

**Audit of the Competitive Service Offerings of
Atlantic City Electric Company
d/b/a Conectiv Delivery Power
Docket No. EA02020095**

Final Report

Presented to the:

**Division of Audits
New Jersey Board of Public Utilities**

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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 (Consultants) 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 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, which implement New Jersey statutes that regulate utility affiliate transactions, and establish standards of conduct in providing competitive services to end users 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; however, 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.

A separate, following section of this report addresses each of these four elements of the Standards.

D. Summary of Recommendations

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

- 1. Treat ASP as an ACE holding company RCBS for purposes of applying the standards. (Page 10)**
- 2. In combination with SJG, solicit bids for meter-reading services being provided by Millennium; if another vendor offers lower costs, then ACE should change contractors. (Page 16)**
- 3. Charge for all work done for Millennium. (Page 16)**
- 4. Submit a corrected Compliance Plan listing TELP as a holding company RCBS. (Page 17)**
- 5. Update the Compliance Plan to reflect the addition of RCBSs as a result of the PEPCO merger. (Page 19)**
- 6. Reinforce in the Compliance Plan and clarify in guidance to employees the applicable restrictions on certain transactions between ACE and an RCBS of the holding company. (Page 22)**
- 7. Revise the ACE Compliance Plan to provide direction to employees on how to implement and adhere to the Standards. (Page 24)**
- 8. Amend the ACE Compliance Plan Compliance Procedures on Section 14:4-5.3(n) either to prohibit the advice to customers about its PUHC RCBS, or to provide guidance to employees on what advice is appropriate and how that advice can be provided with regard to competitors. (Page 40)**
- 9. Provide for regular verification that all data-base specific procedures, communications and training plans are adequate to assure full compliance with the access and security requirements of the Standards. (Page 61)**
- 10. Include in the Compliance Plan additional statements addressing the joint products and services requirements of Section 14:4-5.5(f). (Page 62)**



11. **Adopt and enforce the requirement that indirect purchasing costs be captured in a fashion that will support their apportionment according to the amount of purchases made and make the apportionment of such indirect costs in that manner. (Page 67)**
12. **Include in the Compliance Plan and CAM compliant practices and procedures for the pricing of joint services. (Page 68)**
13. **Modify the pricing procedures in the CAM to be consistent with the Standards. (Page 76)**
14. **Update the CAM to reflect current practices. (Page 76)**
15. **Institute refresher training to ensure that the day-to-day accounting procedures (such as when an affiliate should pay its own invoice) are clearly understood and implemented. (Page 80)**
16. **Reduce dependence on general allocators by implementing a greater degree of direct charging. (Page 85)**
17. **Develop and institute an A&G loader to be included in activity type prices used for direct charges. (Page 85)**
18. **Develop a method for capturing the indirect A&G costs in each cost center, so that any remaining costs that are allocated reflect the fully-loaded cost of that activity. (Page 85)**
19. **Reconcile for differences between budgeted and actual activity type prices. (Page 86)**
20. **Mandate that disclaimer required under Section 14.4-5.5(k) of the Standards be made on all materials circulated in New Jersey from any Conectiv RCBS that uses the Conectiv name and the “floating ‘C’” logo, including faxes and e-mails, regardless of their purpose. (Page 92)**
21. **Make the disclaimer required under Section 14.4-5.5(k) of the Standards on the website whenever a Conectiv Retail Affiliate is mentioned in juxtaposition with a discussion of utility service offerings in New Jersey. (Page 92)**
22. **Prepare and submit to the Board a report describing where Conectiv uses the disclaimer required under Section 14.4-5.5(k) of the Standards, and, when it is not used, its reasoning as to why it is omitted. (Page 92)**
23. **Amend the ACE Compliance Plan to specifically prohibit additional forms of joint advertising and marketing. (Page 98)**



24. In the event that the Board decides that clause (1) of Section 14:4-5.5(p) prohibits RCBS employees from being also involved in the provision of non-competitive utility and safety services, refrain from using any utility holding company RCBS to help maintain its utility infrastructure. (Page 100)
25. Reposition the duties of the individuals who serve as a Director or an Officer for both a utility and a related competitive business segment of the utility's holding company. (Page 102)
26. Establish a procedure to ensure that ACE's employee transfer reporting obligations under Section 14:4-5.5(r) are met. (Page 104)
27. Formulate detailed procedures for pricing transactions under Section 14:4:5.5(t), establish a structured communications and training program for their use, and provide for a formal program of internally verifying compliance with those procedures. (Page 114)
28. Formalize a lease agreement between ACE and Atlantic Southern Properties for the May's Landing office building, with the charges to ACE based on the lower of book value or demonstrated market value. (Page 117)
29. Add the required disclaimer to the Conectiv Energy webpages that mention Conectiv Energy Supply, Inc. (Page 122)
30. Demonstrate the adequacy of steps to protect the utility from the negative effects of affiliation with unregulated businesses and the continuing sufficiency of utility spending. (Page 135)
31. Place restrictions on ACE investments in the money pool similar to those required by the Board for JCP&L. (Page 135)

E. Project Scope

This audit examined the competitive service offerings of Atlantic City Electric Company ("ACE") and any of its 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 first 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. ACE Affiliates

1. Background

ACE is a regulated electric public utility operating in southern New Jersey. ACE supplies transmission and distribution services to approximately 508,600 customers in its roughly 2,700-square-mile service territory.¹ ACE is a subsidiary of Conectiv, a registered holding company under the Public Utility Holding Company Act of 1935. Conectiv was formed in 1998 through a merger between Atlantic Energy, Inc. and Delmarva Power & Light Company (DPL).² After the 1998 merger, and during the audit period, Conectiv's first-tier subsidiaries consisted of:

- ACE
- DPL, a utility company with operations in Delaware, Maryland, and Virginia
- Conectiv Properties and Investments, Inc., which owns and operates buildings leased to Conectiv operating companies, in addition to investing in leveraged leases and energy products
- Conectiv Solutions, LLC, which Liberty discusses in more detail later
- Conectiv Communications, Inc., which offered retail and wholesale telecommunications services until 2001, and now provides telecommunications services only to Conectiv and its affiliates³
- Conectiv Resource Partners, Inc., Conectiv's service company
- Atlantic Generation, Inc., which was created to own the transferred ACE generation assets⁴
- Conectiv Energy Holding Company, which provided natural gas, electricity, and energy-related products and services to residential and commercial customers. Conectiv Energy Supply is a subsidiary of the Conectiv Energy Holding Company and participates in energy trading as well as the procurement, transportation, and wholesale sales of fuels and fuel-related products.
- Atlantic Southern Properties, Inc, which owns and manages investments in real estate.

In August 2002, Conectiv and Potomac Electric Power Company (Pepco) finalized a merger that resulted in both companies' becoming wholly owned subsidiaries of Pepco Holdings, Inc. (PHI), a new registered holding company.⁵ Pepco and Conectiv retained their names, and continued to operate separately in their own jurisdictions after the merger. PHI's first-tier subsidiaries are:⁶

- Conectiv Energy Services, a multi-fuel management and generation company that serves wholesale customers in the Mid-Atlantic
- PHI Service Company, formerly known as Conectiv Resource Partners, which provides centralized support services to PHI's affiliates

¹ ACE Form 10-K, 2001.

² ACE Form 10-K, 2001.

³ DR #49.

⁴ DR #49.

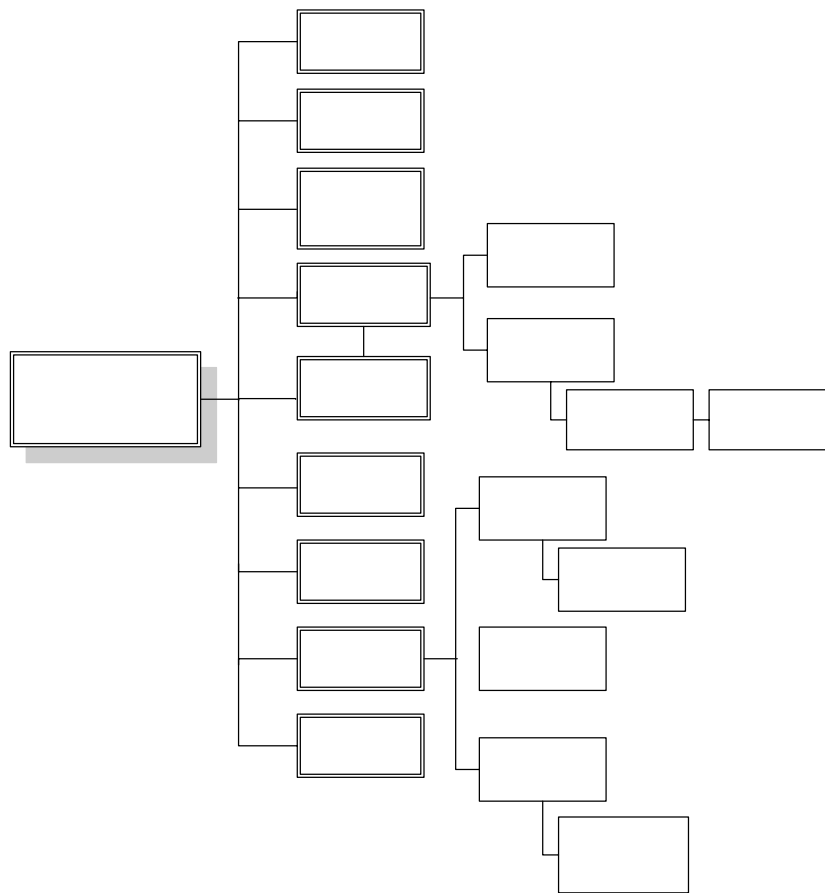
⁵ www.pepcoholdings.com

⁶ www.pepcoholdings.com



- Potomac Electric Power Company (Pepco), a regulated electric utility that engages in the transmission and distribution of electricity in the Washington, D.C. area to approximately 700,000 customers
- PEPCO Energy Services, Inc. (PES), which provides energy-management services to commercial, industrial, and governmental customers and offers electricity and natural gas to residential and commercial customers in the Mid-Atlantic
- Pepco Communications, Inc., which is a strategic alliance with a leading telecommunications provider, offers an array of telecommunication products and services to customers in the Washington, D.C. metropolitan area.
- Potomac Capital Investment Corporation (PCI), which invests in various energy-related financial investments and operating businesses.

Conectiv's organization during the audit period is illustrated below:⁷



The corporate entities that Conectiv recognized as related competitive business segments that offer service to retail customers include:⁸

⁷ DR #6; note that only certain second-tier affiliates are shown.

⁸ DR #8, Compliance Plan dated June 2002. The Company noted in its updated Compliance Plan filed on January, 17, 2003 that Conectiv Solutions is no longer a retail affiliate after the end of the audit period, because its remaining few retail contracts expired or were terminated as of September 1, 2002.



- Conectiv Energy Supply, Inc. (retail line of business only) – a company that sells electricity, natural gas, and fuel oil in New Jersey and elsewhere
- Conectiv Solutions – a company formed to provide power-systems consulting, end-use efficiency services, customized on-site system services, and other energy services to large commercial and industrial customers. Conectiv reported that on April 26, 2001, Conectiv Solutions sold substantially all of its assets, with a few remaining retail contracts in the process of being wound down. Conectiv Solutions is the entity that owns Conectiv’s interest in Millennium Account Services, which is described below.
- Conectiv Thermal Systems – a company that develops, owns, and operates heating and cooling systems and provides other energy services to business and institutional energy users
- Millennium Account Services – a joint venture owned 50 percent by Conectiv Solutions and 50 percent by South Jersey Industries; the venture provides meter-reading services to both companies, and is discussed below

In the compliance plan that was in effect during the audit period, Conectiv took the position that:

Sections 3 through 5 of the Standards do not apply to related competitive business segments of Conectiv providing services to other utilities or common carriers, providing high voltage or other specialty services or products to a relatively limited number of commercial or industrial customers or providing telecommunications services.

Liberty concurs with the first part of Conectiv’s statement, but only when it comes to products and services sold to other utilities and common carriers when those are sales for resale. Liberty does not, however, agree that other sales to utilities or a few commercial and industrial customers are not retail, even if they are specialized. Liberty applies the definition that is standard in the electric and gas utility industries, that only a sale for resale is a wholesale sale. This means, for instance, that providing inputs to a manufacturer is a retail sale. In any case, where the only significant value added by the purchaser is in making the purchased product or service available to a different market, the purchase can be considered wholesale. If, however, the purchaser makes a substantial transformation of the nature of the service or product, or if the purchaser bundles it with others in its offering to a different market, then the purchase should be considered retail. For example, selling windshield wipers to an auto parts store would be wholesale, while selling them to an auto manufacturer would be retail.

Liberty recognizes that there are other possible definitions, many of them in fact, but believes that the Standards would become almost trivial if a substantially more restrictive definition of retail were to be adopted. The Standards could, as is the case in some other states, merely have imposed code-of-conduct requirements on affiliates in the energy supply business; however, this is clearly not what has been done in New Jersey. Adopting a definition of “retail” that would exempt nearly all of the activities that affiliates have undertaken or are likely to undertake did not appear to be consistent with the broad thrust of the Standards. At least, Liberty did not feel comfortable adopting on its own initiative such a definition,

Using its definition, Liberty concludes that Atlantic Southern Properties (“ASP”) is a related competitive business segment (“RCBS”) of ACE’s holding company, Conectiv. As Liberty



describes elsewhere in this report, ACE and Conectiv should treat ASP as an RCBS of ACE's holding company for purposes of compliance with the Standards.

Liberty asked Conectiv to provide certifications as to the corporations that are owned by ACE's ultimate parent company and to state whether they had any retail or wholesale customers in New Jersey.⁹ Using these certifications Liberty determined that the following Conectiv and Pepco companies are RCBSs of ACE's PUHC:

- Conectiv Energy Supply, Inc., because it makes sales at retail
- Conectiv Operating Services Company, because it provides operations and maintenance services for power plants to third parties
- Thermal Systems, Inc., which owns and operates district heating and cooling systems and operates customer-owned thermal systems on customers' sites
- Severn Cable, LLC, which undertakes the construction, installation, maintenance, and repair of telecommunications and low-voltage electrical systems for customers; this company is owned by Potomac Capital Investment Corporation, and offers its services to customers in New Jersey
- W. A. Chester, LLC, which undertakes the construction, installation, maintenance, and repair of electric transmission and distribution cable systems; this company is owned by Potomac Capital Investment Corporation, and offers its services to customers in New Jersey
- Unitemp, Inc., which provides service, installation, and maintenance programs for heating, ventilation, and air-conditioning systems and refrigeration plants to customers in New Jersey
- MET Electrical Testing Company, which provides electrical maintenance and testing services to New Jersey customers
- Pepco Energy Services, whose offerings include energy-efficiency and performance contracting; retail electricity and natural-gas products to large customers; and flat-price natural-gas supply, renewable-energy products, and home-warranty services to homeowners and small businesses.

With the exception of the first three, all of these companies became affiliates of ACE and therefore RCBSs of ACE's holding company when Conectiv merged with Pepco, which occurred after the audit period ended. In its filing of a Comprehensive Compliance Plan with the Board on January 17, 2003, Conectiv drew up the same list as Liberty, omitting only Conectiv Operating Services Company.

Conectiv has not identified any products and services of ACE as competitive, such as servicing customers' appliances. Liberty also found that ACE has no such competitive services. Thus, ACE has no RCBSs.

⁹ DR #53.



2. Conclusions

- a. ASP is an RCBS, despite Conectiv's lack of agreement that it is so.**

3. Recommendations

- 1. Treat ASP as an ACE holding company RCBS for purposes of applying the standards.**

G. Millennium Account Services

1. Summary of Audit Activities

Liberty reviewed a large amount of information about Millennium Account Services LLC ("Millennium" or "MAS") and its relationship with ACE. Liberty examined: (1) ACE's comparison of costs of using Millennium instead of its own employees, (2) the proposal from Millennium to renew its contract, (3) the agreements between ACE d/b/a/ Conectiv Power Delivery ("CPD")¹⁰ and MAS, (4) MAS business plans, and (5) bills rendered between MAS and CPD. Liberty also tested sample transactions between Conectiv and MAS, and conducted interviews of a CPD executive, the head of MAS, and an executive representing South Jersey Industries ("SJI") and South Jersey Gas ("SJG"), which also have an interest in MAS. Section IV.I of this report addresses the results of transaction testing.

2. Findings

MAS has been reading most of ACE's customer meters since January 1999 as a vendor. MAS also provides certain services associated with the reading of meters. MAS does not read the meters of large industrial customers.¹¹ SJI, the corporate parent of SJG, and Conectiv Solutions, LLC, a non-utility affiliate of ACE jointly own MAS.

ACE and Millennium entered into their first Meter Reading Services Agreement on January 4, 1999.¹² This contract was not negotiated by Millennium and ACE, but instead was written by Conectiv and SJI when they started their joint venture. The MAS owners arrived at the pricing of services by giving ACE a 15 percent discount from its meter-reading costs in the first year of the contract and a 20 percent discount through the end of the next year.¹³ The current agreement, which is called the Interim Meter Reading Services Agreement, was signed on March 8, 2002.¹⁴

In anticipation of the expiration of the first Meter Reading Services Agreement, Millennium submitted a renewal proposal to ACE d/b/a/ Conectiv Power Delivery in September 2001. That proposal was accepted. It included a price increase of 2.5 percent for a 22-month period ending

¹⁰ CPD is the current trade name used by the line of business comprised of ACE and DPL. ACE is the utility entity in New Jersey, operates under the trade name CPD, and has management in common with DPL.

¹¹ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.

¹² DR #198.

¹³ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.

¹⁴ DR #200, Attachment 4.



at the end of 2003, to be followed by a 5 percent increase for the 3-year period of January 2004 through December 2006.¹⁵

The first contract between MAS and ACE had no penalty or incentive clause for missing few meter reads or reading meters inaccurately. The second contract between MAS and ACE included an incentive provision that rewards MAS for reading the most meters possible with a minimum of errors. When MAS exceeds the specified minimums the first time in a contract year it receives \$2,500 and for the second month in which it does better than the standard ACE pays \$5,000.¹⁶ There is a symmetric penalty provision for less than targeted performance.

Through October 2002 MAS only failed in two months to receive an incentive payment. MAS earned total bonus payments of \$65,000 for both customer populations combined for the contract year starting December 2001. Except for January, in 2002 MAS read on average 99 percent of ACE's meters,¹⁷ compared with read rates of 91 and 94 percent, respectively, in 1999 and 2000.¹⁸ The MAS error rate was only about two-tenths of one percent.¹⁹

The reason that the second contract has such a long term (December 1, 2001 to November 30, 2006)²⁰ is to ensure MAS an opportunity to return the investment it planned to make in new meter-reading equipment over an extended period. The total cost of the new system, which was put in place from July through November 2002, was about \$720,000.²¹ The meter-reading equipment that Millennium had been using was nearing the end of its useful life.²²

Millennium's monthly billings to ACE during the audit period averaged \$269,000 in 2001 and \$248,000 through the first half of 2002.²³ Millennium was profitable in its first year of operation, and has since shown increased profitability. In 1999 it earned a pre-tax profit of \$360,000, increasing to \$873,000 in 2000.²⁴ In 2001, Millennium's total revenues were \$5.5 million, of which \$3.2 million came from meter reading for ACE, and the balance from SJI. Net income in 2001 was \$1.1 million.²⁵ Through the ten months ending in October 2002, net income was \$1.2 million on revenues of \$4.7 million, of which \$2.6 million came from ACE. Liabilities were \$2.5 million; nearly all (\$2.4 million) was shareholders' equity.²⁶ MAS's assets consist predominantly of cash and accounts receivable, and its non-equity liabilities of accounts payable and accrued expenses. Virtually all of its liabilities consist of shareholders' equity.²⁷

¹⁵ DR #198.

¹⁶ DR #200, Attachment 4.

¹⁷ DR #201, Attachment 2.

¹⁸ DR #201, Attachment 1.

¹⁹ DR #203.

²⁰ DR #200, Attachment 4.

²¹ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.

²² DR #201, Attachment 1.

²³ DR #234.

²⁴ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002. While MAS started in 1999, it did not read all of ACE's meters at the start; instead, it started reading meters on a pilot basis, but, after the test ended in April 1999, MAS started reading all of ACE's non-industrial meters.

²⁵ DR #202, Attachment 1.

²⁶ DR #202, Attachment 2.

²⁷ DR #201, Attachment 1.



The Millennium partners decide on cash distributions. In February 2001 they distributed \$500,000 to each owner, and in July 2002 distributed another \$250,000 to the partners. A decision on the next cash distribution was to be made at the December 2002 executive committee meeting;²⁸ available cash at the time of Liberty's examination was ample to support another large cash distribution.

Liberty asked ACE to provide any documents that would show the results of solicitations of alternative, prospective providers of meter-reading services to the utility during the period 1998 to 2002. ACE made no such solicitations during that period.²⁹

Conectiv has analyzed the savings that ACE realized by using the services of Millennium. The analysis that Conectiv provided to Liberty compared the costs of salaries, benefits, vehicles, supervision, and clerical support that ACE itself would have incurred for meter reading as of the end of 1997 (inflated to 2000 costs) against the costs of using Millennium, corrected for the expenditures for meter readers who were made available from the utility to Millennium. The analyses showed a saving to ACE of about \$500,000 in 2000. A similar comparison showed a saving of about \$600,000 for 2001.³⁰

MAS receives services from both owners. A MAS business plan states that, "...appropriate fees and expenses are charged to MAS..." Liberty found otherwise, however.³¹ For example, Conectiv Resource Partners performs risk-management services for MAS; it helps MAS to find insurers. In response to a request for documents that showed the charges to MAS for such services, Conectiv replied that:³²

Insurance premium invoices are forwarded to and directly paid by Millennium. There have been no additional charges assessed to Millennium or any other subsidiary in connection with the risk-management services provided to Millennium by Conectiv Resource Partners.

