service as defined in Section 8.b of the Act, is provided through PSEG Power LLC, a subsidiary of Public Service Enterprise Group. PSEG Power was created August 1, 1999, to separate PSE&G's generation and wholesale power marketing businesses from its transmission and distribution utility businesses. All PSE&G employees involved in power generation were transferred to PSEG Power in December 1999. PSE&G's power generation assets were transferred to PSEG Power on August 21, 2000.

In addition to power generation, PSEG Power also provides equipment maintenance and testing services to outside parties through its SERVCO division. These services are offered on a limited but competitive basis and are included in this audit.

The audit verified that PSEG Power's generation service is a wholesale competitive service and therefore not subject to Sections 3, 4, and 5 of the Standards. It is also not subject to Section 6, which refers only to competitive business segments of PSE&G.

The audit also verified that the competitive services offered through SERVCO were offered only to wholesale customers and therefore exempt from the Standards. However, it was noted that PSE&G's position that all service provided to commercial or industrial companies was wholesale is not necessarily true. SERVCO needs to exercise care that it continues to provide services only on a wholesale basis or PSEG Power could become subject to Sections 3, 4, and 5 of the Standards.

### **PSEG Energy Holdings**

PSEG Energy Holdings, Inc. (Energy Holdings) is one of four direct wholly-owned subsidiaries of PSEG. Energy Holdings is the parent of PSEG's energy related businesses not held under PSE&G or PSEG Power. PSEG holdings consists of six wholly owned subsidiaries and 305 indirect subsidiaries. The wholly owned subsidiaries are:

- PSEG Global
- PSEG Energy Technologies, Inc.
- PSEG Capital
- Enterprise Capital Funding Corporation
- Enterprise Group Development Corporation
- PSEG Resources, Inc.

The audit verified that PSE&G's Compliance Plan was correct in its claim that PSEG Energy Technologies (PSEG ET) was the only affiliate within Holdings which offered competitive services to retail customers in New Jersey and therefore subject to Sections 3, 4, and 5 of the Standards. Actions have been taken to separate PSEG ET employees from other employees and to separate the marketing function.

PSEG Global has no assets within New Jersey and does not sell on a retail or wholesale business within the state.

Employee transfers between PSEG ET and PSE&G have been in compliance with Standards. The physical separation between PSEG ET and other affiliates at the Edison office complex is inadequate.

### **PSE&G Appliance Service Business**

The Appliance Service Business (ASB) is a competitive business segment of PSE&G that provides competitive services to retail customers of PSE&G as defined in Section 8 of the Act. Appliance repair services are provided as an adjunct to safety services performed by

PSE&G. The same staff perform required safety functions such as checking for leaks and carbon monoxide as perform appliance repairs. PSE&G has provided home appliance services for as long as it has provided gas utility services.

The audit found that while ASB was in compliance with most sub-sections of the Standards, it was not in compliance with Sections 6.3.e.1 and 6.3.e.7. Field technicians do not inform customers that they may have the work done by another firm unless the customer raises questions about the service or the cost. Customer Service Professionals (CSP) in the call center do not inform callers that there are alternative companies that offer appliance repair services. Both of these actions violate the Standards.

It should be noted that it is virtually impossible to maintain strict compliance with Sections 6.3.e.1 and 6.3.e.7 of the Standards because in some cases the business lead is being passed from a person to the same person. In other cases, clarifying communication with customers may provide adequate compliance.

### **PSE&G Sunburst Customer Solutions and Other Competitive Services**

Sunburst Customer Solutions (Sunburst) is a competitive business segment within PSE&G's Customer Operations organization. Sunburst provides meter reading, billing and payment processing services to municipalities and utilities operating within PSE&G's service territory. PSE&G has offered Sunburst services since July 1995 and has secured new clients as recently as April 1999.

The audit found that PSE&G has not received Board approval for the competitive services offered by Sunburst and for the other competitive services offered by PSE&G as required by Section 6.1.a of the Standards.