Conectiv Resource Partners also prepares the tax returns of MAS. Conectiv Resource Partners did not identify the cost of preparing those tax returns; therefore, those costs were not billed to Conectiv Solutions separately. Conectiv estimates that the costs of preparing those returns would have been the product of 10-15 hours in each year of 2001 and 2002, at the hourly rates of \$72 and \$76 for those years respectively, or about \$1,000 annually.³³

MAS uses its own staff to market its services to other utilities. MAS has not yet signed up any customers beyond ACE and SJG, except for one small project it performed for a non-utility affiliate of SJI.³⁴

²⁸ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.

²⁹ DR #199.

³⁰ DR #197.

³¹ DR #201, Attachment 1.

³² DR #206.

³³ DR #206.

³⁴ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.



ACE has not submitted the 2002 contracts with MAS to the Board for its approval. Millennium and ACE did file the original agreement between ACE and MAS with the Board; that agreement involved the transfer of assets at book value from the utilities to Millennium. That filing included an explanation of the reasons for the transfer. The Board has not acted on the filing.³⁵

A MAS executive committee serves as the functional equivalent of a board of directors. Two officers each from SJI and Conectiv Solutions comprise that committee.³⁶ The Conectiv Solutions members are from non-utility Conectiv companies.³⁷

Millennium began operations with about 100 meter readers seconded to MAS from the utilities' meter-reading units. Over the two years since the new enterprise was formed, those meter readers bid back into jobs with the utilities. As of the end of 2002, only SJG employees remained at MAS; there were none from ACE. MAS's current total staffing complement, including management personnel, is about 75. The meter readers are represented by a union local that represents employees who work for SJG.³⁸

During the audit period Millennium used the services of some ACE meter readers at the rate of \$5,700 per month per reader.³⁹ The following table shows the labor expense that ACE billed to Millennium for leased meter readers.⁴⁰

January 2001	\$85,500
February 2001	85,500
March 2001	85,500
April 2001	85,500
May 2001	85,500
June 2001	85,500
July 2001	45,600
August 2001	34,200
September 2001	34,200
October 2001	31,350
November 2001	28,500
December 2001	28,500
Total 2001	\$715,350

Liberty asked Conectiv for market price or other analysis supporting the charge of \$5,700 per month per meter reader leased. Conectiv undertook no market analysis. Conectiv did not provide Liberty with calculations that supported the \$5,700 rate, but it did describe the factors used to generate the number.⁴¹

³⁵ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.

³⁶ DR #201, Attachment 1.

³⁷ Interview with G. Stockbridge, November 20, 2002.

³⁸ Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.

³⁹ Under the contract, Millennium agreed to continue to lease 15 meter readers employed by ACE until November 30, 2001, at a minimum. Millennium agreed to pay the total costs incurred by ACE for employing the meter readers.

⁴⁰ DR #166.

⁴¹ DR #237.



At its inception MAS also leased facilities, trucks, and meter-reading equipment from ACE and SJG, but had ceased doing so by the start of 2002.⁴²

3. Conclusions

a. Millennium is an RCBS of ACE's holding company.

Millennium provides services to customers who can be construed as end users and therefore retail customers of meter reading services, which is a competitive service.

b. ACE has not created or maintained adequate documentation to support its charges for meter readers that it made available to Millennium.

There is not a firm basis for establishing the pricing basis for services that ACE provided to an RCBS. However, the rate used appears to minimize the potential for cross subsidization, because it is not likely to be materially less than ACE's fully allocated cost. Moreover, the practice of providing the employees ended during the audit period (by the beginning of 2002), and does not appear likely to recur.

c. Millennium pricing makes meter reading available to ACE at less cost than would be required for ACE to perform the service internally and alone, but at greater cost than would be the case in a cost-based joint venture with the other utility involved.

Millennium reads the meters of ACE's customers at a lower cost than when ACE's employees read the meters. Meter-reading service quality, as shown by the fewer missed meter reads, is also higher. The amount of margin available to the Millennium owners indicates that the charges exceed the average cost of the two utilities. The asset base required for this service is not significant enough to consume this margin.

d. Renewal of the contract with Millennium violated subsection 14:4-5.3(b)(2), which precludes RCBS/utility transactions not subject to competitive procurement.

The first Millennium contract came before EDECA was enacted. When ACE renewed the agreement with MAS in 2002, however, it did so without soliciting bids from other prospective providers.

e. Conectiv Resource Partners's and CPD's books fail to account for some costs of affiliate services provided to Millennium.

Conectiv Resource Partners has not captured the costs of the risk-management and tax-accounting services it has provided to MAS. Those services have probably been worth in the tens of thousands of dollars, cumulatively, since MAS started.

⁴² Interview with J. Scaffidi, MAS, and A. Ruggiero, SJI, November 20, 2002.



f. Despite the customer benefits, the formation and operation of Millennium are troublesome under the Standards.

There is a broader issue than the violation of subsection 14:4-5.3(b)(2). That issue is whether it is appropriate for a utility, without prior approval from the BPU, to outsource a traditional utility function on what is, in effect, a permanent basis, to a non-utility affiliate. Doing so in the manner that has occurred here has the effect of turning a cost center into a profit center. Even where the change produces net savings over a “do nothing” alternative, it begs the question of whether a utility has failed to undertake the best means of serving customers, rather than one that is merely better than the historical option used. Liberty believes that the creation of additional profit opportunities by hiving off core utility functions raises questions that regulators should participate in answering before the fact.

Perhaps, for example, some sharing of the cost-savings margin is appropriate. Sharing can serve to give utilities an incentive to seek creative ways of joining forces and it can provide a proper means of compensating companies for any added risks involved in those new ways. Even so, it is difficult to see the public merit in not giving the BPU an opportunity in advance to consider what level of sharing between customers and investors would be appropriate to provide sufficient incentives to keep customer costs at a minimum. Certainly, the existence of comprehensive Standards in New Jersey underscores the State’s interest in prior review and approval of transactions with RCBSs and in assuring that certain administrative processes and requirements are followed with respect to entry into agreements and their price and other terms.

The MAS profit makes no contribution to offsetting revenues required from ratepayers. In contrast, it seems clear that Millennium’s pricing is lower than ACE’s fully-allocated costs. In the final analysis, however, if costs are the proper determinant, then the correct “costs” to examine are Millennium’s fully-allocated costs, which are lower than ACE’s.

The other available pricing option is market price. ACE does not pay the market price of the service, and none is available for ready reference because any meter-reading contract would have to reflect the unique characteristics of a utility’s meter types, configurations, and geographic distribution. If Millennium had been one of several bidders for the business of providing meter-reading services to ACE and had won in a competition, the pricing of MAS’s services and the profit that the company makes could be benchmarked against a verifiable market price. As a result, no market price was established through bidding. In fact, had there been bidding, it does not seem likely that the bids would have been structured at the start as a discount from the company’s cost of meter reading, or that a renewal would be based on the last cost with an inflation adjustment. Instead, true competition would have caused the winner to offer a price that was closer to its costs of reading the meters, because it would be competing with other contractors, all of whom would understand the risk/reward relationship at issue. As SJI put it in its Form 10-K filing with the SEC:

An excellent example of a low-risk, high-return opportunity is SJI’s joint venture with Conectiv Solutions, LLC -- Millennium Account Services, LLC. 2001 marked



*the third straight year of improved profitability for the company with the partners sharing pre-tax earnings of \$1.1 million.*⁴³

4. Recommendations

2. In combination with SJG, solicit bids for meter-reading services being provided by Millennium; if another vendor offers lower costs, then ACE should change contractors.

One approach is to take steps to make sure that ACE's customers are incurring the market price for contract meter reading. Doing so would reduce the likelihood that ACE is subsidizing MAS. The Board can have the results of a competition that will test the price in less than a year.

ACE and SJG can submit a plan that will show how they will put their meter reading up for bids, with the prospect that another party could take over from MAS. ACE and SJG must do this together or it will not work. The Board can monitor the process from development of a request for proposals through the issuance of a new contract, or the Board can have the companies put the business of reading their meters up for bid and examine the results after the procurement process is done, perhaps in the next biennial EDECA audit.

Whatever method the Board chooses, the primary concern should be that ACE and SJG use a process that gives prospective bidders reasonable assurance that they have a fair chance of taking over MAS's position as the contractor. If MAS is one bidder among several and has the lowest evaluated price then the Board will have taken steps to ensure that the relationship between MAS and ACE does not raise the question of whether ACE is subsidizing MAS.

ACE has the right to terminate its contract with Millennium with 90 days notice to Millennium. If ACE terminates the contract then it must pay MAS the sum of \$3,022 a month for the remaining term of the agreement, and in exchange ACE will own certain equipment.⁴⁴ If the Board were to determine that this term of the contract should be honored in the circumstance that another meter-reading vendor offered a lower price to read the meters of SJG and ACE, then the \$3,022 monthly charge should be included in the companies' and Board's decision on whether the utilities should change vendors. If the difference between the lowest bid from prospective vendors and MAS's pricing is this \$36 thousand a year, then there should be no change in provider. This is unlikely to be the case, however, especially if MAS decides to submit a bid to ACE and SJG.

3. Charge for all work done for Millennium.

Beyond the work done on risk management and taxes, the managers of Conectiv Resource Partners responsible for assuring that the costs of all work done for non-regulated companies is captured correctly should track and assign the costs of executives who provide governance services for MAS on an on-going basis, and also the costs that Conectiv incurred for the start-up

⁴³ SJI's 2001 Form 10-K.

⁴⁴ DR #200, Attachment 4.



of MAS. When all of those costs are identified, the books for 1999-2002 of all the Conectiv companies who are affected should be corrected.

H. Thermal Energy

Liberty asked ACE for documents that would describe the revenues and customers of Thermal Energy L.P. ("TELP"), which is a Conectiv non-regulated company that does business in New Jersey. Conectiv's reply said, in part:⁴⁵

The Company objects to the portion of this data request that solicits information concerning customers and revenues of affiliates on the grounds that it is outside of the scope of this audit and/or seeks information which is not relevant to the issues involved in this proceeding.

ACE did, however:

- Tell Liberty that ACE billed TELP \$4.4 million under ACE's Annual General Service-TOU rate for the year 2001 and \$4.1 million for the first 10 months of 2002
- Provide three agreements between ACE and TELP from May 2000
- Provide a copy of the Board's order in Docket No. EM00060384 which, among other things, approved the transfer of an ACE heating and cooling plant in Atlantic City from ACE to TELP.⁴⁶ The Board's order indicated that TELP makes lease payments to ACE in the amount of \$45,000 annually for the use of ACE's real property.

The lack of information about customers made it difficult to determine whether TELP is an RCBS; however, the available information supported an inference that TELP is providing services at the retail level in New Jersey. At the audit exit conference, ACE agreed to supply information that would permit a more firm conclusion with respect to TELP's potential status as an RCBS. ACE has since agreed that TELP is an RCBS that provides retail services (steam heating and chilled water) to New Jersey customers.⁴⁷

2. Conclusions

- a. TELP is an RCBS of ACE's holding company, but has not heretofore been identified as such by Conectiv.**

3. Recommendations

- 4. Submit a corrected Compliance Plan listing TELP as a holding company RCBS.**

⁴⁵ DR #214.

⁴⁶ DR #214.

⁴⁷ March 18, 2003 e-mail from Pederson to Koppelman.



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. Conclusions

- ACE does not represent in its customer communications that its PUHC RCBS or the customers of the PUHC RCBS will receive any type of preferential treatment.**
- The Conectiv web site does not create any implication of preference.**
- ACE's Compliance Plan generally contains clear and sufficient prohibitions against representing or providing preferential treatment to affiliates or customers of its affiliates, but takes too restrictive a view of what constitute holding company RCBSs subject to the standards.**
- Liberty found no evidence of preferential treatment by the utility in favor of any PUHC RCBS or customers of the PUHC RCBS.**

4. Recommendations

- 5. Update the Compliance Plan to reflect the addition of RCBSs as a result of the PEPCO merger.**

Liberty has also made recommendations regarding the sufficiency of Conectiv identification and treatment of pre-PEPCO-merger affiliated entities as holding company RCBSs in other parts of



this report. The Company subsequently noted that it filed an updated Compliance Plan on January 17, 2003, and that this plan provides the required information.

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 ACE 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.⁴⁸ Conectiv replied that it had not. During interviews and document reviews, Liberty consultants obtained information about many transactions between ACE and affiliates. Liberty checked to see if those transactions violated the requirements of this section of the Standards. During Liberty's transaction testing, Liberty similarly checked to see if any of the transactions violated those same requirements.

During transaction testing, Liberty found that most of the transactions it reviewed fit into those allowed under this section of the Standards as follows:

- Joint purchases allowed by Sections 14:4-5.5(g) and (h):
 - Purchases from Visalign, LLC for various IT services paid by the Service Company and charged to ACE for January 2002
 - EPRI membership fees paid by the Service Company and charged to ACE in February 2001.
- Corporate support allowed by Sections 14:4-5.5(i) and (j):
 - Direct charges for a power delivery engineer from the Service Company to ACE in February 2001
 - Allocated charges for the CEO in August 2001 from the Service Company to ACE
 - Charges paid by the Service Company and passed through to ACE in February 2002 for PricewaterhouseCoopers consulting services
 - Charges from the Service Company to ACE for Information Systems Desktop/Network Support for August 2001
 - Charges from the Service Company to ACE for merchant portfolio management for January 2001
 - IT administrative charges from the Service Company to ACE for July 2001
 - Allocation of residual charges for furnished space for 2001.

ACE does not have its own RCBSs, and thus conducted no transactions relevant under Section 5.6.

However, there were transactions involving sales and purchases made generally available to all market participants through open and competitive bidding that were not in keeping with this section of the Standards. As discussed more fully in Section 5.5(t), ACE sold a substantial amount of "special billing" services to Conectiv Communications. These transactions were not subjected to competitive bidding.⁴⁹ Similarly, there was no evidence that the use by Millennium of meter readers (ostensibly a service available for sale on open market) from ACE during 2001 was subjected to competitive bidding. As noted in Section 5.5(t), ACE did sell a limited amount of other services to TELP and Communication, but these were not open market services and therefore were not subject to the provisions of Section 5.3(b). However, there were two instances in which ACE procured services from Conectiv Communications (totaling \$5,120) that were not

⁴⁸ DR #257.

⁴⁹ DR #261.



competitively bid, and thus were prohibited transactions under this section.⁵⁰ ACE also entered into an informal arrangement with Atlantic Southern Properties for rental of office space; this arrangement was never subjected to competitive bidding either.⁵¹

Finally, as mentioned in Section 5.5(t) and discussed in more detail in Section I.G of this report, when ACE renewed its contract with Millennium, it violated subsection 14:4-5.3(b)(2), which precludes transactions between holding companies and utilities that are not subject to competitive procurement processes. When ACE renewed the agreement with Millennium in 2002, however, it did so without soliciting bids from other prospective providers.

4. Conclusions

- a. Liberty identified prohibited non-compliant transactions between ACE and RCBSs of Conectiv during the audit period.**

5. Recommendations

- 6. Reinforce in the Compliance Plan and clarify in guidance to employees the applicable restrictions on certain transactions between ACE and an RCBS of the holding company.**

Liberty found that ACE engaged in prohibited transactions during the audit period. To reduce the chance of such transactions in the future, ACE needs to make it clear to its employees what transactions and relationships are not permitted under the Standards. At least two of the ways of reducing the likelihood of mistakes are by increasing the coverage of this topic in the Compliance Plan and giving greater guidance to employees in training and manuals.

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.

⁵⁰ DR #261.

⁵¹ DR #261.



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

ACE's Compliance Plan on this section restates the Standards, and adds its interpretation as to what kind of information is covered. In a footnote in the Plan, the Company states that it interprets this provision of the Standards to mean that customer-specific non-public information released in accordance with the requirements of section 5.4(a) of the Standards and non-public supplier information, which is to be released in accordance with section 5.4(d), are not covered by the Standards' requirement for a public posting.⁵² Liberty agrees with this interpretation. The Compliance Plan does not otherwise expand upon the Standards or provide direction as to how the Standard will be implemented.

In response to questions about employee training on the Standards, the Company noted that all new employees receive a Regulatory Codes of Conduct and Accounting Business Practice, and that the Codes of Conduct are posted on the Conectiv intranet site.⁵³ Management and supervisory employees are required to annually review the Conectiv Business Practices and attest that they have been followed. A separate certification states that the manager or supervisor has reviewed the requirements of the Business Practices with employees.⁵⁴

⁵² DR # 8, Compliance Plan, p. 5.

⁵³ DR #66.

⁵⁴ DR #16.



ACE stated that it has made no postings under 5.3(c) because it did not provide any utility information services, unused capacity or supply to a Retail Affiliate.⁵⁵ A periodic review of the Conectiv website since the beginning of this audit has found no postings.

4. Conclusions

- a. During the audit period, ACE engaged in no activity to which the requirements of Standards Section 14:4-5.3 (c) would apply.**
- b. The ACE Compliance Plan provides no direction to employees on how to implement or adhere to this standard.**

5. Recommendations

- 7. Revise the ACE Compliance Plan to provide direction to employees on how to implement and adhere to the Standards.**

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:

⁵⁵ DR #150.



- 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

The Compliance Plan restates the Standards, and notes the location on the website where any public postings would be made.⁵⁶ During the course of this audit, Liberty found no postings on the website.

The Company stated that there were no power sales or purchases transactions with affiliates during the audit period.⁵⁷ ACE further stated it had made no public postings under Standards 5.3(d) or (e) because it did not sell or make an offer to sell surplus energy or capacity on a short-term or long-term basis to a Retail Affiliate.⁵⁸ As has been noted, ACE restricts its Compliance Plan to its defined "Retail Affiliates," which, prior to the newly filed January 17, 2002 Compliance Plan, did not include any PHI companies.⁵⁹

A review of the summary of power and capacity purchases did not reveal any such transactions with ACE affiliates.⁶⁰ All sales and purchases were made for BGS load responsibility, and any net purchase or sale amount went into a deferral account. The Company also purchases from the PJM pool.

4. Conclusions

- a. There is no evidence that ACE sold surplus capacity or energy to any affiliate during the audit period.**

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,

⁵⁶ DR #8, Compliance Plan, p. 5-6.

⁵⁷ DR #157.

⁵⁸ DR #150.

⁵⁹ The Company noted that it filed an updated Compliance Plan with the Board after the end of the current audit period, on January 17, 2003, addressing the merger.

⁶⁰ DR #157.



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.

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

ACE stated that it was unaware of any applicable discounts or waivers to an RCBS of its holding company.⁶¹

4. Conclusions

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

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁶¹ DR #122.



G. Documentation of Discount Bases

1. Statement of Applicable Requirements

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

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 with respect to Section 14:4-5.3(f), ACE offered no discounts or waivers to RCBSs of Conectiv. Therefore, documentation of such discounts was not required.

4. Conclusions

- a. ACE offered no discounts or waivers requiring documentation under Section 14:4-5.3(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

Based upon ACE's responses to data requests, Liberty determined that a demonstration of literal compliance with the tariff requirements applicable to the services provided would present adequate assurances that ACE's activities during the audit period comported with the tariff enforcement requirements of Standard's Sections 14:4-5.3(h) and (i). ACE identified a relatively small number of monthly service transactions and service recipients during the period; one affiliate took service for each of the 18 months in the period, while a second took service for only six months. ACE also noted that, while billing for each month was on a per kWh basis, each monthly bill for the first affiliate was in the amount of \$25,000.

Liberty first decided that it was necessary to determine why the bills for the first affiliate were for equal amounts for each of the first 12 months of the audit period. Liberty also decided that an examination of two monthly billings for the former and one monthly billing for the latter (a sample size representing more than 10 percent of the total billings) would provide an adequate test. Liberty asked ACE to provide tariff references and billing calculations for 3 bills that Liberty selected.

ACE provided tariffed services to two affiliates during the audit period:

- Electricity service to the office facilities of Conectiv Resource Partners in each of the 18 months from January 2001 through June of 2002
- Electricity service to the office facilities of Conectiv Resource Partners in each of the 6 months from January 2002 through June of 2002



ACE served Conectiv Resource Partners (CRP) under the “Avg. BGS Non-Res Rate” of its New Jersey Retail tariff. It served Atlantic Southern Properties under “AGT, AGS, MGS.” The following chart summarizes the service charges that ACE made to each affiliate.⁶²

**ACE Billings to Conectiv Resource Partners
January 2001 though June 2002**

Month	Monthly Usage	Special Charges	Total
January 01	\$25,000	\$0	\$25,000
February 01	25,000	0	25,000
March 01	25,000	0	25,000
April 01	25,000	0	25,000
May 01	25,000	0	25,000
June 01	25,000	0	25,000
July 01	25,000	0	25,000
August 01	25,000	0	25,000
September 01	25,000	0	25,000
October 01	25,000	0	25,000
November 01	25,000	0	25,000
December 01	25,000	0	25,000
January 02	23,760	0	23,760
February 02	20,520	0	20,520
March 02	19,140	0	19,140
April 02	20,460	0	20,460
May 02	19,800	0	19,800
June 02	21,120	0	21,120

**ACE Billings to Atlantic Southern Properties
January 2001 though June 2002**

Month	Monthly Usage	Special Charges	Total
January 01	\$41,340	\$0	\$25,000
February 01	24,454	0	25,000
March 01	202	0	25,000
April 01	7,793	0	25,000
May 01	29,134	0	25,000
June 01	-	0	25,000
July 01	40,350	0	25,000
August 01	20,592	0	25,000
September 01	20,187	0	25,000
October 01	18,991	0	25,000
November 01	20,355	0	25,000
December 01	26,192	0	25,000

⁶² DRs #132 (original and correct responses).



January 02	21,641	0	23,760
February 02	19,206	0	20,520
March 02	20,718	0	19,140
April 02	17,723	0	20,460
May 02	13,404	0	19,800
June 02	13,917	0	21,120

ACE stated that the billings to CRP were identical for a number of months because they were estimated during a period of billing system conversion. Actual-usage based bills began in January 2002.⁶³ ACE also explained that the low Atlantic Southern Properties March and April 2001 billings and the lack of an apparent June 2001 billing did not reflect the failure to bill the affiliate on a timely basis; rather, accounts payable failed to input the billed amounts into its process on a consistent basis with respect to timing.⁶⁴

Liberty's analysis of the bills selected for review showed them to be typical bills and to have been calculated correctly according to the applicable tariff.