The audit also found that Sunburst is not in compliance with Section 6.3.e of the Standards, which prohibits utility employees from solicitation and sharing market analysis, among other restrictions. Sunburst shares PSE&G's booth at the League of Municipalities Convention in Atlantic City and Sunburst offers to provide telemarketing services.

## **CHAPTER IV: CORPORATE ACCOUNTING AND CROSS SUBSIDIZATION REVIEW**

This chapter reviews many Corporate Accounting issues our auditors were required to review as part of this assignment. In particular it addresses the formation and operations of PSEG Services Corporation ("Service Company"). The Services Company is a recently formed direct subsidiary of Public Service Enterprise Group Incorporated ("Enterprise"). The Service Company was formed to provide various corporate support, managerial and administrative support services to PSE&G and the other subsidiaries of Enterprise ("Operating Companies").

The primary system for meeting the corporate accounting requirements is the recently installed SAP system. The audit concludes that the system performs the accounting and

cost allocation functions reasonably well but the system is deficient in its ability to provide the managerial reports for monitoring compliance with the Affiliate Standards.

With regard to the review and evaluation of the Service Company, the audit concludes that the Service Company provides corporate support services for PSE&G and other PSEG affiliates that conform to the requirements of the Affiliate Standards. PSEG's efforts to initiate the Service Company are a reasonable response to meeting the rigors of a more competitive industry which will require PSE&G to control prices while maintaining a high quality level of service.

There were however a number of difficulties in conducting the audit.

- The identification of Service Company components, functions and services provided to PSE&G and affiliates was very difficult.
- Procedures for preparing summaries of inter-company monthly billings for PSE&G to PSEG Power, PSEG Power to PSE&G, PSEG Holdings to PSE&G, and PSE&G to PSEG Holdings are cumbersome and subject to employee error because it requires considerable offline work downloading data to Excel spreadsheets.
- No detailed support is provided to service recipients for monthly charges/invoices to/from PSEG affiliates.
- ASB financial reports to the Board of Directors provide little detail and are not timely filed. Cost and performance benchmarking data for functions, products and services provided by PSEG affiliates, including the Service Company is not available.
- PSE&G has not completed the Action Plans included in the 1999 Internal Audit Report on intercompany transactions and has not completed certain Action Plans identified in the 1998 Internal Audit Report on intercompany transactions.

## CHAPTER V: AFFILIATE STANDARDS COMPLIANCE

This chapter provides an overall assessment of PSE&G's compliance with the Affiliate Relations, Fair Competition and Accounting Standards, and a review of the PSE&G's Compliance Plan submitted on June 15, 2000. PSE&G's compliance status with each section and sub-section of the Standards is addressed, as is the overall quality and completeness of the Compliance Plan.

### Sections 1 and 2: Scope and Definitions

While these sections of the Standards do not require any specific compliance action by PSE&G, the audit did reveal that PSE&G's Compliance Plan incorrectly concludes that Section 6 applies only to retail competitive services. Section 1.1.a.ii of the Standards, which

defines the applicability of Section 6, does not differentiate between wholesale and retail competitive services.

### **Section 3: Nondiscrimination**

The audit found PSE&G to be in compliance with Section 3 except for Sections 3.2 and 3.10. PSE&G's Customer Inquiry Center provides PSEG ET with after hours telephone answering support. In addition, PSEG ET utilizes PSE&G employees in providing operation and maintenance support in Project Renaissance. PSE&G has not demonstrated that these services were made available to all market participants on a competitive basis. Therefore, these activities are not in compliance with Section 3.2.

PSEG ET's use of PSE&G's call center may also violate the restrictions on PSE&G providing business development and customer relations support to PSEG ET contained in Section 3.10.

### **Section 4: Information Disclosure**

The audit found PSE&G to be in compliance with all parts of Section 4 with the exception of Sections 4.2 and 4.7. PSE&G has not demonstrated compliance with Sections 4.2 and 4.7 of the Standards.