4. Conclusions

- a. ACE did not provide usage based bills to a holding company RCBS, but it has corrected that situation and the estimated bills it used proved adequate to prevent subsidization of the RCBS at utility expense.**

CRP paid ACE for electricity use on an estimated basis for an extended portion of the audit period. ACE has since begun to bill on the basis of actual usage. The estimates it previously used for billing proved to be significantly in excess of more recent actual usage. This conservative aspect of the estimates previously used assured that ACE was not subsidizing the operations of this affiliate.

- b. In all other respects, ACE applied correctly the provisions of its tariffs for usage based services to those of its customers who were also an RCBS of its holding company.**

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:

⁶³ DR #192.

⁶⁴ DRs #195 and 196.



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 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

ACE stated that it did not receive any requests for new or changed services from any RCBS during the audit period.⁶⁵ Therefore, no testing was required.

4. Conclusions

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

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.

⁶⁵ DR #120.



- 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 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

As noted above regarding Section 14:4-5.3(a) of the Standards, Conectiv Power Delivery does not represent in its customer communications or on its website any implication of preferential treatment for any PUHC RCBS or the customers of any PUHC RCBS. These conclusions also apply to any conditions or tying of the provision of utility services or discounts to the taking of any products from a PUHC RCBS.

The ACE Compliance Plan restates the Standard, noting that the Company is prohibited from conditioning or otherwise tying the provision of any products or services to the taking of any products or services from the Retail Affiliates.⁶⁶

4. Conclusions

- a. Conectiv Power Delivery does not specify or imply in its customer communication the tying of the provision of utility goods and services to the taking of products and services from its PUHC RCBS.**
- b. Liberty found no evidence of the tying of the provision of utility products and services to the taking of goods and services from its PUHC RCBS.**
- c. The Conectiv Power Delivery web site does not specify or imply the tying of the provision of utility products and services to the taking of goods and services from its PUHC RCBS.**
- d. ACE's Compliance Plan states that the tying of utility products and/or services to the taking of goods and services from a Retail Affiliate is prohibited.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁶⁶ DR #8, Compliance Plan, p. 7.



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

ACE stated that it did make any assignments of customers to any party during the audit period.⁶⁷ Therefore, no testing was required.

4. Conclusions

- During the audit period, ACE engaged in no activity concerning which the requirements of Standards Section 14:4-5.3 (l) would apply.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁶⁷ DR #134.



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 reviewed ACE's Compliance Plan in effect for the audit period. The compliance plan states that it will comply with this section of the Standards and will not provide leads, solicit business, acquire information related to business development, acquire information related to marketing or customer enrollment, share marketing analysis, share customer usage, pass on



customer information, represent or imply that utility speaks on behalf of retail businesses, or imply that customer will receive preferential treatment as a consequence of conducting business with Retail Affiliate.⁶⁸

Liberty reviewed ACE's strategic and business plans for adherence to these provisions, and found that the plans were in compliance with the Standard.⁶⁹

Liberty reviewed the information provided during the planning process to ensure that competitively sensitive information such as market analysis, customer usage information, and end use information are not inappropriately shared. Liberty found that during the planning process each of the affiliated companies prepares its own business plan and only high level data are provided between the companies during the planning cycle. Further, information such as end-use data, customer usage and other customer information are retained by the utility and not provided to other affiliates.⁷⁰

Atlantic City Electric does not provide customer information unless requested by the customer. Liberty also found that during the period of the audit, ACE has not had a competitor or consumer complaint concerning the improper release of information.⁷¹

4. Conclusions

- a. ACE's Compliance Plan adequately addresses customer enrollment, marketing, and business development limitations contained in Standards Section 14:4-5.3(m).**
- b. ACE's educational materials used in training of customer service employees cover the requirements of the Standards.**
- c. ACE has sufficient controls in place to protect competitively sensitive information.**
- d. Liberty found no evidence of ACE offering customer enrollment, marketing, and business development assistance to its affiliates that are prohibited by Section 14.4-5.3(m).**
- e. ACE has the necessary controls in place to be in compliance with Section 14:4-5.3(m).**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁶⁸ DR 8 pages 7 and 8.

⁶⁹ DR 23.

⁷⁰ Interview with (Mr. Zibinski, Mr. Walthum, and Mr. Barndt) October 22., 2002

⁷¹ DRs #253 and 20.



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

ACE provided to Liberty the packets of information it supplies in response to inquiries about Energy Choice.⁷² ACE offered customers during the audit period either a full enrollment package, which includes a cover letter, usage history, informational brochure, and a listing of approved suppliers, or the customer can request the usage history or supplier listing alone. No holding company RCBS is mentioned in any of those enclosures, except that Pepco Energy Services, Inc., d/b/a Power Choice, is included on the supplier listing. The listing of available suppliers is in alphabetical order, contact information is provided for each third party supplier, and the typeface and font are the same for the Pepco information.

The Conectiv Power Delivery webpages, which are accessed through www.conectiv.com, provide links to the BPU web page and directly to the BPU supplier listing. No listing of third

⁷² DR #154.



party suppliers is offered on the website. Customers are directed to make a telephone request for electric enrollment information.

Pepco Energy Services indicates in the supplier listing that it offers service only to commercial and industrial customers. The website for Pepco Energy Services that is shown on the supplier listing, www.pepco-services.com, asks for a zip code to identify the best products for the customer. If the selection is “residential” and a NJ zip code is entered, the customer is taken to a shopping page that offers air cleaners, lighting products, battery backups and surge protectors.

In a Data Request asking about any listing of product and service providers, as the Standards address in Section 5.4(g), the Company responded with the copy of the electric supplier listing it sends to customers about Energy Choice.⁷³ In a footnote in the Compliance Plan, the Company states that it will rely on the Board to supply appropriate listing of licensed utility-related suppliers; if the Board does not supply such a listing, the Company will direct customers to a generally available listing.⁷⁴

The ACE Compliance Plan first restates the Standard, including the requirement that any response can be made only upon the unsolicited request of the customer, and that the Company will comply with all of the other requirements of the Standards, including Section 5.4(g). The Compliance Plan states the Company will comply with the requirements of Section 5.3(n), and to ensure such compliance, that training has been and will continue to be provided to employees of the Company and, as appropriate, to employees of the shared services company and the Retail Affiliates.⁷⁵ The Compliance Plan offers no directions to employees about what kind of information can be shared or how identical information is to be provided about competitors. Liberty again notes the restrictive definition of Retail Affiliates in the ACE Compliance Plan.

4. Conclusions

- a. The ACE Compliance Plan does not provide sufficiently clear direction to employees regarding Section 5.3(n) in terms of what advice about Retail Affiliates can be provided to customers, and how similar advice can be provided with regard to competitors.**
- b. The listing of third party suppliers provided in response to customer requests does not highlight any supplier, and meets the requirements of this section of the Standards, as well as Section 14:4-5.4(c).**
- c. The ACE Compliance Plan states how the electric supplier listing is to be presented to the public, and meets the requirements of this section as well as Section 14:4-5.4(c).**

⁷³ DR #155.

⁷⁴ DR #8, Compliance Plan, p. 13.

⁷⁵ DR #8, Compliance Plan, p. 9.



- d. The Conectiv Power Delivery website does not provide a listing of alternative electric suppliers; therefore the requirements of this section do not apply to the website.
- e. The Conectiv Power Delivery section of the Conectiv website provides no references to any PUHC RCBS, and meets the requirements of this section as well as Section 14:4-5.4(f).
- f. The ACE Compliance Plan meets the requirements of this section.
- g. ACE's other communications with customers do not promote affiliates of the holding company.

5. Recommendations

- 8. Amend the ACE Compliance Plan Compliance Procedures on Section 14:4-5.3(n) either to prohibit the advice to customers about its PUHC RCBS, or to provide guidance to employees on what advice is appropriate and how that advice can be provided with regard to competitors.

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

In its response to the data request, ACE indicated that it was unaware of any kind of fee waivers or discounts from ACE to any affiliate.⁷⁶ In this case no posting would be required, although when directly asked about postings under various sections of the Standards, the Company did not answer with respect to this particular section.⁷⁷ The Compliance Plan states that the Company will comply with the requirements of Section 5.3(o). To ensure such compliance, the Company restates that extensive training has been, and continues to be, provided to employees of the Company and, as appropriate, employees of Conectiv Resource Partners, Inc, and the Retail Affiliates. Periodic review of the website by Liberty during the course of this audit did not reveal any postings.

4. Conclusions

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

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁷⁶ DR #106.

⁷⁷ DR #150.



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 ACE offered a discount or waiver to any RCBS of the holding company 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

As the Company has offered no discounts, rebates, or waivers to any customer, including its PUHC and RCBSs of its PUHC, during the audit period, Section 14:4-5.3(q) is not applicable.

4. Conclusions

- a. Liberty found no evidence that ACE offered a discount or waiver to any RCBS of the holding company 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

ACE considers customer proprietary information to be any information received from a customer in the provision of electric service. ACE participates in the Retail Choice Program, and provides customer information via electronic data interface with participating suppliers. The EDI interface is governed by the standard BPU file format, and requires that a signed contract be entered into by alternative suppliers.⁷⁸ Other proprietary customer information is provided to the PUHC and related competitive business segments, and to third parties only after signed confidentiality agreements are completed.⁷⁹ ACE has not requested nor has it released customer specific proprietary information through an alternative approval process.⁸⁰

Liberty reviewed Conectiv's processes for maintaining the security of customer proprietary information. Liberty examined training of customer service personnel. Liberty undertook this examination to verify that customer service personnel were trained on maintaining the security of customer proprietary information. For the audit period Conectiv stated that they provided four months of training to their customer service employees.⁸¹ In response to data requests, Conectiv provided only limited information concerning the training of customer service employees.

ACE provided Millennium Account Services access to the customer proprietary information necessary to provide meter-reading services. Conectiv thus has released customer proprietary information to Millennium as necessary for billing purposes.⁸² Conectiv did not release any unauthorized customer proprietary information during the period from January 1, 2001 through June 30, 2002.⁸³ Conectiv did not receive any formal or informal customer complaints related to release of customer proprietary information.⁸⁴

Conectiv Call Center employees undergo Code of Conduct training that is in addition to their normal customer service training. Conectiv's system known as LINKS provides job aids and information that should assist the customer service representative in maintaining the security of customer proprietary information.⁸⁵

⁷⁸ Interview, October 22, 2002 (Scott Razze and Christie Cannon)

⁷⁹ DR CO 51

⁸⁰ DR CO 73

⁸¹ Interview, October 22, 2002 (Razze, Short, Tall, Daniels)

⁸² DR CO 51

⁸³ DR CO 115

⁸⁴ DR CO 125

⁸⁵ Interview and observation of LINKS system on October 22, 2002



4. Conclusions

- a. ACE appropriately limited the release of customer proprietary information during the audit period to cases where there was prior written authorization of the customer.**
- b. ACE applied adequate processes to protect customer proprietary information during the audit period.**

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:

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

ACE listed aggregated load research, energy forecasts, and load forecasts as examples of the types of non-customer specific information that fit this category of information.⁸⁶ ACE uses a separate computer systems for storing load and forecasting information that is not accessible by the affiliates.⁸⁷ Conectiv does not provide access to non-customer specific information to either its PUHC or related competitive business segments other than aggregated data that are available on their web site.⁸⁸

4. Conclusions

- ACE did not provide covered information to those affiliates that it recognizes as RCBSs; however it is not clear whether it provided such information to the full range of entities that Liberty considers to be RCBSs.**

⁸⁶ Interview with W. Bart, October 22, 2002.

⁸⁷ Interviews with Conectiv personnel (Zibinski, Wathum, and Barndt), October 22, 2002.

⁸⁸ Interviews with Conectiv personnel (Zibinski, Wathum, and Barndt), October 22, 2002.



5. Recommendations

Liberty has no recommendations regarding the requirements of this standard, but does make recommendations in other sections of the report addressing the need for expansion of the holding company affiliates that should be recognized as RCBSs.

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
- 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 holding company and RCBS 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 holding company or a related 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 holding company 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

During the audit period, Conectiv did not request information or data from unaffiliated suppliers to share with an RCBS.⁸⁹

⁸⁹ DR #246.



4. Conclusions

- a. During the period of the audit, ACE did not provide or release non-public information subject to 14:4-5.4(d) from any unaffiliated supplier to Conectiv affiliates.**

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.

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 holding company or RCBS an opportunity to limit access to competitively sensitive information
- Restricting the use of non-public information provided by unaffiliated suppliers to only the holding company or related 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

During the audit period ACE did not solicit non-public data or information from unaffiliated suppliers within its certified territory during the audit period.⁹⁰

⁹⁰ DR #242.



4. Conclusions

- a. During the audit period ACE did not release unaffiliated supplier's non-public information to affiliated entities.**

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 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

Liberty found that ACE was able to provide requested documentation.

4. Conclusions

- a. ACE's success in providing all requested agreements and transaction documents during Liberty's transaction testing activities demonstrated compliance with the provisions of Section 14:4-5.4(h) of the Standards.**

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.

3. Findings

There are procedures that provide for the retention of transaction records. There are also provisions that provide for measures to be taken in the event that transaction-related



documentation in SAP needs to be removed from that system.⁹¹ Liberty's transaction testing produced no case where transaction documentation was unavailable because of a failure to retain it.

4. Conclusions

- a. ACE provides adequately for the retention of records of transactions involving it and its holding company or holding company RCBSs.**

5. Recommendations

Liberty has no recommendations regarding this provision of the Standards.

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 the records and documents as required during the audit.

4. Conclusions

- a. ACE was in compliance with 14:4-5.4(j) insofar as supporting reasonable audit time frames.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

⁹¹ DR # 263, 267, 268.



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 of Conectiv and reviewed the contracts it received.

Liberty also sought to determine the utility's practices for retaining the documents required by this provision.

3. Findings

There are procedures that provide for the retention of transaction records. There are also provisions that provide for measures to be taken in the event that transaction-related documentation in SAP needs to be removed from that system.⁹² During transaction testing, ACE was able to supply all the agreements that Liberty requested.

4. Conclusions

- a. PSE&G's practices and procedures were sufficient to assure retention of all contract information requested as part of transaction testing.**

5. Recommendations

Liberty has no recommendations with respect to this provision of the Standards.

⁹² DR # 263, 267, 268.



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 that Atlantic City Electric existed and operated as a distinct corporate entity during the audit period, as it has historically, and as it may be expected to do in the future. The compliance plan for Atlantic City Electric states the following:⁹³

The company is a separate corporate entity from each of the Retail Affiliates, and also is a separate corporate entity from Conectiv, the registered public utility holding company, and from Conectiv Resource Partners, Inc., the shared services company.

⁹³ DR #8 (Attachment 2); Conectiv identified the Retail Affiliates as Conectiv Energy Supply, Inc., Conectiv Solutions LLC, Millennium Account Services, and Conectiv Thermal Systems, Inc.



4. Conclusions

- a. Conectiv'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 conducted on-site interviews to review the company books and records.

3. Findings

Liberty found that Conectiv maintains separate books and records for the required entities.

4. Conclusions

- a. ACE was in compliance with the provisions of Section 14:4-5.5(b) during the audit period.**

5. Recommendations

Liberty has no recommendations with respect to this provision of the Standards.

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

This provision requires that the utility maintain books and records in accordance with USOA. Liberty did not undertake a full-scale examination of conformity with each USOA requirement. However, Liberty did conduct an overall review of compliance, and, during its transaction testing work, which is addressed later in Section IV.I of this 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

The ACE chart of accounts is consistent with USOA.

4. Conclusions

- a. ACE complied with the requirements of Section 14:4-5.5(c) during the audit period.**

5. Recommendations

Liberty has no recommendations with respect to this requirement.

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, utility holding company and 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

ACE provided substantially complete responses or satisfactory support for the failure to provide such responses to all of Liberty's audit data requests. With narrow exceptions, ACE demonstrated adequate support for the timely provision of information to Liberty's audit team. The exceptions concerned areas where good faith concerns about the proper scope of the audit existed. Liberty believes that ACE has demonstrated sufficient willingness to make its books and records open for examination for compliance with the standards.

4. Conclusions

- a. ACE complied with the requirements of Standards Section 14:4-5.5(d) insofar as responding to Liberty audit data requests was concerned.**

5. Recommendations

Liberty has no recommendations regarding the requirements of this standard.

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.

The effect of the two bulleted exceptions is, despite what it appears to be on first review, 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

Conectiv provided a list of major data bases used within the organization.⁹⁴ Conectiv did not provide a record of individuals and their organizational units that had been permitted access to these databases on an exception basis. Conectiv indicated that typically application owners and end users access the information or data in the corporate databases through their applications. Application owners and support personnel will be granted limited direct read access to specified production database environments dependent on application specific reporting requirements.⁹⁵ Also:

Database administrators create, build and maintain the application schemas at the database level and exercise all the structural changes in the production environments. System / DBA level database access is only available to members of the Information Management group in all Oracle and SQLServer environments. Access to application schema-owner will only be available to members of the Information Management group in the production environments and only available to application support personnel in production environments when expressly requested and justified by business need.

Conectiv provided a list of topics addressed in its IT security standards guidelines and procedures that are available on its internet site. The Company indicated that.⁹⁶

⁹⁴ DR #146.

⁹⁵ DR #145.

⁹⁶ DR #147.



Also electronically stored on the Conectiv Intranet Homepage under Information Technology are the IT Access Forms & processes required to access key systems platforms (NT, Mainframe) and applications (SAP, WMIS, GIS). The premise is that if management approval is granted to access processing platforms and / or key applications, the individual will have access to the data bases that support those platforms / applications.

Finally, Conectiv provided Liberty with a list of electronically stored security standards, guidelines and procedures. These included the following topics: Information Security Policy, Electronic Insight Security Tolls, Suspicious Mail Guidelines, Ray Civatte on Security, and InFocus: Terrorism. None addressed the prohibitions against sharing information specified in the standards.

4. Conclusions

- a. Existing practices designed to prevent information sharing described in the Competitive Standards are not sufficient to ensure compliance.**

Data base access in Conectiv is left to various managers throughout the organization. It is unclear that these managers have been provided with specific guidance regarding limitations on access to their databases as dictated by Section 14:4-5.5(e) of the Standards.

5. Recommendations

- 9. Provide for regular verification that all data-base specific procedures, communications, and training plans are adequate to assure full compliance with the access and security requirements of the Standards.**

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.

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 examined *The Compliance Plan of Atlantic City Electric Company*⁹⁷ to review the Company's position for its compliance with the Standards. Liberty also requested and reviewed documents of all joint purchasing agreements that include both a regulated utility and an unregulated affiliate of the parent/holding company.

The section of the *Compliance Plan of Atlantic City Electric Company* designated for Section 14:4-5.5 (f) consists of the following:

The Company also is permitted, under Section 5.5(f) of the Standards, to offer joint products and services (such as joint billing services) with the Retail Affiliates, so long as such joint products/services are approved by the Board and made available to all unaffiliated product and/or service providers on the same terms and conditions.

The Compliance Plan does not address the manner in which ACE is, or will be, in compliance with this Standard. Instead, the portion of the compliance plan addressing this section simply provides the Company's interpretation of the Standard.

Liberty found that the Company has no joint marketing, promotional, and advertising programs that benefit both regulated and competitive services.⁹⁸

4. Conclusions

- a. There were no joint product or service offerings by ACE and any RCBS of its holding company during the audit period; therefore, the provisions of Section 14:4-5.5(f) did not come into play.**
- b. The Compliance Plan does not sufficiently describe how compliance with the Standards is to be achieved and measured.**

5. Recommendations

- 10. Include in the Compliance Plan additional statements addressing the joint products and services requirements of Section 14:4-5.5(f).**

⁹⁷ DR #8 (Attachment 2).

⁹⁸ DR #47.



The ACE compliance plan provides the Company's interpretation of Section 14:4-5.5(f), however it does not describe the manner in which the Company is in compliance, plans to be in compliance, or is not in compliance. ACE should include such descriptions to provide complete coverage of this section of the Standards.

G. Joint Purchases

1. Statement of Applicable Requirements

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

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 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

Section 14:4-5.2 of the Standards provides the following definitions relevant to Section 14:4-5.5(g):

“Joint purchases” means purchases made by a parent or holding company or affiliate thereof for use by one or more affiliates, the fully allocated costs of which are allocated to be paid proportionally by the affiliates, based upon utilization.

“Joint purchases allowed” means purchases not associated with merchant functions, examples of which would be joint purchases of office supplies and telephone services.

“Joint purchases not allowed” means purchases associated with merchant functions, examples of which would be gas and electric purchasing for resale, purchasing of gas transportation and storage capacity, purchasing of electric transmission, system operations and marketing.



“Merchant functions” means the marketing and/or the provision of electric generation service and/or gas supply service to wholesale or retail customers, as opposed to the marketing and/or provision of transmission and distribution services, by an electric and/or gas public utility.

Given the definitions provided by the Standards, Liberty reviewed the list of joint purchasing agreements that included both the regulated utility and a holding company or holding company RCBS and found no instances involving joint purchases for merchant functions.

A review of the compliance plan determined that “the Company will comply with this requirement, ensuring that no single purchase of electricity supply and/or transmission is apportioned among the Company and the Retail Affiliates.”⁹⁹

4. Conclusions

a. ACE complies with Section 14:4-5.5(g) of the Standards regarding joint purchases associated with merchant functions.

ACE is in compliance with this section of the Standards because there were no joint purchases of products and/or services associated with merchant functions during the audit period.

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.

⁹⁹ DR #8 (Attachment 2).