Even though PSE&G has policies and procedures in place for handling confidential information, the types of information which would be governed by Section 4.2 have not been identified. Therefore, employees cannot be instructed as to what information is restricted by Section 4.2.

The audit team was unable to verify PSE&G's compliance with the Section 4.7 because PSE&G could not provide the requested records of all contracts and related bids.

### **Section 5: Separation**

The audit found PSE&G to be in compliance with all parts of Section 5 with the exception of Sections 5.5 and 5.6.e.2. PSE&G is not in compliance with Section 5.5. of the Standards.

Section 5.5 along with the definition of "services that may not be shared" found in Section 2.1 of the Standards prohibits marketing as a shared corporate service. PSEG Services provides marketing as a shared corporate service to both PSE&G and PSEG ET.

The call answering service PSE&G provides to PSEG ET does not comply with Section 5.6.e.2, which prohibits PSE&G from participating with PSEG ET on communications with existing customers.

### **Section 6: Competitive Products and/or Services Offered by a Utility or Related Competitive Business Segments of a Utility**

PSE&G's Appliance Service Business is in compliance with all parts of Section 6 except Sections 6.3.e.1 and 6.3.e.7. PSE&G is not in compliance with most of Section 6 with regard to the competitive services offered through Sunburst Customer Solutions and other

competitive service services offered by PSE&G. These issues were described above in the overview of findings for Chapter 3.

### **Section 7: Regulatory Oversight**

While the audit found PSE&G in compliance with Section 7, several deficiencies were noted in the Compliance Plan. The Plan failed to demonstrate compliance in several areas (noted in the sections above), was organized in a confusing manner, and reflected an interpretation of the scope of coverage for Section 6 of the Standards which was significantly too narrow.

### **Section 8: Dispute Resolution**

PSE&G is in compliance with Section 8.1 of the Standards.

### **Section 9: Violations and Penalties**

Section 9 does not require any specific action by PSE&G.

## **OVERALL CONCLUSIONS**

PSE&G is, in general, making an effort to meet the requirements of the Standards. Given that the Standards were made public in March 2000, progress has been substantial.

PSE&G has interpreted the Standards and used definitions in a manner to minimize the areas where the Standards apply to the Company. As one might expect, given a certain lack of definition in the rules, PSE&G has interpreted them in a self-serving manner.

While no material errors or major mis-allocations were discovered in our accounting audit, there are serious problems with the SAP system implemented recently. Recommendations for change are contained in this audit report.

The audit identified a number of areas where PSE&G is not in compliance with the Standards. These are identified and recommendations for compliance are contained in this audit report.

Other key findings:

- The separation of utility and non-utility organizations complies with the Standards.
- The audit did not reveal any adverse affects on ratepayers from the use of utility assets in the provision of non-safety related competitive services.
- The provision of competitive services does not adversely affect utility workers.
- PSE&G's practices in providing competitive services do not adversely affect the market for such services.



## D. AUDIT APPROACH

### BACKGROUND

The Audit Team conducted its investigation during the period of July 2000 through October 2000, with on-site field work and interviews completed by September 2000.

A total of 13 consultants from the Audit Team, plus a Project Administrator, were involved in the investigation and contributed to the final report. In addition, the BPU Staff was involved in the investigation. At least one BPU staff member attended the majority of the interviews and the BPU Staff helped facilitate communications between the Audit Team and PSE&G.

### AUDIT PROCESS

Prior to beginning field work, PSE&G management, the BPU Staff, and Vantage project managers met to refine the scope of the audit and to clarify procedures for submitting interview and information requests. Field work commenced with initial interviews of key personnel who detailed the SAP system and internal audit activities relative to cost allocations and competitive services.