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 ACE. Liberty also reviewed numerous purchasing agreements, and 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; Conectiv's response is summarized below:¹⁰⁰

Type of Service	Vendor
Power Plant Services	U.S. Filter
	Scott Gases
Environmental Consulting	Clean Air Engineering
	Entrix
	Heck Associates
Industrial Marine Services	
IT Services	NTH Consultants
	Teksolv, Inc.
	InteGreyted Consultants
	Ajilon Consulting
	FLK Consulting
	Visalign
	ICG Commerce
	SunGuard
	Meridian Knowledge Solutions
	PurchasePro
Software Licenses	IBM
	Logica, Inc.
	GE Network Solutions

¹⁰⁰ DR #44.



	Microsoft
	ASAP Software
Security	Day & Zimmerman
Staffing	Randstad
	Integrity
	Crigar
Telecommunications	Arch Communications
	Verizon Wireless
	Sprint Communications
Uniforms	Tyndale
Courier Services	Brooks Courier Services Inc.
Transportation Services	Transportation Bureau of Baltimore
Fire Systems	Delmarva Systems
Travel	World Travel
Materials	Utiliserve
Stationary	Relizon

During working sessions, Liberty asked Conectiv to clarify the nature of the joint purchase agreements listed, for example whether the contracts listed were more like blanket purchase orders (where purchases can be requested by individual affiliates under a given master set of terms), or whether they indicated charges specifically for each affiliate for a certain product or service. Conectiv attendees were unable to speak to the nature of individual contracts, but told Liberty that the service company, Conectiv Resource Partners (“CRP”), typically pays the bills for joint purchases, and that the relevant amount is then direct-charged to the affiliates.¹⁰¹ They added that in some cases, the purchasing group negotiates master agreements, and then affiliates make purchases against individual purchase orders. In other cases, such as telecommunications services, individual invoices are not assigned directly to affiliates, but rather become part of the common IT charges that are then allocated based on numbers of users. Liberty reviewed some of the contracts while on-site for transaction testing. In general, these joint purchases were typically retainer agreements, license agreements, or purchase orders with master contracts. ACE purchases its own materials for its storeroom, and pays for those purchases directly.

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 Conectiv 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 backup documentation supporting the amount assigned to ACE.

First, Liberty reviewed direct charges for January 2002 associated with an invoice from Visalign, an IT services company that was the second largest outside vendor to CRP in 2001.¹⁰² Visalign staff works on general IT efforts as well as on affiliate-specific projects. The total amount of invoice selected was \$266,696, of which \$1,703 was related to an ACE-specific project. The majority of the bill related to IT services that are allocated, rather than direct-charged. The

¹⁰¹ Work session November 19, 2002.

¹⁰² DR #26. IBM was the largest outside vendor.



Visalign invoice was very detailed, and identified time and charges by individual project or work order numbers; therefore Conectiv was able to identify the specific charges on the invoice related to the ACE project. The charges were adequately documented, and Liberty reviewed the settlement of charges in the Company's accounting system to verify that the appropriate costs were actually charged. As a further check, Liberty also traced the charges on the same invoice for a specific project done for Conectiv Operating Services Company.

Although not specifically identified by the Company as a joint purchase, Liberty reviewed EPRI fees, which are incurred under a master agreement with EPRI. Liberty reviewed \$17,909 in charges posted to ACE in February 2001 from CRP for fees paid to EPRI (the fees were incurred during 2000). Liberty reviewed supporting documentation for the separation of a \$96,807 EPRI invoice between ACE and DPL. The division was made based upon the EPRI program charges relevant to each utility. For ACE, the charges pertained to programs at the B.L. England and Deepwater plants. Liberty found the documentation supporting the determination of charges to be adequate, and reviewed the settlement of charges on the accounting system to verify that the appropriate costs were actually charged.

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

As discussed more fully in Section IV.I of this report, which addresses shared services, the indirect costs of purchasing, *i.e.*, the cost of the purchasing department, are allocated as part of shared services provided by CRP. There is no direct relationship between the dollar amount of purchases by any given affiliate and the amount allocated to it for the purchasing department; general purchasing services are allocated to affiliates based on number of employees.

4. Conclusions

- a. There were adequate recordkeeping practices for apportioning the direct costs of joint purchases made during the audit period.**
- b. ACE failed to comply during the audit period with the portion of Section 14:4-5.5(h) that requires indirect joint purchasing costs to be apportioned according to the amount of joint purchases made.**
- c. The Compliance Plan and CAM do not provide sufficient guidance with respect to the cost treatment of joint purchases.**

5. Recommendations

- 11. Adopt and enforce the requirement that indirect purchasing costs be captured in a fashion that will support their apportionment according to the amount of purchases made and make the apportionment of such indirect costs in that manner.**



12. Include in the Compliance Plan and CAM compliant practices and procedures for the pricing of joint services.

I. Shared Services

1. Background

There are a large number of shared administrative services provided by Conectiv Resource Partners (“CRP”). 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 by a list of specific criteria that Liberty employed in assessing the Company’s adherence to that requirement.

Organizational Structure

CRP is the Conectiv service company that provides management, administrative, support and other services to ACE and the other Conectiv companies pursuant to a Service Agreement filed with the SEC.

The services provided under the Service Agreement are as follows:

- Executive Management
- Procurement and Corporate Services
- Financial Services
- Human Resource and Performance Improvement Services
- Legal and Internal Audit Services
- Customer Services
- Marketing Services
- Information Technology
- Public Affairs
- Environmental and Safety Services
- Regulated Electric and Gas Delivery
- Energy Business
- Internal Consulting Services

The Company was unable to provide an organizational chart for CRP.¹⁰³

Information Technology

The IT group is one of the largest departments within the Service Company, and was a particular focus of Liberty during the audit. It has a budget of approximately \$67 million (roughly one-

¹⁰³ DR #6.



quarter of the Service Company) for the year 2002 and a total of 144 employees.¹⁰⁴ The major divisions of IT are:¹⁰⁵

- Solutions Delivery – provides applications support, including technical consulting and project management, and ongoing support of systems operations;
- SAP Group – provides technical and functional support for the business processes enabled by SAP;
- Web/EDI Group – provides web application consulting, development, and ongoing technical support, and technical support of business processes that require the transfer of data electronically;
- Workstation Group – provides help desk phone support, desktop services technical support, network administration, engineering, application certification, procurement, and deployment;
- Infrastructure Group – provides engineering and operations for UNIX and Windows servers, voice, and LAN/WAN; network capacity, performance, and monitoring; change management, disaster recovery, and security;
- Database Group – provides engineering and operation of database technology including database administration and computer operations;
- Planning and Finance – provides preparation/coordination of the annual budgeting cycle, including tracking monthly actual results to budget including variance analysis and forecasting;
- The Project Office – provides implementation of standardized project management methodologies for IT projects.

Service Company Services Provided

CRP has approximately 1,300 employees, of which 475 perform work almost exclusively for a specific subsidiary or group of subsidiaries.¹⁰⁶ There are three main categories of CRP employees:¹⁰⁷

- Delivery Business/Regulated Gas and Electric Utility – functions include operations, customer care (billing, credit and collections, call center, *e.g.*), management, and engineering.
- Energy Business – functions include merchant trading support, fuel supply, engineering support, and others.
- Shared Services – functions include controller/accounting, human resources, IT, treasury, safety & environmental, legal, supply chain, corporate communications, public affairs, and others.

Conectiv further distinguishes shared services as “core” or “leveraged.” Core services are those related to governance, *i.e.*, the cost of operating as a corporation, and include such costs as executive management, auditing, corporate accounting, and treasury. Leveraged services (legal,

¹⁰⁴ DR #139.

¹⁰⁵ DR #138.

¹⁰⁶ DR #1, Cost Accounting Manual (CAM), p. 12.

¹⁰⁷ Work session of October 17, 2002.



facilities, IT, *e.g.*) are those that an affiliate can “buy” and are, at least to some degree, variable depending upon usage.¹⁰⁸

Costs of the Service Company are accumulated in roughly 200 cost centers.¹⁰⁹ Costs captured at the cost center level include:¹¹⁰

- Direct costs – labor and materials needed to support people
- Employee overheads – primarily employee benefits and payroll taxes¹¹¹
- Vehicle costs – costs for vehicles assigned to the cost center
- Occupancy charges – charges for space utilized
- Information system support costs – desktop, phone, SAP user fees, etc.

Three of these charges – vehicles, occupancy and IT – are overhead “pool” type charges, which get assigned to a cost center each month based on estimated yearly expenditures for these three functions. Each cost center receives a charge for vehicles assigned to that cost center; costs include such items as maintenance, fuel, insurance, accident repair, and registration fees, as well as overheads such as facilities and IT charges.¹¹² Annual IT charges (\$12,000 per user in 2002) are applied to cost centers to cover common support costs (desktop, laptop, and phone). Annual occupied finished-space charges are assigned per full-time equivalent employee (\$5,400 in 2002).¹¹³ At year-end, the difference between the estimated per unit charges and the actual costs incurred by the Company for these categories are reconciled.

There are limited circumstances where the Service Company is not the literal provider of shared services, due to asset ownership and other limitations. For example, computer hardware acquired prior to the merger between ACE and DP&L is leased to the Service Company, and vehicles are not owned by CRP, but owned or leased by ACE and DP&L. In these situations, CRP may actually be the receiver of costs, although these costs are then charged back out to the Conectiv companies along with other CRP costs. There are also certain IT functions and activities performed in organizations other than CRP (such as within ACE/DP&L or Energy). Their costs are typically captured in cost centers within the Service Company that have been set up to allocate costs across multiple subsidiaries.¹¹⁴ These instances are exceptions to Conectiv’s standard policy that prohibits direct charging to the Service Company.¹¹⁵

ACE provided some of these shared services to CRP during the audit period, as summarized below:¹¹⁶

¹⁰⁸ Work session, November 19, 2002.

¹⁰⁹ DR #113.

¹¹⁰ DR #1, CAM, p. 18.

¹¹¹ Pension and post-retirement benefits are not included in the activity type prices for CRP. These costs are allocated each month as a benefit residual to Conectiv affiliates based on the portion of gross charges that were billed to each affiliate in the previous month (DR #189).

¹¹² DR #109.

¹¹³ DR #109.

¹¹⁴ DR #138.

¹¹⁵ DR #1, CAM, p. 26.

¹¹⁶ DR #110.



Cost Area	2001	6 months 2002
Vehicles	\$108,767	\$56,299
Information Systems	2,525,152	1,082,599
Buildings	586,595	232,005
Stores	600	2,276
Total	\$3,223,115	\$1,375,187

Certain Conectiv buildings are owned by ACE, and are used by employees of certain entities within Conectiv. In certain cases, inter-company leases had been set up between CRP and ACE for buildings that are principally used by CRP; in other cases, ACE charges CRP based on actual costs for the building each month.¹¹⁷

Shared Service Billing and Transaction Volumes

The Service Company has a tiered approach to billing each month. First, costs in each cost center are direct charged to the extent possible. Direct charges are of two types: charges to an affiliate for a specific activity performed by a CRP employee, or pass-through charges paid by CRP on behalf of the affiliate, such as vendor invoices (to which CRP adds no additional administrative charge). The remaining costs in each cost center are then allocated to the appropriate affiliate cost centers using one of the Company’s allocation ratios, or Shared Key Factors (“SKFs”). At the end of a given month, the cost in any given CRP cost center is therefore zero.

Direct charges for specific activities performed by CRP employees are calculated using a standard rate, which is called an activity type price. An individual CRP cost center will have as many activity type prices as necessary to distinguish among different services provided. Cost centers are able to track time spent on affiliate-specific projects, because all employees positively time report (rather than exception time report).¹¹⁸ Activity type prices, which are calculated annually, are based upon budgeted costs and activity levels (*i.e.*, available hours to perform work), and are designed to reflect both direct and overhead costs (wages, employee benefits, IT, facilities, vehicles, training, travel expenses, etc.) The IT and legal cost centers within CRP are the only two that are allowed to charge other Service Company cost centers.¹¹⁹

For those Service Company employees who have both straight time and overtime rates, Conectiv uses both regular and overtime pay in determining a blended activity type price.¹²⁰ If a contractor were needed to perform an activity, then it would be included in the activity rate. There are cases when separate rates are developed for contractors, especially in the IT area, which makes substantial use of contractors. One example is SAP contractors, who in most cases charge time to routine support and maintenance work (which is allocated to all users of SAP).¹²¹ A policy

¹¹⁷ DR #1, CAM, p. 24. Conectiv clarified that the lease agreements for the Cape May Courthouse and Pleasantville buildings expired at year-end 2001. As noted in DR #86, starting in 2002, ACE charged CRP based on actual costs for the building (O&M, depreciation, property tax, facilities services, etc.). As discussed in Section 5.5(t) of this report, ACE leases a building from ASP, a portion of which is then charged to CRP.

¹¹⁸ DR #42 and #103.

¹¹⁹ Work session, October 17, 2002.

¹²⁰ DR #102.

¹²¹ DR #114.



regarding the use of contractors versus employees was formally documented in June 2002.¹²² The policy sets forth criteria for consideration of whether employees or contractors should be used for a given project, such as the skill set needed, the length of assignment, any labor or security risks, and importance of assignment to the corporation.

As noted above, any cost center charges not otherwise direct-charged are allocated to some or all of Conectiv's affiliates. CRP uses an extensive number of SKFs, roughly 50, to apportion its costs (although roughly half pertain only to IT, facilities, or vehicles alone). CRP makes many of its allocations based on the number of employees, labor dollars, or O&M costs of the affiliates. In some cases, CRP uses a blended ratio, which is the average of three other ratios: number of employees, labor dollars, and asset costs. CRP's use of allocators is discussed more fully later in this section. According to the Service Agreement, allocation ratios are to be reevaluated at least annually (although Conectiv now updates these quarterly).

The following charts summarize the direct and allocated charges from CRP to the Conectiv affiliates during the audit period:

CRP Charges to Conectiv Affiliates During 2001¹²³

	Direct Cost Charges	Allocated Charges	Total Billed	% of Total CRP Billings
Delmarva	\$25,254,155	\$70,258,733	\$95,512,888	40.9%
Atlantic City Electric	16,970,024	66,860,978	83,831,002	35.9%
Conectiv Properties	46,580	36,028	82,608	0.0%
DCI I Inc.	42,742	10,578	53,321	0.0%
DCI II	392	0	392	0.0%
Conectiv Oper. Services Co.	2,830,201	4,088,755	6,918,955	3.0%
DCTC-Burney	48,090	2,198	50,287	0.0%
Conectiv Energy Supply	8,824,723	5,340,329	14,165,051	6.1%
Conectiv Delmarva Generation	1,897,127	6,692,179	8,589,305	3.7%
Conectiv Atlantic Generation	436,500	974,502	1,411,002	0.6%
Conectiv Mid-Merit	3,636,161	507,104	4,143,264	1.8%
Conectiv Bethlehem	497,321	0	497,321	0.2%
Conectiv Energy Holding Co.	39,981	78	40,059	0.0%
Atlantic Southern Properties	22,751	76,167	98,918	0.0%
Atlantic Generation, Inc.	654,074	31,685	685,760	0.3%
Vineland General, Inc.	432	0	432	0.0%
Pedrick General, Inc.	5,009	0	5,009	0.0%
ATE Investment	33,457	86,121	119,578	0.1%

¹²² DR #114.

¹²³ Figures calculated from data provided in DR #164. The figures represent gross numbers (charges out from CRP) and do not reflect any charges from affiliates to CRP.



King Street Assurance	15,130	18,491	33,621	0.0%
Conectiv Services II, Inc	136,970	99,693	236,663	0.1%
Conectiv Solutions	1,281,577	3,322,422	4,603,999	2.0%
Vital Services Home	2,154	0	2,154	0.0%
Conectiv Energy Inc.	2,155,125	0	2,155,125	0.9%
Conectiv Thermal Systems	212,186	623,661	835,847	0.4%
Atlantic Jersey Thermal	432	0	432	0.0%
Thermal Energy Limited Part.	403,850	59,894	463,744	0.2%
Conectiv Communications	1,483,015	6,344,783	7,827,798	3.3%
Conectiv Holding Co. Inc.	11,592	1,413,883	1,425,475	0.6%
Total	\$66,941,748	\$166,848,260	\$233,790,009	
Percentage of Total	28.60%	71.40%		

CRP Charges to Conectiv Affiliates Jan-June 2002¹²⁴

	Direct Cost Charges	Allocated Charges	Total Billed	% of Total CRP Billed
Delmarva	\$10,401,419	\$33,665,937	\$44,067,356	39.7%
Atlantic City Electric	8,185,984	31,432,799	\$39,618,783	35.7%
Conectiv Properties	45,086	30,268	\$75,354	0.1%
DCI I Inc.	48,360	22,862	\$71,222	0.1%
Conectiv Oper. Services Co.	2,163,861	2,779,365	\$4,943,225	4.4%
DCTC-Burney	12,962	1,242	\$14,204	0.0%
Conectiv Energy Supply	4,776,007	2,833,034	\$7,609,041	6.8%
Conectiv Delmarva Generation	2,171,407	5,945,311	\$8,116,719	7.3%
Conectiv Atlantic Generation	193,303	1,099,259	\$1,292,562	1.2%
Conectiv Mid-Merit	917,056	501,443	\$1,418,500	1.3%
Conectiv Bethlehem	1,331,121	195,274	\$1,526,394	1.4%
Conectiv PA Generation Inc.	131,636	2,300	\$133,936	0.1%
Conectiv Energy Holding Co.	113,873	145	\$114,018	0.1%
Atlantic Southern Properties	11,434	44,684	\$56,118	0.1%
Atlantic Generation Inc.	206,400	11,907	\$218,307	0.2%
Vineland Ltd. Inc.	399	0	\$399	0.0%
Vineland General, Inc.	475	0	\$475	0.0%
Binghamton Ltd. Inc.	760	0	\$760	0.0%
Binghamton General, Inc.	988	0	\$988	0.0%
Pedricktown Generation	190	0	\$190	0.0%
ATE Investment	5,389	19,356	\$24,745	0.0%

¹²⁴ DR #163. The figures represent gross numbers (charges out from CRP) and do not reflect any charges from affiliates to CRP.



King Street Assurance	14,844	16,328	\$31,172	0.0%
Conectiv Services II Inc	49,522	0	\$49,522	0.0%
Conectiv Solutions	107,298	187,428	\$294,726	0.3%
Conectiv Thermal Systems	64,829	309,145	\$373,974	0.3%
Atlantic Jersey Thermal	228	0	\$228	0.0%
Thermal Energy Limited Part.	216,814	81,224	\$298,038	0.3%
Conectiv Communications	55,919	69,241	\$125,161	0.1%
Conectiv Holding Co. Inc.	12,953	631,710	\$644,663	0.6%
Total	\$31,240,516	\$79,880,264	\$111,120,780	
Percentage of Total	28.0%	71.5%		

During the audit period, approximately 28 percent of CRP’s costs were directly charged to Conectiv affiliates. The balance, 72 percent, was allocated based on the specific allocation factor for each functional area. During the year 2001, the Service Company charged ACE a total of \$83.8 million, compared to a planned amount of \$76.8 million. For the first six months of 2002, CRP charged ACE a total of \$39.6 million, compared to a planned amount of \$42.0 million.¹²⁵ Approximately 75 percent of all CRP charges were either allocated or directly charged to Conectiv’s two regulated utilities ACE and DP&L.

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.

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.

The Service Agreement generally describes how costs associated with these services are to be charged. To the extent possible, costs are to be direct charged by applying a standard rate per

¹²⁵ DRs #163, 164 and #121(budget attachments).



hour. Methods for allocating remaining costs for each service, as well as the definitions of the ratios employed in making these allocations, are specified in the agreement.

Conectiv also has a Cost Allocation Manual (“CAM”) that describes the Uniform System of Accounts used for the Company and sets forth in further detail the methods for all direct charges and allocations from the Service Company. The CAM includes a description of activity type prices and overhead loaders. The update and maintenance of the CAM is under the management of the Company’s Controller’s department.¹²⁶

3. Audit Activities

Liberty’s goal was to determine if CRP’s methods of capturing costs, pricing services, and charging for shared services resulted in cross-subsidization. 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 CRP, the cost of those functions, and their allocation methods. In addition, Liberty tested transactions between CRP and ACE, and CRP 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.

The CAM is the primary document governing the pricing of services by CRP. The pricing procedures in the CAM are not consistent with the Standards. While the activity type prices used for direct charges reflect direct and some overhead costs (employee benefits, IT, facilities, vehicles, training, travel expenses, etc.), they do not reflect all indirect costs associated with a given employee providing services. As an example, an unregulated affiliate charged for a CRP merchant portfolio manager would not pick up the cost of payroll processing or human resources that is associated with that employee. Thus the absence of an additional A&G loader means that there is the potential for cross-subsidization. This issue is discussed more fully later in this section.

Liberty also found instances in which the CAM was out of date. The CAM incorporates as an exhibit the Service Agreement, which specifies allocation methods for year 1999 and 2000 costs,

¹²⁶ DR #3.



but not those for 2001 and 2002.¹²⁷ When reviewing examples of activity type price workbooks, Liberty found that such incidental costs as training and travel are included in some activity type prices, but these costs are not mentioned in the CAM. In at least one case, the Service Agreement did not match Conectiv's other working documents on SKFs. Specifically, the "enterprise business group calling center" (allocated by number of reps) in the agreement no longer existed during the audit period, and instead call center costs are now allocated based on number of customers.¹²⁸

Much of what Liberty learned about specific costs was not gleaned from reading the CAM, but rather through interviews with Conectiv personnel. For example, one cannot discern from reading the CAM that the pension and post-retirement costs for CRP employees are not assigned to individual cost centers within CRP, but rather allocated out to affiliates. Thus, there may be over-dependence on personal knowledge, rather than documented procedures.

Conclusions: Clarity/Completeness of Governing Documents and Procedures

- a. CRP's governing procedures for the pricing of its services are inconsistent with the Standards and could result in cross-subsidization.**
- b. The CAM should be updated to conform with current practices.**

Recommendations: Clarity/Completeness of Governing Documents and Procedures

- 13. Modify the pricing procedures in the CAM to be consistent with the Standards.**
- 14. Update the CAM to reflect current practices.**

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

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

- 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 from each major group within CRP – Delivery, Energy and Shared Services. Liberty reviewed transactions between CRP and ACE, and between CRP and non-utility affiliates from different months over the audit period. Liberty

¹²⁷ The CAM is dated August 2000; the Company told Liberty that the year 2000 allocation factors shown were used for 2001 and 2002 (DR #90).