After the preliminary interviews, the Team modified the preliminary work plan it submitted in its proposal to accurately reflect the requirements of the project. The Team revised its work plan and developed it into an Audit Plan that provided details to the Team's consultants and accountants on work steps, interviews, information, and analysis. The Audit Team submitted its revised Audit Plan to the BPU with its first status report.

The on-site field work phase lasted approximately six weeks. Throughout this phase, the Audit Team conducted a total of 43 interviews and field visits, and submitted 207 information requests. The Team also visited locations of affiliates, call centers and other facilities. Our accountants spent almost 40 person-days working with the SAP system on terminals that were provided. The field visits, SAP auditing, interviews, and information request responses formed the basis of the factual information provided in this report.

The Audit Team conducted interviews with a broad range of personnel including:

- Accounting managers and technical staff
- Officers from all major affiliates
- The Compliance Officer
- Field and operations personnel
- Managers from the appliance service business
- The President of PSE&G

After all interviews and verifications were complete, the Team developed Draft Report Chapters and submitted the drafts to the BPU Staff for review and comment. After reviewing and commenting on the drafts, the BPU Staff forwarded the draft report to PSE&G on October 2, 2000 for its comments. The Team and the BPU Staff reviewed

PSE&G's comments and discussed them in a telephone meeting. The Team incorporated PSE&G's comments into its final draft, where issues of accuracy arose, and forwarded the final draft to the BPU Staff for approval. Upon approval, the Team published its Final Report.

The report is organized in the following manner in order to provide a logical presentation of the information and detail:

- *Chapter I – Executive Summary*, provides a brief synopsis of the report, as well as a listing of each recommendation made, its relative priority, and potential for quantifiable cost savings, where appropriate.
- *Chapter II – Background and Organizational Issues*, provides an introduction into the organization of PSEG and its subsidiaries as well as discussions about compliance infrastructure, SAP, and compensation programs.
- *Chapter III – Competitive Services*, sets forth a detailed analysis of each of the major areas of service provided. This includes PSEG Power, Appliance Services Business, Global and Energy Technologies, and Sunburst.
- *Chapter IV – Corporate Accounting Issues*, provides the bulk of the accounting and financial audit. The analysis of SAP and cross-subsidization issues are reviewed. The proposed Service Company organization are also reviewed.
- *Chapter V – Compliance With the Standards*, addresses the individual standards and determines whether PSE&G is in compliance.
- *Chapter VI – Appendix*.

## E. SUMMARY OF RECOMMENDATIONS

The following summary of recommendations provides key information on actions that the Team believes PSE&G should undertake. The recommendation table is laid out as follows. Column one provides the recommendation number with an **R** indicating a recommendation. The roman numeral refers to the chapter of the report, and the number is the sequential number of the recommendation in the report. The second column provides the recommendation description, taken directly from the report, and the reference to the specific finding(s) that supports the recommendation.

---

**Competitive Service and Affiliate Compliance Audit of PSE&G**

**Exhibit I-2  
Summary of Recommendations**

<b>Rec. Number</b>	<b>Recommendation Description</b>
<b>II-R1</b>	Develop a compliance team within the current legal department or elsewhere that is capable of addressing upcoming issues and further develop the compliance plan into a robust, useful document. (Refer to Finding II-F1)
<b>III-R2</b>	Clarify the Compliance Plan to address the process by which SERVCO will restrict its outside activities to wholesale customers. (Refer to Finding III-F6)
<b>III-R3</b>	Increase security and employee awareness at the Edison complex to prevent information transfer among employees. (Refer to Finding III-F12)
<b>III-R4</b>	Develop and implement training that specifically addresses the real situations likely to be encountered by those affiliates providing competitive retail services. (Refer to Finding III-F13)
<b>III-R5</b>	Training materials should be revised to remove ambiguity regarding solicitation. (Refer to Finding III-F20)
<b>III-R6</b>	Customer inquiry center employees should inform customers during the initial call that if the work needed is not safety-related then other contractors may be available to perform the needed work. (Refer to Finding III-F20)
<b>III-R7</b>	PSE&G should seek clarification of Section 6.3.e.1 of the Standards from the Board. (Refer to Finding III-F20)
<b>III-R8</b>	PSE&G should obtain Board approval for the competitive services offered by Sunburst and the other competitive services offered by PSE&G. (Refer to Finding III-F26)
<b>IV-R9</b>	Sunburst marketing activities should be separated from those of PSE&G. (Refer to Finding III-F27)
<b>IV-R10</b>	Reconcile all internal Service Company documents, lists and accounting systems and procedures manuals to reflect and conform to the same groupings and definitions of Service Company functions and services currently provided to affiliates. (Refer to Finding IV-F29)
<b>IV-R11</b>	Develop appropriate report writers within SAP, with proper controls to produce accurate, timely detailed support for all monthly inter-company billings. (Refer to Finding IV-F36)
<b>IV-R12</b>	Develop appropriate report writers within SAP, with proper controls to produce accurate, timely detailed support for all monthly inter-company billings. (Refer to Finding IV-F36 and F37)
<b>IV-R13</b>	Develop a system of monthly invoices from all PSEG affiliates to ASB

	with sufficient detail for ASB and PSEG management to review the propriety of all inter-company charges on a monthly basis. (Refer to Finding IV-F39)
<b>IV-R14</b>	Develop accurate and appropriate benchmark data for the 2001 planning process, based on FY 2000 actual results. (Refer to Finding IV-F40)
<b>IV-R15</b>	Implement the Action Plans included in the internal audit report referenced in Finding IV-F1 above. (Refer to Finding IV-F43 and F44)
<b>IV-R16</b>	The Accounting Services Department should review each of the audit exceptions presented and make the necessary adjustments to ensure that cross-subsidization does not occur. (Refer to Finding IV-F45)
<b>IV-R17</b>	Choose one of the methods, i.e., planned costs or actual costs and apply it to all Cost Centers' charges and allocations. (Refer to Finding IV-F46)
<b>IV-R18</b>	Develop a comprehensive plan for addressing all of the problems with SAP. (Refer to Finding IV-F48)
<b>V-R19</b>	Improve the Affiliate Standards training materials to support instruction, application, and job duties for all PSE&G and PSEG employees affected by the Standards. Identify potential areas of violation, correct areas that are potentially incorrect, misleading or oversimplified. (Refer to Finding V-F64)
<b>V-R20</b>	PSE&G should either discontinue providing services to PSEG ET or provide them under the conditions specified in Section 3.2 of the Standards. (Refer to Finding V-F65 & F66)
<b>V-R21</b>	Identify the types of information covered by Section 4.2 and inform those employees with access to this information about the Section 4.2 and its requirements. (Refer to Finding V-F77)
<b>V-R22</b>	PSEG Services should discontinue Marketing as a shared corporate service offered to both PSE&G and PSEG ET. (Refer to Finding V-F90)
<b>V-R23</b>	PSE&G should clarify the Board's intent with regard to shared corporate officers to determine if it is in compliance with Standard 5.7.b. (Refer to Finding V-F102)
<b>V-R24</b>	Develop supporting procedures for the Compliance Plan which (1) provide the information necessary to fully demonstrate compliance and (2) can be used as a guide by employees who have questions regarding compliance with the Standards. (Refer to Finding V-F102)

**F. GLOSSARY OF TERMS**

SAP	Systems, Applications, and Products
ASB	Appliance Service Business
CSP	Customer Service Professional
GSIMS	Gas Service Information System
BGS	Basic Generation Service
ERP	Enterprise Resource Planning
IPP	Independent Power Production
APSO	Appliance Parts and Service Order
WBS	Work Breakdown Structure
ASD	Accounting Services Department
RCBSs	Related Competitive Business Segments
VRU	Voice Remote Unit
EHEP	Experimental Hourly Energy Pricing Service





**Mitchell & Titus LLP**



**NorthStar Consulting Group**