¹²⁸ Work session, November 19, 2002,



reviewed several allocated charges, plus direct charges for specific CRP employee services, pass-through charges for invoices, and joint purchases; Liberty also reviewed an example of an allocation of residuals.

Liberty tested eighteen transactions involving charges from CRP to affiliates, including ACE, as summarized below:

Transaction Testing of Service Company Charges

Type of Charge	Affiliate Charged	Month	Amount
<i>Direct Charge:</i>			
Trans/distr. engineer	ACE	Feb. 2001	\$44,690
	Communications	Feb. 2001	2,050
Pricewaterhouse bill	ACE	Feb. 2002	49,555
(pass-through)	Properties	Feb. 2002	8,126
Visalign bill	ACE	Jan. 2002	1,703
(joint purchase)	Operating Services	Jan. 2002	540
EPRI fees	ACE	Feb. 2001	17,909
(joint purchase)			
<i>Allocated Charge:</i>			
CEO	ACE	Aug. 2001	44,380
	CDG	Aug. 2001	12,641
	Holdings	Aug. 2001	14,943
Desktop/network support	ACE	Aug. 2001	194,339
	Thermal	Aug. 2001	3,305
IT Administration	ACE	July 2001	27,360
	Operating Services	July 2001	2,911
Merchant portfolio mgmt	ACE	Jan. 2001	59,608
	CDG	Jan. 2001	24,838
Finished space residual	ACE	Dec. 2001	239,814
	CAG	Dec. 2001	9,504

Liberty first tested direct charges for CRP transmission/distribution engineering services to ACE and to Conectiv Communications. Liberty reviewed the calculation of the activity type price used for the relevant employees and verified that the same rate was used for both ACE and Communications work. Liberty reviewed the supporting time sheets to verify the hours charged to the given work order and duplicated the calculation of the charges. With this transaction, as with all transactions reviewed as part of testing, Liberty then reviewed the settlement of the charge to ACE and to Communications in the Company's SAP accounting system.

As another example of a direct charge, Liberty tested a vendor invoice paid by CRP with the charges passed-through directly to ACE. With Conectiv's assistance, Liberty isolated an invoice from Pricewaterhouse Coopers for ACE work. Liberty reviewed the invoice and substantiated the settlement of the charges in the system. Liberty reviewed another invoice from the same



vendor for Conectiv Properties work to substantiate that the pass-through charges were handled in the same fashion. Liberty also tested two examples of joint purchases, whereby CRP paid the costs of an invoice and a share of the costs were assigned and direct-charged to ACE. These latter charges are discussed more fully in Section 5.5(h).

Liberty next tested charges from different cost areas that were subjected to allocation. First, Liberty tested a monthly allocation of the CEO's salary. Consistent with the CAM, ten percent of the CEO's salary was first allocated to the holding company; the balance was then allocated to all affiliates using the blended ratio SKF. Liberty reviewed the calculation of the SKF used to allocate these costs and verified that the correct amount of these costs were then charged to ACE and to Conectiv Delmarva Generation ("CDG").

Because IT costs are such a large portion of shared services, Liberty tested two such costs. First, Liberty tested a monthly allocation of desktop/network support. These charges are allocated to affiliates using the PC Users SKF. Liberty reviewed the calculation of the SKF used to allocate these costs and verified that the correct amounts were then charged to ACE and to Conectiv Thermal.¹²⁹ Secondly, Liberty tested the July 2001 allocation of IT administration costs. These charges are allocated to all affiliates using the blended ratio SKF. Liberty reviewed the calculation of the SKF and verified that the correct amounts were then charged to ACE and to Conectiv Operating Service Company.

Liberty then tested a monthly allocation for one of the activities within the Energy line-of-business ("LOB") group within CRP, specifically merchant portfolio management. These charges are allocated to specific affiliates using the Energy O&M SKF. Liberty reviewed the calculation of the SKF used to allocate these costs and verified that the correct amount of these costs were then charged to ACE and to CDG.

Liberty reviewed the allocation of the finished space residual for 2001. Costs in excess of those initially assigned to affiliates (\$5,200 per FTE per year) are collected in a general pooling cost center. These residuals are first divided between the energy and the delivery lines of business based on the relative percentage of finished space used by each. The delivery portion is then allocated among DP&L gas and electric and ACE based on a ratio of T&D O&M costs. The energy portion is similarly allocated among Conectiv Atlantic Generation, Conectiv Delmarva Generation and others based on a ratio of energy O&M costs. Liberty reviewed the calculation of the finished space SKF, and recalculated the portion of the delivery-related residual assigned to ACE and the energy-related residual assigned to CAG.

During transaction testing, Liberty found that Conectiv was applying its documented methods consistently, and in conformity with its CAM and Service Agreement. Backup calculations for yearly activity type prices and quarterly SKFs covering the entire audit period were maintained in separate worksheets or binders, and the documentation was clear and complete.

¹²⁹ Desktop/network support costs are one of the costs included in the \$12,000 per user per year allocation to each affiliate using CRP IT desktop services. The charges that settle to ACE and the other affiliates each month go to an internal pooling cost center for that affiliate, which allows reconciliation of the \$12,000 per user with actual costs.



According to Conectiv, there is a great deal of monthly review of financial results by various levels of management in the Conectiv organization to determine the appropriateness of costs charged to the various business lines. This review includes:¹³⁰

- Analysis by line of business finance and accounting analysts
- Reviews of reports for costs centers, work processes, and product segments by responsible managers
- Review and discussion of financial results versus budget results by senior management.

In 2001, Conectiv performed an internal audit to review the Service Company's transaction accounting. One of the objectives of the audit was to verify that the SKFs were accurate.¹³¹ In the audit, the company identified three SKF allocations with minor errors, resulting in \$338,622 being over-reported to the regulated business in 2000. The errors were the result of clerical data entry or mistakes in not considering all amounts in the calculation for the SKF.¹³² The Company subsequently made the required correction in the accounting system for these errors. The audit report identified a risk of not knowing whether SKF allocations were correct or not, and recommended that SKF calculations be reconciled quarterly.¹³³

The Company began monthly audits in 2002 to review CRP billings.¹³⁴ Liberty reviewed the monthly audit reports and, in most cases, there were only minor problems that had no impact on cost allocation. In one audit, however, the internal audit group found that one cost that had been incorrectly allocated.¹³⁵

Oversight of the Company's activity type price development is centralized in the Internal Costing Department within CRP.¹³⁶ At the beginning of each budget process, cost center heads receive a standardized workbook and a series of worksheets that guide the development of a cost center's activity type prices. Internal Costing reviews these for accuracy and inputs them into the SAP system.¹³⁷

Liberty found that the Company has good controls in place regarding the development of activity type prices, and that the monthly audit reviews will help ensure the continued accuracy of the allocation procedures. Liberty saw no errors during testing; however, Conectiv pointed out that the Pricewaterhouse invoice that Liberty tested should have been sent and paid directly by ACE, rather than flowing through the Service Company. This was an indication that some of the specific day-to-day accounting procedures (*i.e.*, when to forward an invoice directly to an affiliate, versus when to pay it through the Service Company) might not be well understood by some employees.

¹³⁰ DR #2.

¹³¹ DR #22 (marked confidential).

¹³² DR #18 (marked confidential).

¹³³ DR #18 (marked confidential).

¹³⁴ DR #22 (marked confidential).

¹³⁵ DR #18 (marked confidential).

¹³⁶ DR #115.

¹³⁷ DR #115.



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

- a. **With minor exceptions, the Company has in place adequate systems and procedures to perform all required cost collection and price calculation work.**
- b. **The Company has in place good procedures for periodically testing the accuracy of its systems and procedures and minimizing errors.**

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

- 15. Institute refresher training to ensure that the day-to-day accounting procedures (such as when an affiliate should pay its own invoice) are clearly understood and implemented.**

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.

Separate and distinct from transaction testing, which examined how accurately the Company implemented its chosen method for distributing Service Company costs, Liberty analyzed the Company's methods to determine if they produced results consistent with the Standards, *i.e.*, that they did not produce opportunities for cross-subsidization.

CRP's total charges for 2001 by major functional area are summarized below.¹³⁸

CRP Cost Area	Amount (\$ millions)
<i>Regulated Gas & Electric:</i>	
Power Delivery LOB	\$34.1
Customer Care	<u>74.3</u>
Subtotal	\$108.4

¹³⁸ DR #164.



<i>Energy LOB</i>	\$42.6
<i>Services LOB</i>	0.1
<i>Shared Services:</i>	
Corporate Support (procur., facilities, vehicle, envir., etc.)	\$10.8
Financial Services (acct, treasury, tax, insurance, etc.)	17.1
Human Resources	6.8
IT ¹³⁹	22.0
Corporate Services (executives, legal, audit, etc.)	<u>26.0</u>
Subtotal	\$82.8
Total	\$233.8

Liberty's first concern is the Company's heavy reliance on the use of general allocators, rather than direct charging. For example, the CRP costs associated with the Delivery LOB, which totaled \$34.1 million in 2001, were also charged almost exclusively to ACE and DP&L.¹⁴⁰ One the surface, little or no opportunity for cross-subsidization with non-utility affiliates might appear to exist, because currently all of Delivery LOB costs are charged to ACE and DP&L. The Company allocates between DP&L and ACE based on relative O&M costs (excluding depreciation, fuel costs and CRP allocations). It is not clear, however, that O&M costs necessarily track with each utility's use of these services. For example, DP&L received 63 percent of the Delivery LOB services that were directly-charged, but 55 percent of the allocated ones.

Instead of relying on an allocation, there appears to be no reason why Conectiv could not implement direct charging for essentially all of these costs. Of the \$83.8 million in CRP charges to ACE in 2001, \$13.2 million was for such Delivery LOB-specific services as drafting, delivery administration and management, and analytical/technical services.¹⁴¹ Of the \$13.2 million, \$8.1 million was directly charged and \$5.1 million was allocated. Given that a large portion of these costs are direct-charged already and that all employees report their time, it should be relatively simple to track hours for these activities to ensure that DP&L and ACE are receiving the correct shares relative to each other.

In some cases, allocation can produce approximately equivalent results to that of direct charging. Conectiv's customer care costs, which were \$74.1 million of the total \$233.8 million in CRP costs charged in 2001 (roughly 32 percent), were charged almost exclusively to DP&L and ACE

¹³⁹ Because IT can charge other cost centers within CRP, not all of the department's costs are indicated here. For example, during 2001, \$47.6 million of IT costs were charged to cost centers within CRP (DR #140).

¹⁴⁰ CRP direct-charged small amounts for Delivery LOB services to affiliates other than DP&L or ACE, roughly \$291,000 in 2001 and \$74,000 for the first six months of 2002 (DRs #101 and 187).

¹⁴¹ DR #164.



(\$37.1 million to ACE).¹⁴² The majority of customer care costs are allocated to DP&L electric and gas and ACE electric operations based on the number of customers. Relatively little is direct-charged. On the surface, allocation seems acceptable for these costs, because little or no cross-subsidization is possible as the regulated utilities currently absorb all of the costs. Also, tracking costs by separate regulated utility for customer care representatives would likely be unwieldy or impractical, and allocations between ACE and DP&L based on the number of customers seems reasonable.

Energy LOB costs are allocated using more than one SKF. For energy-specific financial and accounting activities, Conectiv uses an O&M ratio, which spreads costs to all affiliates, even those ostensibly not in the energy business including Solutions and Atlantic Southern Properties. For merchant functions, and for most generation support activities like engineering, power plant siting and related support, Conectiv uses the Energy O&M ratio. The Energy O&M ratio excludes the delivery portion of DP&L and ACE (but includes the transitional utility business portion for ACE), along with affiliate not involved in energy businesses.

Similar to Delivery LOB costs, there are questions about whether using O&M costs produces a reasonable approximation of the relative use of services by the affiliates. Unlike Delivery LOB services, however, Energy LOB services are used extensively by the non-utility operations, and therefore opportunities for cross-subsidization do exist.

During 2001, affiliates were charged a total of \$42.6 million in Energy LOB costs. Of the \$42.6 million, \$25.3 million was direct-charged (for activities such as merchant scheduler, trader, fuel analysis, etc), while \$17.3 million (for activities such as engineering administration, finance support, strategic planning, risk management) was allocated.¹⁴³ Conectiv Energy Supply (CES) used \$8.5 million (34 percent) of directly-charged services, and received \$4.3 million (or 24 percent) of the allocated charges. Absent other evidence that there is a reason why O&M costs are reasonable for one variety of Energy LOB costs but not the other, it appears that again the chosen SKF may not be the best predictor of cost causation. There appears to be no reason why Conectiv could not implement direct charging for essentially all of these costs.

Of the \$82.8 million in shared services charged out to affiliates for 2001, roughly \$15 million was direct-charged, and the balance allocated. For some shared services, the allocation factors Conectiv used appear to produce equitable results. For example, allocating the costs of security, mail distribution, and human resources administration based on the number of employees or labor dollars seemed appropriate and could produce a close representation of actual usage.

Some of the SKFs for IT services are summarized below:¹⁴⁴

IT Cost	SKF
Phone Services	Phone Users
SAP Applications	SAP Users
Mainframe Operations Mgmt	CPU Time

¹⁴² DR #164. Less than \$200,000 in customer care costs was charged to affiliates other than DP&L and ACE.

¹⁴³ DR #164.

¹⁴⁴ DR #37.



UNIX Operations Mgmt	UNIX Users
IT Applications Support	End Users
PC Support	PC Users
IT Data Management	Storage Ratio (MB)
IT Administration	Blended Ratio

The SKFs used for certain IT services such as number of phone users, SAP users, and PC users also appear to provide a reasonable match between the cost of the activity and the usage by a given affiliate. While most of the IT allocation factors appear appropriate, the allocation of IT administration costs on the basis of the blended ratio may not be as equitable as it could be. Instead, CRP might use the percentage of total IT costs charged to each affiliate in the prior year, which might provide a better indication of cost causation for that function. However, given that IT administration costs in total were \$1.7 million in 2001, the effect would be relatively minimal.

Some selected activities within the Shared Services group with relevant SKFs are summarized below.¹⁴⁵

Shared Service	SKF
Executive management	Blended ratio
Corporate accounting	O&M ratio
Controller, Tax Accounting	O&M ratio
Human resources admin.	Employee ratio
Treasury services	SC O&M ratio
Purchasing services/admin.	Employee ratio
Corporate communications	O&M ratio
Document/security	Employee/labor \$ ratio

The Company uses the O&M ratio for a large number of its shared service allocations. It is not clear, however, whether the same problems exist with the O&M ratio for Shared Services group activities as it does for Energy and Delivery, *i.e.*, whether the ratio produces a fair representation of actual usage of these service. The Company also uses a general allocator, the blended ratio (average of number of employees, labor dollars and assets), for roughly 10 percent of all CRP costs (corporate safety and environmental services, insurance administration, IT administration, executive management and the corporate secretary). It is not clear whether the Company has analyzed how well the allocation factors it employs track with each affiliate's actual usage of individual shared services.

Simply moving to a large percentage of direct charging, rather than allocation, will not, however, correct another problem creating the potential for cross-subsidization. Liberty's second concern with CRP's methods is that the costs directly charged or allocated from any given CRP cost center do not fully represent the true cost of those services. Although many of the indirect costs are captured in CRP's activity type prices and cost centers (IT costs, vehicles, facilities, etc.), these do not include some of the indirect costs of the personnel performing the activity. For example, pensions and post-retirement benefits are not included in activity type prices. CRP cost

¹⁴⁵ DR #37.



centers make use of such areas as payroll, human resources, accounts payable, etc., but do not receive any charges for these services.

If each Conectiv affiliate received roughly equivalent portions of direct and allocated charges, then the effects of this problem would be somewhat offset. A concrete example involving Conectiv Energy Supply (“CES”) may help illustrate this point. Charges from CRP to CES for 2001 are summarized below:¹⁴⁶

CRP Service Provided	Amount
Energy LOB services – direct	\$8,536,591
Energy LOB services – indirect	4,288,507
Power delivery – direct	30,879
Customer Care	183,854
Shared services – direct	212,947
Shared services – indirect	912,263
Total	\$14,165,041

CES used \$12.8 million of CRP services for Energy LOB activities (roughly 5 percent of total CRP costs). Yet only 2.35 percent of executive management costs, corporate safety and environmental services, and insurance administration, allocated using the blended ratio, were assigned to CES. Such costs as corporate purchasing, human resources, and mailroom, which are allocated using an employee ratio, were assigned to CES at 2.9 percent. Arguably, then, CES did not pick up the correct proportion (at least 5 percent) of indirect costs for the services it receives through its share of Energy LOB alone.

To correct the problem would require two changes: (1) adding an A&G loader to activity type prices, and (2) capturing the associated indirect costs in each CRP costs center for any portion that continues to be allocated. In this way, all usage by CRP subsidiaries of shared services would carry the full cost of that usage.

Conclusions: Cost Charging Methods

- a. CRP relies too heavily on the use of general allocators, when it appears that direct charging can be efficiently implemented for a large portion of its costs.**
- b. There are certain instances when the use of an allocator may be appropriate, as for customer care costs.**
- c. CRP’s activity type prices used to directly charge affiliates do not reflect fully-loaded costs.**
- d. CRP’s cost centers do not capture the true indirect costs of providing a given service.**

¹⁴⁶ Calculated from data provided in DR #164.



Recommendations: Cost Charging Methods

- 16. Reduce dependence on general allocators by implementing a greater degree of direct charging.**
- 17. Develop and institute an A&G loader to be included in activity type prices used for direct charges.**
- 18. Develop a method for capturing the indirect A&G costs in each cost center, so that any remaining costs that are allocated reflect the fully-loaded cost of that activity.**

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.

CRP uses three loaders to capture some of the indirect costs associated with the activities performed. Liberty reviewed the Company's calculations for budgeted overhead charges – IT, facilities, and vehicles – and reviewed its procedures for reconciling these charges at year-end.¹⁴⁷ For example, common IT charges pertain to SAP costs, phone and desktops, and are charged to ACE, DP&L, Operating Services, Conectiv Atlantic Generation, Conectiv Delmarva Generation, CRP and Conectiv Thermal (those affiliates making use of CRP centralized IT services). When the residual is settled at year-end, it is divided among the same affiliates. In the year 2001, there was a residual of \$1.4 million that was divided among the affiliates (with \$0.6 million going to CRP),¹⁴⁸ which indicated that the budgets were relatively accurate.

Conclusions: Overhead Pools

- a. The three overhead loaders captured in CRP cost centers and activity type prices are proper, are uniformly and consistently applied, and the Company maintains adequate documentation to support the calculation of these rates.**

Recommendations: Overhead Pools

Liberty's recommendation regarding an A&G loader is discussed in the prior subsection.

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

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

¹⁴⁷ DR #109.

¹⁴⁸ DR #141.



- 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.

The use of activity type prices introduces a potential problem, because they are based on budgeted costs. Monthly allocations, on the other hand, are made using actual costs. There are potential opportunities for inequities if the activity type prices are considerably off. In other words, if the activity prices were too low, then the “savings” would go to the affiliate directly charged, and the overage in actual costs would be allocated out among affiliates in not necessarily the same percentages that direct charges were billed. In Conectiv’s current process for monthly settlement, one cannot distinguish between the allocated dollars and the allocation of residuals (*i.e.*, the difference between actual cost and activity type prices). Conectiv needs to introduce a method to reconcile for any over- or under-charging through the use of estimated activity type prices.

Conclusions: Pricing

- a. **Conectiv does not reconcile for differences between budgeted and actual activity type prices used for direct charging.**

Recommendations: Pricing

- 19. Reconcile for differences between budgeted and actual activity type prices.**

Parent Cost Retention

The Conectiv holding company’s CEO and executives are part of the Service Company; the parent company is used for legal and financial purposes only, and has no employees of its own. Costs of the holding company, including those charged by CRP, are not allocated or charged out to the operating subsidiaries.¹⁴⁹ Costs retained at the parent company include:¹⁵⁰

- Costs related to the acquisition and merger with a new company (if a subsidiary acquires a company then acquisition costs would be born by that company and not the parent).
- Allocation of corporate governance costs from CRP (typically the cost of executive officers, legal, controller, treasury and corporate communications).
- Interest on commercial paper issued by Conectiv for itself and its subsidiaries. The debt and associated interest is retained at the parent.
- The costs of its own tax liability.

Conclusions: Parent Cost Retention

- a. **Liberty concludes that cost retention by the Conectiv holding company does not represent a vehicle for cross-subsidization.**

¹⁴⁹ DR #190.

¹⁵⁰ DR #38.



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

The criteria that Liberty applied were as follows:

- Sufficient controls should be in place to protect competitively sensitive information regarding joint services
- The compliance plan should address handling of market sensitive information when joint services are being utilized
- Joint planning should be conducted in a manner that will protect competitively sensitive information.

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 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.

3. Findings

Liberty reviewed the utility's compliance plan and the compliance procedures included to comply with Section 14:4-5.5(j) of the Standards. ACE indicated in its plan that any shared support shall be priced, reported, and conducted in accordance with this section. Further, ACE indicated that shared service would not be used as a means to transfer customer information, create customer confusion, or create significant opportunities for cross-subsidization. ACE indicated that it would comply with the requirements of Section 14:4-5.5(j) of the Standards.¹⁵¹

Liberty reviewed the planning process at ACE to determine if it resulted in competitively sensitive information being acquired by affiliates. At Conectiv, corporate planning is responsible for high-level business planning, financial forecasting and budgeting.¹⁵² Each of the operating groups/companies within Conectiv has a planning group responsible for preparing its plan. Each of the operating companies maintains its own financial data information and prepares its own budget and business plans. Information shared during the planning process was sufficiently aggregated that competitively sensitive information was not transferred. Atlantic City retains ownership and control of disaggregated and competitively sensitive information that is used to create its one-year budget and outlook.¹⁵³ This would include marketing studies, sales forecasts, and specific operating data.¹⁵⁴

¹⁵¹ DR #8, Exhibit A-14.

¹⁵² Interview with (Mr. Zibinski, Mr. Walthum, and Mr. Barndt) October 22, 2002

¹⁵³ Ibid.

¹⁵⁴ Ibid.



Liberty reviewed strategic and business plans of Atlantic City Electric. Liberty found that the business plans were separate from those of affiliated companies and Liberty could not identify any use of ACE information.¹⁵⁵

4. Conclusions

- a. ACE has sufficient controls in place to ensure that competitively sensitive information is not shared in accordance with Section 14:4-5.5(j)**
- b. ACE's Compliance Plan is in conformance with Section 14:4-5.5(j) of the Standards**
- c. The planning process does not provide an undue disadvantage or advantage to ACE vis-à-vis other affiliates.**
- d. ACE appears to be in compliance with Section 14:4-5.5(j) of the Standards.**

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."*

¹⁵⁵ DR #23.



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 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

ACE indicated that most of the Conectiv System companies use a variation of the Conectiv logo,¹⁵⁶ which consists of the word "conectiv" in lower case sans-serif font below or beside a stylized "floating 'C'" with a subsidiary's specific business name below the word "conectiv," e.g., Power Delivery, Energy, Thermal Systems, etc.¹⁵⁷ The Company provided color copies of the logos used by Conectiv corporate, the utility, and the affiliates.¹⁵⁸

The Compliance Plan states that the Company is trading under the name Conectiv Power Delivery, which is not the same as, but is similar to, the Conectiv name variations used by the Retail Affiliates, and the logos all have common elements.¹⁵⁹ The Retail Affiliates are listed as Conectiv Energy Supply, Inc., Conectiv Solutions LLC (which is being wound down), Millennium Account Service, LLC, and Conectiv Thermal Systems, Inc.¹⁶⁰ For these reasons, the Company believes the Retail Affiliates are subject to the disclosure requirements of this section of the Standards, and they will comply by putting the disclaimers on all correspondence, business cards, faxes, electronic mail, and internet or hardcopy advertising or marketing materials circulated in New Jersey.¹⁶¹

The Company has chosen to use a disclaimer of two sentences, rather than the three sentences specified in the Standards. The Conectiv disclaimer reads, "Conectiv Energy is not the same company as Conectiv Power Delivery and is not regulated by the Board of Public Utilities. You don't have to buy Conectiv Energy products in order to continue to receive quality regulated services from the electric utility."¹⁶² The Company further states that it interprets the requirement, with respect to faxes and electronic mail delivered to persons within New Jersey, as

¹⁵⁶ DR #151.

¹⁵⁷ DR #152 and 153.

¹⁵⁸ Ibid.

¹⁵⁹ DR #8, Compliance Plan, p. 20.

¹⁶⁰ Ibid., p. 2-3.

¹⁶¹ Ibid., p. 20.

¹⁶² Ibid., p. 20, footnote 32.



including those that are sent for solicitation or advertising purposes, but not those that have no solicitation or advertising purpose.¹⁶³ Liberty notes that the requirement of the Standards applies to any circulated material, and does not limit the use of the disclaimer specifically to marketing materials.

Liberty's concern with the Company's interpretation is how employees discern exactly when the disclaimer is required, and how they remember to add the disclaimer as needed. If the disclaimer is added to all Retail Affiliate fax cover sheets, whether paper copy or electronic copy, and as part of an electronic signature to all emails, there could be no opportunity for the employee to incorrectly apply, or to forget to apply, the disclaimer.

Conectiv Communications and Conectiv Services are no longer used, and the Conectiv Energy logo is used only for the energy wholesale/trading business. Conectiv and Conectiv Energy logos appear in press releases, on the website, and on building signage. Conectiv, Conectiv Energy, Conectiv Solutions, Conectiv Thermal Systems and Conectiv Operating Services Company (COSC) logos appear on some vehicles, on business cards, and on letterhead. The COSC logo also appears in promotional brochures, on promotional products, on hard hats, on the website, and on building signage. The Company notes that it no longer actively markets retail energy services.¹⁶⁴

Liberty requested copies of advertising literature, brochures, etc., for holding company competitive services, in order to examine whether the disclaimer needed to be or had been included on the communications. In its response, ACE provided a single print ad for Conectiv Energy that had been included in the February, 2002, Gas and Power Mart conference catalogue. It did not include the disclaimer. ACE stated that materials promoting COSC were available at the Carneys Point, NJ, location for auditor review.¹⁶⁵ These items were not reviewed by Liberty.

Despite the clear statements in the Compliance Plan that the disclaimer is necessary for the Retail Affiliates, Liberty found no evidence that the disclaimer was used.

4. Conclusions

- a. The ACE Compliance Plan meets the requirements of Section 14:4-5.5(k) of the Standards.**
- b. The Conectiv website does not make the disclaimer on the Conectiv Energy pages, nor on the pages where the identified Retail Affiliate, Conectiv Energy Supply, Inc., is mentioned.**
- c. Liberty found no evidence that Conectiv System Companies used the disclosure in any marketing or communications materials, despite the statements in the Compliance Plan.**

¹⁶³ Ibid., footnote 33.

¹⁶⁴ DR #152.

¹⁶⁵ DR #159.



- d. The interpretation in the Compliance Plan that the disclosure is required on some, but not all, faxes and e-mails leaves the inclusion of the disclaimer to the judgment of the employee, which is problematical.

5. Recommendations

20. Mandate that disclaimer required under Section 14.4-5.5(k) of the Standards be made on all materials circulated in New Jersey from any Conectiv RCBS that uses the Conectiv name and the “floating ‘C’” logo, including faxes and e-mails, regardless of their purpose.
21. Make the disclaimer required under Section 14.4-5.5(k) of the Standards on the website whenever a Conectiv Retail Affiliate is mentioned in juxtaposition with a discussion of utility service offerings in New Jersey.

See the related recommendation in the Chapter VI of this report, which addresses implementation of the prior audit’s recommendations.

22. Prepare and submit to the Board a report describing where Conectiv uses the disclaimer required under Section 14.4-5.5(k) of the Standards, and, when it is not used, its reasoning as to why it is omitted.

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

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 utility bill inserts. Liberty has also reviewed the utility compliance plan with regard to this section of the Standards.



3. Findings

ACE stated that Conectiv has no joint marketing, promotional and advertising programs that benefit both regulated and competitive services.¹⁶⁶ The Company noted an instance where Conectiv Energy participated in Camden, NJ, “Make a Difference Day” activities by providing seedling trees for planting, and Conectiv Power Delivery was a sponsor of the same event. The Company stated that, prior to the day of the event, neither entity knew of the other’s participation, and that the costs of each company’s participation were borne separately by each company.¹⁶⁷ Liberty believes this coincidental attendance at the same event is not a violation of the Standards.

The utility bill inserts do not promote the holding company or its RCBSs.¹⁶⁸

As noted previously in this report, information sent to customers inquiring about Energy Choice does not promote any holding company RCBS.

The ACE Compliance Plan restates the Standard and further states that Conectiv will comply with the requirements of section 5.5(n).¹⁶⁹

4. Conclusions

- a. ACE did not provide advertising space for its PUHC or PUHC RCBSs in utility billing inserts during the audit period.**
- b. ACE did not provide an affiliate with advertising space in any written customer communications to its PUHC or PUHC RCBSs during the audit period.**

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:

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.

¹⁶⁶ DR #47.

¹⁶⁷ DR #159.

¹⁶⁸ DR #48.

¹⁶⁹ DR #8, Compliance Plan, p. 21



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

ACE stated that there was no joint marketing among ACE and its affiliates.¹⁷⁰ The Compliance Plan restates the Standard, and notes that it will comply with the Standard, with the following caveats added in footnotes:¹⁷¹

- The Company does not consider it to be joint advertising if Conectiv Energy includes messages on the Company's bill, or includes bill inserts in the Company's bill envelope, if the inclusions are provided on the same terms and conditions as other retail energy suppliers for which the Company provides billing services.
- The Company interprets "marketing" to mean the activities and materials related to solicitation and sale to end-use retail customers of the products and/or services provided by the Retail Affiliates.
- The Company does not believe this provision applies to material containing a factual statement regarding the affiliation of a Retail Affiliate, so long as the disclosure required in Standard 5.5(k) is included, nor does it apply to general branding and image advertising of Conectiv which mentions all of the products and services offered under the Conectiv brand.
- The prohibition against participating jointly with the Retail Affiliates in trade shows, conferences or other marketing events in New Jersey does not mean that Conectiv representatives attending such events are prevented from promoting the Conectiv brand and image, and providing information about all of the products and services offered under the Conectiv brand.

Liberty's initial concern was that billing inserts were available only to third parties who used ACE for billing services. In its comments on the draft of this audit report, ACE clarified that the

¹⁷⁰ DR #47.

¹⁷¹ DR #8, Compliance Plan, p. 21-22. The Compliance Plan also states that "to ensure such compliance, extensive training has been, and continues to be, provided to employees of the Company and, as appropriate, employees of the Retail Affiliates regarding such requirements."



Compliance Plan refers to messages on the billing invoice, not for advertising purposes, but to communicate billing or service-related information to customers, whether the energy supplier is affiliated or not. Liberty accepts this understanding, but believes that the point should be clarified in the Compliance Plan.

Liberty accepts the second bullet point, to the extent that ACE construes "Retail Affiliate" to mean any RCBS of its holding company. However, the term marketing should not be limited to what can be directly construed as solicitation or sale of products and services, but should be construed expansively enough to include the provision or solicitations of any material information regarding products or services individually, or regarding product or service lines collectively.

Liberty also agrees that a holding company may promote itself through general branding and image advertising, as discussed in the third bullet point, as long as no solicitation is included. Liberty disagrees, however, with the caveat that Conectiv may advertise not only the brand and image, but also the products and services offered under the Conectiv brand. Liberty believes that the activities described in the Company's footnote are, in fact, a violation of the Standards, and ACE should amend its Compliance Plan to clearly prohibit such activity.

For the same reasons cited immediately above, Liberty also believes that Conectiv has misconstrued the Standards as they relate to activities set forth in the final bulleted item.

The Company was asked about policies and guidelines around the utility's participation in non-sales meeting with affiliates or non-affiliated entities as allowed in 5.5(o)1. The Company stated that during the audit period ACE has not participated in non-sales meetings with any affiliate to discuss technological or operational subjects regarding the provision of distribution service. The Company also stated that it has not participated in non-sales meetings with its affiliate's competitors or other non-affiliated entities. ACE stated that, had there been any such meetings, account executives would be responsible for the meetings and would comply with Section 14:4-5.5(o) governing the utility's role in such meetings.¹⁷²

R&D

According to the Company, it did not renew its membership in EPRI in 2001.¹⁷³ During the audit period, ACE participated in a co-sponsored project with the DOE, administered by the Board, regarding integrated testing of fuel cells and micro-turbines. Reportedly, ACE spent labor on the project but did not track it separately.¹⁷⁴ ACE was also active in the EPRI Cyclone NO_x interest group and provided \$50,000 to EPRI in June 2002. ACE is currently a member of the EPRI cyclone interest group, which is funded locally through the B.L. England plant O&M budget (the plant is part of ACE's transitional utility business). Conectiv identified no other research and development or advanced technology expenditures within the Conectiv holding company.¹⁷⁵

¹⁷² DR #258.

¹⁷³ DR #232 (supplemental response).

¹⁷⁴ DR #123.

¹⁷⁵ DR #123.



Liberty tested the charges to ACE for EPRI fees during transaction testing, which is discussed in Section 5.5(h).

The ACE Compliance Plan states that it interprets the prohibition from subsidizing costs, fees or payments of research and development activities or advanced technology funding with RCBSs to mean that all such costs must be appropriately apportioned, and information related to the Company and its customers must not be used in violation of the Standards.¹⁷⁶ Liberty agrees with this interpretation.

4. Conclusions

- a. ACE represents that it did not engage in joint marketing or business activities with its PUHC RCBSs prohibited by Section 14:4-5.5(o) during the audit period.**
- b. ACE's Compliance Plan and the information it supplied in the audit unduly constrain the scope of the provisions that preclude joint advertising and marketing.**
- c. ACE's Compliance Plan prohibits subsidizing costs of R&D and advanced technology research in accord with Section 14:4-5.5(o)4 unless the costs are appropriately apportioned among the participants.**

5. Recommendations

- 23. Amend the ACE Compliance Plan to specifically prohibit additional forms of joint advertising and marketing.**

The changes need to address the following issues:

- Clarifying the Compliance Plan to indicate that the reference (on page 21, footnote 34) is to billing or service-related information that third-party suppliers include when using the ACE/CPD invoice for billing the supply component, rather than to advertising
- Expanding the definition of marketing beyond solicitation and sales
- Precluding provision of material information about products and services that cross utility/non-utility lines in general branding or image advertising
- Preclude the provision of information about products and services that cross utility/non-utility lines at trade shows, conferences or other marketing events in New Jersey.

P. Joint Employees

1. Statement of Applicable Requirements

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

¹⁷⁶ DR #8, Compliance Plan, p. 22.



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.

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

Liberty asked about employees of affiliates who were involved in providing non-competitive utility and safety services. ACE told Liberty that it had no such employees.¹⁷⁷

4. Conclusions

Millennium Account Services (Millennium), as discussed in Section I.G of this report is a covered holding company RCBSs under the Standards. Millennium's employees were during the audit period "involved in," as that term is defined in Section 14:4-5.5(p)(1) of the Standards, providing non-competitive utility and safety (meter-reading) services, through their role as employees of the contractor who provided infrastructure services to the utility.

Section 14:4-5.3(b) may be read to allow a utility to contract with an RCBS for such work, subject to certain administrative requirements. However, depending on its intended scope, clause (1) of Section 14:4-5.5(p) may preclude it. Based upon the wording of clause (1) and uncertainty over whether it addresses only a subset of or independent of what is covered by subparagraph (p), Liberty found itself unable to formulate a clear audit standard in this instance.

¹⁷⁷CO-255 and CO-256.



There are two alternatives:

- Clause (1) applies: Millennium's services provided were inappropriate because in no case may an RCBS of the holding company provide non-competitive utility and safety services, even as a separate employee of an RCBS;
- Clause (1) does not apply: The services were allowable, albeit subject to the administrative requirements of Section 14:4-5.3(b), because the RCBS employees (as opposed to the RCBS itself) cannot be construed as utility employees, independent contractors, consultants, or any other included category under 14:4-5.5(p)

5. Recommendations

24. In the event that the Board decides that clause (1) of Section 14:4-5.5(p) prohibits RCBS employees from being also involved in the provision of non-competitive utility and safety services, refrain from using any utility holding company RCBS to help maintain its utility infrastructure.

Q. Common Directors and Officers

1. Statement of Applicable Requirements

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

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.

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 period.¹⁷⁸

3. Findings

Diana C. DeAngelis served as Assistant Secretary at Atlantic City Electric, Conectiv Energy Supply, Solutions, and Thermal Systems.

Nina J. Clements served as Assistant Secretary at Atlantic City Electric, Conectiv Energy Supply, Solutions, and Thermal Systems.

Howard E. Cosgrove served as Chairman at Atlantic City Electric, and Chairman and CEO at Conectiv Energy Supply, Solutions, and Thermal Systems. He also served as Director at ACE, Conectiv Energy Supply, Conectiv Solutions, and Conectiv Thermal Systems. He was removed from each of these positions on August 2, 2002, after the audit period ended.

John C. van Roden, Jr. served as Chief Financial Officer at Atlantic City Electric, and Senior Vice President and CFO at Conectiv Energy Supply, Solutions, and Thermal Systems. He also served as Director at ACE, Conectiv Energy Supply, Conectiv Solutions, and Conectiv Thermal Systems. He was removed from each of these positions on August 2, 2002, after the audit period ended.

James P. Lavin served as Controller at Atlantic City Electric, Conectiv Energy Supply, Solutions, and Thermal Systems. He was removed from his position at Atlantic City Electric on August 2, 2002, after the audit period ended.

Nathan L. Wilson served as Assistant Secretary at Atlantic City Electric and Conectiv Energy Supply. He was removed from each of these positions after the audit period ended.

Peter F. Clark served as Secretary & General Counsel at Atlantic City Electric and Secretary at Conectiv Energy Supply, Solutions, and Thermal Systems. He was removed from each of these positions after the audit period ended.

Phillip S. Reese served as Vice President & Treasurer at Atlantic City Electric, Conectiv Energy Supply, Solutions, and Thermal Systems. He was removed from each of these positions on August 2, 2002, after the audit period ended.

¹⁷⁸ DR#127.



4. Conclusions

- a. ACE was not in compliance with Section 14:4-5.5(q) of the Standards, because there are instances where individuals served as a Director and/or an Officer for both a utility and a related competitive business segment of the utility's holding company.**

5. Recommendations

- 25. Reposition the duties of the individuals who serve as a Director or an Officer for both a utility and a related competitive business segment of the utility's holding company.**

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.

3. Findings

ACE had one employee transfer from an affiliate into it, but no employees transferred from ACE to an affiliate.¹⁷⁹ Therefore, during the period of the audit, ACE did not have any employee transfer to Conectiv or related competitive business segments.¹⁸⁰ Neither ACE nor Conectiv have transferred any employees with less than one year in their job during the audit period pursuant to the Company's Human Resources requirements.¹⁸¹ ACE was initially unable to verify that the information had been filed with BPU but did indicate that it would file immediately.¹⁸² Conectiv did not have in place a procedure to provide an annual report to the Board as required by Section 14:4-5.5(r) 2 of the Standards

¹⁷⁹ DR #57.

¹⁸⁰ DR #12.

¹⁸¹ Interview with Conectiv personnel (Hampton and Blezard), October 22, 2002.

¹⁸² DR #60. The Company subsequently informed Liberty that it had filed a report for 2001 with the Board on September 4, 2002, and that it filed the report for 2002 on January 29, 2003.



4. Conclusions

- a. ACE was unable to verify that it had reported to the Board concerning a transfer of an employee from Conectiv in 2001.
- b. ACE has met the remaining requirements under Section 14:4-5.5(r) of the Standards.

5. Recommendations

26. Establish a procedure to ensure that ACE's employee transfer reporting obligations under Section 14:4-5.5(r) are met.

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 Human Resources department provides the control concerning the transfer of information by transferring employees. Employees are required to sign a regulatory and accounting code of conduct. Transferring employees are not provided information concerning the BPU Competitive Standards.¹⁸³ Further as a part of the exit process, employees are required to turn in ACE property including pagers, cell phones, keys and computers. Employees are allowed only to take their personal belongings; they must leave all company information.¹⁸⁴ Liberty found that ACE has in place controls that prevent the inappropriate transfer of information from the utility to a related competitive business segment through files, personal digital appliances, cell phones, and computers.¹⁸⁵

During the audit period no employees transferred, were temporarily assigned, or rotated to Conectiv or ACE.¹⁸⁶ Atlantic City has in place controls that to prevent the inappropriate transfer of information from the utility to a related competitive business segment through files, personal digital appliances, cell phones, and computers.

4. Conclusions

- a. During the period of the audit there were no employee transfers from ACE to either Conectiv or a related competitive business segment, thus there was no occasion for inappropriate transfer of information under this section.**
- a. ACE has reasonable controls in place to prevent prohibited transfers of information.**
- c. 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:

¹⁸³ DR #175 and interviews with Conectiv personnel (Hampton and Bleazard), October 22, 2002.

¹⁸⁴ Interviews with Conectiv personnel (Hampton and Bleazard), October 22, 2002.

¹⁸⁵ Interviews with Conectiv personnel (Hampton and Bleazard), October 22, 2002.

¹⁸⁶ DR # 248.



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 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 obtained information about many transactions between ACE and affiliates. Liberty continually checked to see if those transactions violated the



pricing rules of this section of the Standards. During Liberty’s transaction testing, Liberty similarly checked to see if any of the transactions violated those same pricing rules.

3. Findings

Conectiv provided the following summary of transactions between ACE and Conectiv’s affiliates (other than DP&L and CRP).¹⁸⁷

Company	2001 Total Net Affiliate Transactions From (to) ACE	Jan-June 2002 Total Net Affiliate Transactions from (to) ACE
Conectiv Operating Services	\$3,475	\$322
Conectiv Delmarva Generation	(591)	10,302
Conectiv Atlantic Generation	176,243	68,631
Conectiv Mid-Merit	1,054	0
Atlantic Southern Properties	179,903	(979,474)
TELP I	15,000	8,700
Conectiv Communications Inc.	41,265	0
Total	\$416,349	(\$891,519)

Liberty reviewed a detailed breakdown of these transactions between ACE and the affiliates, all of which were direct charged. For the most part, the charges from ACE to the affiliates were for such items as vehicles, building services, technicians, and construction/maintenance. There were relatively few charges from these affiliates to ACE, and all were for relatively small amounts, from a few hundred to a few thousand dollars. The only exception was the May’s Landing lease agreement between ACE and Atlantic Southern Properties (ASP), for which ACE paid \$1.1 million for the period January to June 2002. It should be noted that ACE did not reflect payments to Millennium Account Services, a joint venture of Conectiv Solutions, in the above figures.

During transaction testing, Liberty reviewed three of the above detailed transactions between ACE and an affiliate. First, Liberty reviewed a \$5,228 charges from ACE to Conectiv Atlantic Generation for communications services. Liberty reviewed the supporting calculations for the standard rate (the activity type price), verified time sheet entries for the relevant employee, and reviewed the settlement of the charges in the Company’s accounting system. As discussed previously, activity type prices (developed in the same fashion for ACE and affiliates as for the Service Company, except ACE includes storeroom costs) are designed to include both direct and overhead costs, which include wages, employee benefits, payroll taxes, and miscellaneous costs (training, travel, office expenses, e.g.), as well as common charges for building space and IT support; they do not, however, reflect charges for other A&G costs such as accounting, human resources, or other costs allocated from CRP. As such, ACE charged its services at something less than fully allocated cost.

¹⁸⁷ DR #29.



The requirements of this section of the Standards as it relates to transfer from the utility of non-open market products or services applied only to Conectiv Communications and TELP during the audit period.

ACE Service Transfers to Conectiv RCBSs¹⁸⁸

Company/Service Transferred	2001 Total Affiliate Transactions from ACE	Jan-June 2002 Affiliate Transactions from ACE
<i>TELP:</i>		
Vehicle (truck)	\$15,000	\$8,700
Total TELP	\$15,000	\$8,700
<i>Conectiv Communications:</i>		
Vehicle Resource Mgmt	\$1,672	
Technician Services	25,755	
Design Services	7,998	
Const. & Maint. Labor	5,976	
Const & Maint. Substation	3,078	
Communication Services	1,700	
Overhead Residuals	41	
Goods and materials issues	164	
Total Communications	\$46,384	\$0

Because these services provided by ACE are likely not produced for sale on the open market, the correct standard is fully allocated cost. As ACE charged activity type price, a total of \$46,384 in services transferred to Communications and \$23,700 in services transferred to TELP were not in compliance with the Standards.

Next, Liberty tested a charge from an affiliate to ACE during the audit period. The Standards require that the price for “non-open market” service from an RCBS to ACE to be the lower of fully allocated cost or fair market value, and that the price for “open market” service be at no more than fair market value. Liberty reviewed a charge of \$1,920 for engineering services charged by Conectiv Communications to ACE during 2001. It should be noted that Liberty did not substantiate whether Conectiv considered these services as “open market” or not. Liberty reviewed the settlement of the charges in the Company’s accounting system. Liberty could not, however, validate the activity type price used to develop the charges. According to Conectiv, no new activity type prices were developed for Conectiv Communications for 2001. Management decided instead to use those from 2000, because its staff was otherwise involved in the process of divesting its telecommunications business. Also, there were very few times that Communications cross-charged to another line of business.¹⁸⁹

¹⁸⁸ DR #29.

¹⁸⁹ DR #240.



At issue here is the price paid by ACE for the services from an RCBS. The total transactions from Communications to ACE during the audit period are summarized below:

Conectiv Communications – Charges to ACE during 2001¹⁹⁰

Service Transferred	2001 Total Affiliate Transactions To ACE
CCI Engineering Services	\$1,920
CCI Engineering Supervision	3,200
Total	\$5,120

Communications reportedly charged its activity type price for these services, which price excludes an A&G adder. Therefore, it appears that Communications charged something other than the lower of fully allocated cost or fair market value in this case. Consequently, it cannot be demonstrated that the requirements of the Standards were met in these two transactions.

Liberty then reviewed charges of \$182,440 associated with rent for the May's Landing office building for January 2002. The building is owned by ASP, and the entire building is leased to ACE. The building consists of approximately 77,000 square feet of finished (office) space and 138,000 square feet of unfinished (shop) space. The building is not fully occupied. Approximately 51,000 square feet of finished space (roughly two-thirds) are occupied by ACE and CRP employees. Of the unfinished space, roughly half, or 61,000 square feet, is occupied.¹⁹¹

There is no formal lease agreement between the parties.¹⁹² Instead, costs for the building (O&M, depreciation, property taxes, utilities, etc.) are captured in a separate building cost account, consistent with the Company's cost accounting procedures. A portion of total building cost is considered "finished space" costs. For January 2002, finished space was assigned \$97,693 of the total month's building costs of \$182,440.¹⁹³ ACE charges a portion of the finished space costs to CRP according to square footage occupied, and similarly retains a portion of the charge for its own space. However, the cost of the vacant finished space (\$32,659 of the \$97,693) becomes part of the residual for finished office space that is allocated to all users at year-end. Thus, the burden of the cost of the building is placed on all affiliates receiving office space charges, rather than on ASP alone.

Unfinished space is charged at \$0.83 per square foot. If the space is occupied, the rate is charged to the cost centers of whoever is using the unfinished space. The cost of unoccupied unfinished space is recorded at a high level cost center at ACE, and is allocated at year-end along with other facilities-related residuals.

¹⁹⁰ DR #29.

¹⁹¹ Work session December 2-4, 2002. The allocation of total charges to finished space is based on the percentage of O&M, depreciation, utilities, facilities services, and related costs that are related to the finished space total square footage.

¹⁹² DR #235.

¹⁹³ Work papers from transaction testing, December 2-4, 2002.



During transaction testing, Liberty reviewed the work papers supporting the calculation of building expenses for the month, and reviewed the settlement of charges to ACE and CRP in the accounting system.

Under the Standards, open-market services from an RCBS to the utility are to be priced at no more than fair market value. Liberty saw no evidence that fair market value had been determined for this facility. Without such determination, it is not possible to conclude whether the Company complied with this standard. Conectiv does not consider ASP to be an RCBS. However, Liberty believes that the provision of office space is a retail enterprise, and as such the same arm's length standard for RCBS pricing should be applied in this case.

Not all transactions between ACE and affiliates were reflected in the first chart in this section; some work done by ACE for affiliates is regarded as "special billings." Conectiv's use of special billing applies to any non-energy billing, such as burying a wire at a customer's request, rental income, or other "one of a kind" type requests.¹⁹⁴ While special billings are typically used for third parties, in some instances ACE uses special billings for work done for an affiliate.

According to ACE, it uses direct charging, based on standard activity rates, for an affiliate when the affiliated company has a project or order number and is requesting that ACE provide services similar to that of a contractor. However, if ACE is required to upgrade its facilities or perform other modifications to existing facilities in order to fulfill the request of the affiliated company, the charges are handled via special billings; the affiliate must reimburse ACE its full cost including overheads.¹⁹⁵ The same activity type price is used whether the work is done for Conectiv affiliates or for third parties.¹⁹⁶ There are three loaders generally applied in special billings (although there are no loaders applied on agreement for rental income from billboards, right of way, etc.¹⁹⁷). The first two, a materials loader and a high volume/low usage ("HU/LV") loader are applied only to materials. During June 2002, the material overhead rate was 18 percent and the HULV rate was 5 percent.

For special billings, an infrastructure loader is applied to the subtotal of an entire bill, and is thus applied to labor, materials and any other relevant charges.¹⁹⁸ According to Conectiv, there is only one overhead costing method used for all billable projects, so whether the special billing work is done for a third party of an affiliate, both will receive the same material, HULV, and infrastructure loaders.¹⁹⁹

The infrastructure rate for the year 2002 was 18 percent. This loader is developed at the beginning of each year based on budgeted data, although it may be restated on an as-needed basis during the year if actual data warrants a change.²⁰⁰ ACE defines the infrastructure loader as the ratio of indirect costs to direct costs for ACE cost centers that charge billable jobs.

¹⁹⁴ Work session November 19, 2002.

¹⁹⁵ DR #179.

¹⁹⁶ DR #120.

¹⁹⁷ Work session November 19, 2002.

¹⁹⁸ Work session November 19, 2002.

¹⁹⁹ DR #119.

²⁰⁰ DR #183.



The following chart summarized ACE’s special billings for the audit period:²⁰¹

Category	2001	1/1/02 - 6/30/02
O&M Billings:		
Rent	\$1,561,290	\$564,138
Transmission Agreements	437,716	239,004
Value Added Services	1,670,792	53,814
Non-Utility Operations	1,174,096	522,753
Property Damage Claims	3,326,515	1,303,539
Other Accounts Receivable	1,686,310	441,008
State Highway Relocations	1,756,240	1,930,623
Installment Billing (Interest Only)	159,746	72,955
Miscellaneous	327,120	115,413
Sub-Total O&M Billings	12,099,826	5,243,248
Capital Billings	3,521,670	7,306,793
Affiliated Company Billings	1,584,723	3,341
Total Billings	\$17,206,219	\$12,553,383
Amount of Total “non-regulated”	\$10,457,625	\$4,244,472

Of the \$17.2 million total special billings in 2001 and \$12.6 million in 2002, Conectiv stated that \$10.5 million in 2001 and \$4.2 million in 2002 were considered non-regulated revenues, or “competitive services.”²⁰²

During 2001, ACE did special billings work for Conectiv Operating Services, Conectiv Communications, Conectiv Energy, and Conectiv Atlantic Generating.²⁰³ Part of special billings revenues includes the payments from Millennium for meter readers during 2001. Of particular relevance under the Standards is the work done for the RCBSs, Millennium and Communications.

As part of transaction testing, Liberty reviewed several examples of special billings services provided by ACE to substantiate the method of pricing of this work. In particular, Liberty reviewed an invoice for \$816,405 from ACE to Conectiv Communications. This work involved the installation of fiber optic cables on existing poles, and the majority of the work was done by outside contractors. Liberty reviewed the calculations supporting the relevant activity type prices, reviewed a sample contractor invoice, verified that the materials and HULV loaders were appropriately applied, and verified that the infrastructure loader was applied to the subtotal of all

²⁰¹ DR #116.

²⁰² DRs #80 and 178. Conectiv categorized as non-regulated revenues those from merchandising, jobbing and contract work, property claims, other accounts receivable; state road work, non-utility operations, and miscellaneous value-added services.

²⁰³ DR #181.



labor, material and contractor charges. Liberty also reviewed the settlement of charges in the accounting system.

To verify that ACE used the same method to calculate charges for special billings to third parties, Liberty also reviewed transactions between ACE and two other customers, the PJM Interconnection (February 2002) and Shalom House (May 2002). In both cases, ACE used the relevant activity type prices, applied the same material and HULV loaders, and applied the same infrastructure loader used for billings to its affiliates.

Liberty has therefore concluded that ACE appropriately priced its services to RCBSs for special billing work during the audit period. ACE reflected at least fully allocated cost with the addition of the infrastructure loader. Because ACE used the same method of pricing for RCBSs and third parties, Liberty has concluded that the Company met the standard of fair market value.

As part of testing of special billings, Liberty also reviewed the revenues from Millennium Account Services for the lease of ACE meter readers during 2001. Under the contract between ACE and Millennium, Millennium paid ACE \$5,700 per month per reader.²⁰⁴ Liberty reviewed an \$85,500 invoice from ACE to Millennium for meter readers in April 2001; Liberty substantiated that ACE charged \$5,700 per meter reader, reviewed supporting documentation for the 15 meter readers leased that month, and reviewed the settlement of the transaction on the Company's accounting system. As discussed more fully in Chapter I of this report, Conectiv did not substantiate that it had priced these meter readers at fully allocated cost. Thus, Liberty cannot determine that ACE met the provisions of the standard with regard to this transaction.

None of the figures provided to Liberty as either affiliate transactions or as special billings reflected the payments by ACE to Millennium for meter reading services. Basically, ACE treats invoices from Millennium as though they were third party invoices. Millennium is an RCBS, and therefore such services are relevant under Section 5.5(t). The following chart summarizes the charges from Millennium to ACE during the audit period.²⁰⁵

	Charges to ACE
January 2001	\$270,105
February 2001	271,265
March 2001	271,891
April 2001	272,111
May 2001	272,496
June 2001	274,355
July 2001	259,497
August 2001	260,347
September 2001	255,511
October 2001	275,845
November 2001	276,325
December 2001	273,891

²⁰⁴ Under the contract, Millennium agreed to continue to lease 15 meter-readers employed by ACE until November 30, 2001, at a minimum. Millennium agreed to pay the total costs incurred by ACE for employing the meter readers.

²⁰⁵ DR #234.



Subtotal 2001	\$2,961,415
January 2002	239,445
February 2002	243,408
March 2002	246,728
April 2002	252,623
May 2002	253,076
June 2002	253,312
Subtotal 2002	\$1,488,592

As part of transaction testing, Liberty reviewed an invoice for \$239,017 for January 2002 from Millennium to ACE. Liberty substantiated that Millennium charged ACE \$0.429 per meter read and \$10 per meter for off-cycle reads, consistent with the terms of the contract between the two parties, and reviewed the settlement of the transactions in the Company’s accounting system. As discussed more fully in Chapter I of this report, ACE did not subject this purchase to competitive bidding. Liberty was therefore not able to determine whether the price paid was consistent with the provisions of this section of the Standards.

On occasion, ACE will sell material on a stand-alone basis (as compared to being included in any special billing work) to other affiliates. The price for material charged by ACE is based on an average unit price plus the material overhead loader; the HULV loader is used when applicable.²⁰⁶ During the audit period, the amount of material that ACE sold to other affiliates was minimal.²⁰⁷

	2001	6 months 2002
Delmarva Power	\$1,247	\$1,577
Conectiv Communications	214	322
Conectiv Resource Partners	600	2,276
Total	\$2,061	\$4,175

Liberty conducted no detailed review or transaction testing on these sales of material. However, based on ACE’s description of how it priced materials charged to affiliates, it did not comply with the Standards in pricing material to Conectiv Communications, which would have been an RCBS during the audit period. Material sold to Communications should have included the infrastructure loader, because transfers to RCBSs must be at fully allocated cost. The overall effect of this oversight, however, is de minimis.

4. Conclusions

- a. Liberty’s test work revealed a significant number of transactions that failed to be priced correctly or the correctness of whose price could not be verified under Section 14:4-5.5(u) of the Standards.**

²⁰⁶ Work session, November 19, 2002.

²⁰⁷ DR #108.



Examples include:

- A total of \$46,384 in ACE services transferred to Communications and \$23,700 in services transferred to TELP were not in compliance with the Standards.
 - It cannot be verified that ACE met the requirements of the Standards regarding transfer of services from Conectiv Communications to ACE, totaling \$5,120.
 - Conectiv did not comply with the provision of this section regarding the rental of office building space from ASP during the audit period.
 - As is discussed in Chapter I of this report, ACE did not comply with the requirements of Section 14-4:5-5(t) regarding the sale of materials to Conectiv Communications; the effect was, however, de minimis.
- b. ACE did not comply with the requirements of Section 14-4:5.5(t) regarding the purchase of meter reading services from Millennium Account Services, because the costs were not clearly the lower of fully allocated cost (of Millennium) or fair market value.**
- c. Except for revenues from Millennium for meter readers, Liberty has concluded that ACE met the requirements of the Standards regarding pricing used in “special billings” to RCBSs.**

5. Recommendations

- 27. Formulate detailed procedures for pricing transactions under Section 14-4:5.5(t), establish a structured communications and training program for their use, and provide for a formal program of internally verifying compliance with those procedures.**

While there are no other, separate recommendations here, there are related recommendations with respect to the treatment of Millennium in Chapter I of this report and with respect to formalizing a lease agreement between ACE and Atlantic Southern Properties in the next ensuing section of this report.

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

Liberty sought information from Conectiv regarding asset transfers, leases, rentals, easements and other encumbrances through data requests. Specifically, Liberty asked Conectiv to:

- Identify and describe each asset transfer from the regulated utility to each of the unregulated affiliates (and from each unregulated affiliate to the regulated utility) during the audit period.
- List all asset leases and rentals between the regulated utilities and the unregulated affiliates of the parent/holding company
- List all licenses, easements, or other encumbrances of utility assets between the regulated utilities and the unregulated affiliates of the parent/holding company.

3. Findings

Regarding Section 5.5(u), the Conectiv Compliance Plan stated that the “pricing requirements shall not apply to the transfer of the generation assets, fuel purchase contracts supporting the generation assets, the land on which these assets lie, and power purchase contracts, all of which were approved by the Board prior to issuance of the Standards, in the Summary Order.”²⁰⁸

Conectiv identified the following asset transfers between ACE and the unregulated affiliates of the holding company during the audit period:²⁰⁹

Assets Transfers Between ACE and RCBSs During Audit Period

Asset	From	To	Amount
Vehicles	ACE	Conectiv Delmarva Generation	\$20,338
Project Costs	ACE	Conectiv Atlantic Generation	158
Convention Center/Bayside plant	ACE	Conectiv Thermal Systems (TELP)	2,984,286

²⁰⁸ DR #8, Compliance Plan, p. 26-27. The Summary Order was dated July 15, 1999 in Docket No. EO97070456, et.al.

²⁰⁹ DRs #17 and 177.



Liberty also asked the Company for a list of licenses, easements, or other encumbrances of utility assets between the utility and the holding company or RCBSs; Conectiv's response is summarized below:²¹⁰

Licenses, Easements, and Encumbrances Between ACE and RCBSs During Audit Period

Licensee	Agreement	Terms
Conectiv Atlantic Generation	6 agreements for non-exclusive access easements to generation facilities that were transferred from ACE to CAG at book value	\$10 one-time payment each, based on book value
Conectiv Atlantic Generation	Lease agreement for facilities and 1,400 acres associated with Cumberland Station	\$1,667.67 per month, based on fair market value ²¹¹

During transaction testing, Liberty selected an example of an asset, license, easement or encumbrance transfer for further examination. The purpose of the review was to determine whether the asset had been transferred at a value consistent with the Standards, and whether it had been recorded correctly on the Company's books.²¹² Liberty selected the largest transaction, involving the transfer of the thermal plant to TELP, an RCBS of Conectiv.

According to the Company, the Bayside heating and cooling plant was not included in ACE regulated rate base, and was considered a non-utility asset.²¹³ The asset was originally on ACE's books for a net value of \$5.9 million. However, a \$3 million reserve to write down the asset (ostensibly to market value) was set up in 1999 at the time of the Conectiv merger. The Board approved the transfer of the plant at the \$2.9 million value.²¹⁴ As such, the transfer was made in keeping with the Standards. Liberty substantiated the accounting entries that reduced the value of the asset on ACE's books and transferred the asset to Conectiv Thermal Systems.

When asked to provide a list of all asset leases and rentals between ACE and any unregulated affiliate of the holding company, Conectiv initially identified a lease agreement between Atlantic Southern Properties and ACE as the only such lease or rental.²¹⁵ When asked for a copy of the lease, Conectiv subsequently clarified that there was actually no formal lease between the parties. Instead, charges were calculated in accordance with the cost accounting manual.²¹⁶ The charges under this informal agreement are discussed more fully in Section 14:4-5.5(t). Conectiv later supplemented its response regarding lease agreements, noting that there was a lease

²¹⁰ DR #161.

²¹¹ The Company indicated that the most recent and comparable sale was at \$1,016 per acre. The rental was calculated at \$1,000 times the 140 acres, plus a 10 percent return.

²¹² Liberty substantiated that the six agreements to transfer easements were approved by the Board in connection with the transfer of the utility's combustion turbine facilities (DR #259). However, CAG is not considered an RCBS, and the provisions of this section of the Standards do not apply.

²¹³ Working sessions, December 2-4, 2002.

²¹⁴ DR #58, Order Conditionally Approving Transfer, Docket No. EM00060384, December 17, 2001. The Board also approved a lease between ACE and TELP by which TELP would lease certain real property upon which the Bayside plant was situated at \$45,000 per year.

²¹⁵ DR #51.

²¹⁶ DR #235.



arrangement between ACE and TELP in connection with the transfer of the thermal heating and cooling plant.²¹⁷ The basic rent was based on fair market value, which was approved by the Board.²¹⁸ Thus, the ACE-TELP lease was consistent with the Standards.

The Company has confirmed that there have been no transfers of intellectual property between ACE and the holding company or an RCBS of the holding company during the audit period.²¹⁹

4. Conclusions

- a. Liberty has concluded the ACE complied with Section 14:4-5.5(u) regarding transfer of assets during the audit period.**
- b. ACE was in compliance with Section 14:4-5.5(u) regarding its one asset lease to TELP during the audit period.**

5. Recommendations

- 28. Formalize a lease agreement between ACE and Atlantic Southern Properties for the May's Landing office building, with the charges to ACE based on the lower of book value or demonstrated market value.**

Under the Standards, asset leases between an RCBS and the utility are to be at the lower of book value or market value. Liberty saw no evidence that either book value or market value had been determined for this facility. Without such determinations it is not possible to comply with this standard. Also, as noted in the discussion under Section 14:4-5.5(t), the building is not fully occupied, and there is therefore opportunity for speculative losses that might otherwise be incurred by Atlantic Southern Properties to be absorbed by ACE.

ASP is a first-tier subsidiary of the Conectiv parent company. Conectiv does not include ASP on its list of RCBSs.²²⁰ However, rental of office space is clearly a retail business, and transactions between ACE and ASP should be governed by the same arm's length dealings as with any other RCBSs.

Whether the transaction between ACE and ASP regarding the building are a "lease" under Section 14:4-5.5(u) or a "service" under Section 14:4-5.5(t), the implication is the same. The cost of a service can be no more than fair market value, and the cost under a lease must be the lower of book or fair market value. Implicit in either standard is that the utility pay for only the portion of the service or asset that it is utilizing.

The Company subsequently noted that it has completed a lease document that will be executed in the first quarter of 2003. Liberty has not reviewed that lease for compliance with the Standards.

²¹⁷ DRs #161 and 185.

²¹⁸ DR #161 and Order in Docket No. EM00060384.

²¹⁹ DR #124.

²²⁰ DR #8, Compliance Plan.



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 ACE 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

ACE had no utility RCBSs during the audit period.

4. Conclusions

- a. **During the audit period, ACE 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.



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. The Board's recommendations were as follows:

- Recommendation II.B.1 – Provide required segregation of competitive products and services on corporate website.
- Recommendation II.B.2 – Call transfers provided by ACE Customer Care representatives to affiliated competitive service providers infers preferential treatment to affiliates over nonaffiliated service providers.
- Recommendation III.B.3 – Conectiv should move to comply with Standards pertaining to corporate identification and advertising.
- Recommendation III.B.4 – Conectiv should move to reassign corporate officers that should not be in the utility and RCBS corporate organization.
- Recommendation IV.B.5 – Modify the Conectiv websites (specifically the home page) to make the distinction between regulated and non-regulated services clearly.
- Recommendation V.B.6 – The Board and ACE should consider reclassifying Millennium as an RCBS, fully subject to the Standards.
- Recommendation V.B.7 – Should the Board or ACE adopt the previous recommendation, ACE should update the compliance plan to reflect standards that apply to Millennium.
- Recommendation V.B.8 – ACE should develop an action plan as part of the compliance plan, or supporting document, for implementing steps it deems necessary for deregulation.
- Recommendation V.V.9 – The relationship between ACE and Millennium is based on the opportunity for cost reductions in meter reading, but the cost/benefits have not been documented.

The Board ordered the implementation of 7 of the 9 recommendations on February 8, 2002, and ordered the implementation of V.B.6 and V.B.7 on March 27, 2002.

B. Summary of Audit Activities

Liberty submitted data requests asking ACE to address the status of any approved 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 ACE Compliance plan and related documents.



C. Recommendation II.B.1 – Provide required segregation of competitive products and services on corporate website.

1. Findings

ACE provided Liberty with its March 1, 2002 implementation plan, which stated that the Company did agree to make revisions to its web site to segregate products and services.²²¹ As part of its implementation plan, the Company provided screen shots of the Conectiv homepage as of the date of the implementation plan, showing three sections. The *Discover Conectiv* shot is corporate-oriented, and mentions the merger with Potomac Electric Power Co (Pepco). The *Conectiv Power Delivery* shot notes that the company serves “homes and businesses in the regulated electricity and natural gas markets.” The *Conectiv Energy* shot states that this company serves wholesale, industrial and large commercial customers within the deregulated energy marketplace. The customer clicks on a section to find more information about the selected Company, including utility customer service. Liberty found that the www.conectiv.com homepage appeared very similar to the screen shots provided in the implementation plan. Liberty found no mention of Conectiv Energy (“CE”) within the Conectiv Power Delivery (“CPD”) pages, nor any mention of CPD within the CE pages.

The implementation plan also noted that Conectiv has divested itself of its retail products and service affiliates that provided services to residential customers, and now focuses on regulated power deliver and wholesale energy trading. On the Conectiv Energy page, selecting the “residential/commercial” icon directs the customer to the statement, “As Conectiv focus (sic) its resources on the wholesale energy market, Conectiv Energy will no longer be seeking new retail customers.”

The remaining place on the website where both Conectiv Power Delivery and Conectiv Energy are mentioned together is the page that can be reached through the “contact us” icon. This icon appears on the homepage, on all Conectiv Power Delivery pages and on all Conectiv Energy pages. Selecting the “Investor Relations” icon links the customer to Pepco Holdings, Inc. (“PHI”), (www.pepcoholdings.com), where there is a separate contact listing for all PHI companies, including the Conectiv entities.

ACE lists Conectiv Energy Supply, Inc. (“CESI”), a subsidiary of Conectiv Energy, as a “Retail Affiliate” in its Compliance Plan.²²² However, the “Contact Us” icon does not identify CESI specifically.

2. Conclusions

a. ACE has adequately implemented this recommendation.

²²¹ DR #19.

²²² Response to DR #8, Atlantic City Electric Company Updated Compliance Plan, dated June 28,2002 (Compliance Plan), p. 3.



3. Recommendations

Liberty has no recommendations regarding Recommendation II.B.1 of the prior audit.

D. Recommendation II.B.2 – Call transfers provided by ACE Customer Care representatives to affiliated competitive service providers infers preferential treatment to affiliates over nonaffiliated service providers.

1. Findings

ACE stated that it is against Company policy to make such call transfers.²²³ ACE stated that it reinforced the policy, and provided reminders of all Code of Conduct issues to Customer Service representatives. There is also an on-line help system on the representatives' desktops to allow them to search for help by a keyword or topic. The Company further stated, however, that there are no retail affiliates of Conectiv to which representatives would forward calls.

2. Conclusions

- a. ACE provides adequate training and refreshers to inform customer service representatives about the applicable prohibitions on providing preferential treatments for affiliates.**

3. Recommendations

Liberty has no recommendations related to this recommendation from the prior audit.

E. Recommendation III.B.3 – Conectiv should move to comply with Standards pertaining to corporate identification and advertising.

1. Findings

The concern of the prior audit involved the website and a specific marketing brochure that promoted Conectiv and RCBSs. Neither the website nor the brochure contained the disclaimer required by Section 14:4-5.5(k). ACE stated that Conectiv Energy has complied with the Standard by including the disclaimer on the website and in advertising brochures since mid-1999.²²⁴ The Company states that the brochure in question was produced in 1999, before the Standards were adopted in March, 2000; therefore it predated the requirement in question. ACE did not say whether the brochure was still being distributed. In comments on a draft of this audit report, the Company confirmed that the brochure was no longer in use, and had not been in use during the audit period.

The Company further stated that it has now exited the residential marketplace, and no longer markets/advertises retail energy products and or services to any customer.

²²³ DR #19.

²²⁴ DR #19.



Liberty requested copies of marketing and promotional items used by any RCBS of the holding company. The Company said items for Conectiv Operating Services Company were available at the NJ location of the subsidiary, but did not provide the items. A print ad for Conectiv Energy placed in a February, 2002, Gas and Power Mart conference catalogue, included in the same response, did not include the disclaimer.²²⁵ In comments on a draft of this audit report, the Company stated that the ad was not intended for use in New Jersey, and dealt with its wholesale business, not retail, so that the disclaimer requirement would not apply.

Liberty found that the Conectiv website currently does not present the disclaimer. The Compliance Plan provides procedures under section 5.5(k) of the Standards that seem to be at odds with the implementation plan submitted by the Company in DR #19. The Compliance Plan states:

*The Company currently trades under the name Conectiv Power Delivery, which is not the same as, but is similar to, the Conectiv name variations used by the Retail Affiliates. The Company and the Retail Affiliates all also use a logo having the common elements of the "Conectiv" name and the "floating 'C.'" Therefore, it is the Company's view that the Retail Affiliates are subject to the disclosure requirements of Section 5.5(k) of the Standards. The Retail Affiliates will comply with this requirement by putting the required disclaimers on all correspondence, business cards, faxes, electronic mail, and internet or hardcopy advertising or marketing materials circulated within the state of New Jersey.*²²⁶

The Conectiv Energy portion of the website includes the Conectiv Energy logo, with its acknowledged similarity to the logos of all affiliates, including the utility, when discussing CESI. Because CESI is a defined Retail Affiliate under the Company's Compliance Plan, Liberty believes that the disclaimer should be included on the website.

2. Conclusions

- c. The Conectiv Energy portion of the Conectiv website does not contain the disclaimer required under Recommendation III.B.3.**

3. Recommendations

- 29. Add the required disclaimer to the Conectiv Energy webpages that mention Conectiv Energy Supply, Inc.**

²²⁵ DR #159.

²²⁶ DR #8, Compliance Plan, p. 20.



F. Recommendation III.B.4 – Conectiv should move to reassign corporate officers that should not be in the utility and RCBS corporate organization.

1. Findings

The Company stated that it had made changes in its slate of ACE officers to comply with the Standard [14:4-5.5(q)] requiring that ACE and the Retail Affiliates not have the same persons serving on the Board of Directors while serving as corporate officers of ACE.²²⁷ The Company acknowledges that the Chief Financial Officer and the General Counsel serve on Boards of Directors of both the utility and the Retail Affiliates, but believes they fall under the shared services exemption of Sections 5.5(i) and (j).²²⁸

ACE provided a listing of Directors for 1) Conectiv and Conectiv Resource Partners, Inc., 2) Delmarva Power & Light Company and Atlantic City Electric Company, 3) Conectiv Energy Holding Company and Conectiv Energy Supply, Inc., and others. For the first three sets of companies listed in the response,²²⁹ five of the Directors were common among the Companies:

John M. Derrick, Jr., Chairman in all cases, CEO of Pepco Holdings, Inc. (PHI)

Dennis R. Wraase, President & COO, PHI

William T. Torgerson, Executive Vice President and General Counsel, PHI

Andrew W. Williams, Senior Vice President and CFO, PHI

Thomas S. Shaw, executive Vice President, PHI and President and COO, Conectiv

The issue of shared Officers and Directors is discussed in additional detail in Section IV.Q of this report. Liberty found that ACE was not in compliance with this provision of the Standards during the audit period, and made a recommendation in Section IV.Q.

2. Conclusions

- a. The Standards contain no shared services exception that would support the ACE claim that the common directorships noted in the prior audit are permitted.**

3. Recommendations

Liberty has no recommendations regarding this prior audit recommendation, but does make a recommendation in another section of the report addressing the need for repositioning the duties of individuals who serve as directors or officers for both the utility and an RCBS of the holding company.

²²⁷ DR #19.

²²⁸ DR #8, Compliance Plan, p. 23.

²²⁹ DR #35



G. Recommendation IV.B.5 – Modify the Conectiv websites (specifically the home page) to make the distinction between regulated and non-regulated services clearly.

1. Findings

ACE stated that it addressed this recommendation in conjunction with its response to recommendation I.B.1, above.²³⁰ The prior audit identified several issues involving links between the utility homepage and affiliated companies involved in competitive services. Liberty found that once the customer was into either the regulated utility section (“CPD”) or the competitive services section, there was no link to the other without returning to the homepage. Competitive product and service offerings are not listed at all in the CPD section, and are not summarized in a listing with links in the competitive services section. In fact, Liberty found no mention of three of the four Retail Affiliates – Conectiv Solutions LLC (most of whose assets were sold in April, 2001, and whose remaining contracts are being wound down),²³¹ Millennium Account Services, LLC, and Conectiv Thermal Systems, Inc.

2. Conclusions

- a. ACE has adequately implemented this recommendation.**

3. Recommendations

Liberty has no recommendations regarding Recommendation IV.B.5 of the prior audit.

H. Recommendation V.B.6 – The Board and ACE should consider reclassifying Millennium as an RCBS, fully subject to the Standards.

I. Recommendation V.B.7 – Should the Board or ACE adopt the previous recommendation, ACE should update the compliance plan to reflect standards that apply to Millennium.

1. Findings

The Company’s Compliance Plan dated June 28, 2002 lists Millennium Account Services, LLC as a Retail Affiliate of ACE’s holding company, Conectiv.²³² Liberty provides a more detailed discussion about Millennium in Section I.G of this report.

2. Conclusions

- a. ACE’s Compliance Plan correctly identifies Millennium as an RCBS of ACE’s holding company.**

²³⁰ DR #19.

²³¹ DR #8, Compliance Plan, p. 4.

²³² DR #8, Compliance Plan dated June 15, 2000, p. 3.



3. Recommendations

Liberty has no recommendations regarding Recommendations V.B.6 and V.B.7 of the prior audit. Liberty accepts the Company actions to these recommendations.

J. Recommendation V.B.8 – ACE should develop an action plan as part of the compliance plan, or supporting document, for implementing steps it deems necessary for deregulation.

1. Findings

The Company response stated that it disagreed that it did not have an action plan for implementing deregulation.²³³ ACE indicated it has had a Corporate Deregulation Steering Committee in place for several years, with representatives from senior management, from the business areas affected, and from information systems. The Steering Committee's responsibility has been to deal with the issues of energy choice, unbundling, securitization and any other issue arising from deregulation. The Company further stated that responsibility for implementation of deregulation is now with Conectiv Power Delivery's Retail Choice team. During 2002, the team met once or twice a month as needed to monitor deregulation issues and to implement appropriate actions.

Liberty finds that under the Standards, a more specific action plan is not required. Liberty's audit did not find any other reason from which to determine that more detailed implementation planning for deregulation, as it relates to the Standards, is necessary or appropriate.

2. Conclusions

a. Liberty found no need for further specificity in ACE planning for deregulation.

3. Recommendations

Liberty has no recommendations regarding Recommendation II.B.8 of the prior audit. Liberty accepts the Company response to this recommendation.

K. Recommendation V.B.9 – The relationship between ACE and Millennium is based on the opportunity for cost reductions in meter reading, but the cost/benefits have not been documented.

1. Findings

The prior audit noted in the text of its recommendation that ACE should also present its cost/benefit studies to the Board for review. ACE stated that the Company performed a high-level cost/benefit analysis which indicated a significant opportunity for savings, prior to entering

²³³ DR #19.



into a service agreement with Millennium,²³⁴ which was dated January 4, 1999; *i.e.*, before the Standards.²³⁵ The term of the original agreement went to November 30, 2001, and an additional agreement has been entered into with Millennium for the term December, 2001 through November, 2006.²³⁶ The Company also included a summary of a cost/benefit evaluation performed at the end of 2000 for 2000 and 2001.²³⁷ An electronic version of the file, created in April 2001, was attached to DR #197 from this audit.

Liberty found no evidence that the cost/benefit studies have been shared with the Board; however, the need to do so is subsumed by the prior recommendations of this report with respect to the ACE relationship with Millennium.

2. Conclusions

- a. Given the prior recommendations of this report with respect to Millennium, Liberty believes that no further action with respect to Recommendation V.B.9 is necessary.**

3. Recommendations

Liberty has no separate recommendations regarding prior audit recommendation V.B.9; however, the previous recommendation in this report addressing Millennium subsumes the prior audit's recommendation.

²³⁴ DR #19.

²³⁵ DR #149.

²³⁶ DR #200.

²³⁷ DR #19.



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

A. Background

Three elements of the Standards 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. Such troubles include wholesale generators that 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 these companies' 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 factors arising out of the risks at other holding company entities.

In Liberty's experience, the financial relationships between utilities and their non-regulated affiliates have been of consequence from a risk perspective for more than a decade. While Liberty had no reason to believe in advance that such consequences are likely for the utility Liberty believed that it was appropriate to conduct baseline inquiries in this area. 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 the participants, operations, debt instruments, credit, and restrictions.
 4. Permanent Financing: Review of the holding company, utility and other subsidiary 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; discussion of key credit influences and 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

1. PHI's Corporate Structure

ACE is one of three utility companies in the corporate family of the newly-formed Pepco Holdings, Inc. (PHI). Upon the consummation of the merger between Pepco and Conectiv on August 1, 2002, Pepco and Conectiv became wholly-owned subsidiaries of PHI.²³⁸ The subsidiaries of the pre-existing Pepco and Conectiv holding companies, including ACE, became affiliated on completion of the merger and the formation of PHI.

PHI's utility operations consist of ACE, Potomac Electric Power Company ("Pepco"), and Delmarva Power and Light ("DPL"). Each of the utilities maintains its corporate legal entity and issues long-term debt securities based primarily on the assets and operations of that entity.

PHI's Competitive Energy business sector consists of the non-utility operations of Conectiv Energy Holding Company ("CEH") and Pepco Energy Services ("PES"). CEH is principally engaged in electricity production, energy-risk management, and trading and marketing. PES provides integrated energy solutions to commercial, industrial, and governmental customers and offers electricity and natural gas to residential and commercial customers in the Mid-Atlantic region.²³⁹ CEH is the parent of Conectiv Delmarva Generation ("CDG") and ACE REIT, which is the direct parent of Conectiv Atlantic Generation ("CAG"). CDG and CAG are generation companies that will seek exempt wholesale generator status ("EWG") from the SEC in the future.²⁴⁰ Conectiv has several non-utility businesses.

PHI's "Other Non-regulated" business sector consists of the operations of Potomac Capital Investment Corporation ("PCI") and Pepco Communications, Inc. ("Pepcom"). PCI focuses on energy-related financial investments, while Pepcom has a 50-percent joint venture interest in a cable and telecommunications business in Washington D.C.²⁴¹

2. ACE's Financial Operations

PHI's money pool is the successor to a similar money pool that was in operation at Conectiv prior to the merger. The PHI money pool includes the 23 companies that were participants in the Conectiv money pool, plus PHI, Pepco, PES, and PCI. The only entities in the PHI family that are not eligible to participate in the money pool are exempt wholesale generators ("EWGs") and exempt telecommunications companies. CDG is eligible to participate in the money pool, but does not due to its anticipated conversion to EWG status. CEH is allowed to participate in the money pool until July 31, 2003 due to a one-year SEC waiver on CEH's registered holding company status.²⁴²

²³⁸ PHI SEC Form U-1.

²³⁹ Cnet Investor News.

²⁴⁰ PHI SEC Form U-1.

²⁴¹ Cnet Investor News.

²⁴² Interview with PHI treasury management, December 2, 2002.



The money-pool operation nets the daily cash borrowing and investing needs of the participating entities to minimize the overall holding company need to borrow or invest cash. Money pool participants who have excess cash invest funds in the pool daily, while participants who need cash generally borrow from the money pool. In the case of the PHI money pool, the utility entities (ACE, DPL and Pepco) invest excess funds in the money pool, but do not borrow from the pool.

Each of the utility entities has its own commercial-paper program to meet its borrowing needs; their programs have higher ratings than the commercial paper that PHI issues for the PHI money pool.²⁴³ ACE's commercial paper program is rated A2/P1, versus A2/P2 for the PHI program. PHI's commercial-paper credit rating is based on the credit of the PHI consolidated entity, which holds a somewhat lower standing than that of the PHI distribution utilities.²⁴⁴

PHI's commercial-paper program is sized at a total of \$1.0 billion. The ACE, DPL, and Pepco commercial paper programs are sized at a total of \$500 million. The programs are backed by a \$1.5 billion, 364-day credit agreement with a consortium of banks who charge facilities fees for this service; \$1.0 billion of the credit facility is set aside for use by PHI and its non-regulated subsidiaries. ACE, DPL, and Pepco have access to a maximum of \$500 million in aggregate of the credit facility at any point in time. ACE has a sub-limit of \$300 million outstanding under the facility at any one time. In the event of a default by PHI under the credit agreement, there is no cross-default to the utilities, and their borrowing capability would not be restricted. The absence of cross-fault provisions for the utilities ensures that the utilities' short-term borrowing capability would not be impaired by non-regulated business problems. The utility companies are charged a facility fee for their \$500 million portion of the credit facility, which is divided equally among the three companies. PHI and its non-regulated subsidiaries pay a separate facility fee on the remaining \$1.0 billion of the credit facility.²⁴⁵

PHI provided Liberty information regarding the average invested and borrowed positions and the allocation of facilities fees for the 26 companies in the PHI money pool for the 2-month period of August and September 2002. The average investments of money pool companies during the period were about \$342 million, while average borrowings were about \$1.182 billion, for a net average market borrowing position of about \$840 million. ACE was a small investor in the money pool of about \$3.8 million, on average, during this period.²⁴⁶

The net borrowers in the money pool pay the facilities fees on the credit used from the \$1.0 billion PHI portion of the credit facility through allocations in proportion to their average borrowings as a percentage of the total facility used. PHI pays the remainder of the facilities fees on this portion of the credit facility.²⁴⁷

²⁴³ Interview with PHI treasury management, December 2, 2002.

²⁴⁴ Interview with PHI treasury management, December 2, 2002.

²⁴⁵ DR #222.

²⁴⁶ DR #224.

²⁴⁷ DR #224.



3. ACE's Cash Flow and Dividends

ACE was in a small borrowed position of less than \$50 million of commercial paper as of December 2, 2002. ACE's current borrowing needs are primarily caused by an accumulating deferral balance for restructuring. That balance has reached about \$90 million. ACE's cash flow will not be sufficient to match its capital requirements before the restructuring transition period ends. ACE is planning to fund all of its cash needs with its commercial-paper program, and no long-term securities issuances are planned for the foreseeable future, with the exception of stranded cost securitization financing. In 2004 and 2005, ACE is expected to fund more than 100 percent of its capital requirements with internally-generated cash.²⁴⁸

ACE's dividend policy is not formal, but ACE pays quarterly dividends in amounts that would allow it to maintain a mix of capital that is consistent with its current credit ratings and that approximates the regulatory capital structure in place. ACE's long-term target for credit ratings is to maintain or slightly improve the current ACE corporate credit ratings. ACE also wants to maintain the regulatory equity ratio in the low-to-mid forties as a percentage of total capital. Each of these considerations affects the decision regarding the dividends that ACE pays to Conectiv on a quarterly basis. ACE's dividends provide a funding source for PHI's dividend to its shareholders, which currently is \$1 per share annually.²⁴⁹

There are three restrictions on ACE's payment of dividends. First, the Public Utility Holding Company Act requires that utility dividends be paid only from retained earnings. Second, New Jersey state corporation law restricts dividends if the corporation is unable to pay debts as they are due or if assets are less than liabilities. Third, ACE's Articles of Incorporation require that preferred dividends are paid first, and that equity levels must be greater than the liquidating value of preferred stock.²⁵⁰

4. ACE's Financial Risk Factors

The credit ratings and ratings rationale regarding the debt securities of holding companies and their subsidiaries can be indicators of the financial risks inherent within a holding-company family. In light of this, Liberty reviewed rating-agency reports for PHI, ACE, and the holding-company family for the past few years.

In May 2002 Standard and Poor's lowered the corporate credit ratings of ACE, DPL, Pepco, and PCI, and established the new corporate credit rating for PHI at BBB+. The decrease in ACE's corporate credit rating was the first change by Standard and Poor's since about 1993.²⁵¹

Standard and Poor's explained the ratings as follows:

The ratings for PHI, Conectiv, Pepco, DPL, ACE, and PCI are based on Standard and Poor's consolidated credit methodology, which includes all of PHI's

²⁴⁸ Interview with PHI treasury management on December 2, 2002.

²⁴⁹ Interview with PHI treasury management on December 2, 2002.

²⁵⁰ DR #226.

²⁵¹ DR #226.



*operating subsidiaries, excluding Conectiv Energy Holding Company (CEH). Standard and Poor's considers CEH to be a noncore business due to PHI's intention to limit its financial support of CEH. The consolidated ratings reflect the credit quality of PHI's primary subsidiaries, whose strengths include low-risk transmission and distribution businesses, a high percentage of residential and commercial customers, modest annual customer growth (1% per year), strong service territories, and secure power supplies. These strengths are offset by a multi-year rate freeze for Pepco and DPL, and higher-risk, nonregulated energy services and HVAC companies, a financial investment subsidiary, and a telecommunications company.*²⁵²

Standard and Poor's consolidated rating method has the effect of equalizing the corporate credit rating of all *core business* affiliates in a holding company family, thereby lowering the ratings of the stronger affiliates and increasing the ratings of weaker affiliates.

On October 30, 2002, Fitch Ratings assigned similar initial ratings (BBB+ on senior secured debt) to ACE's securities. Fitch also recognized the credit strength of the PHI distribution utilities:

ACE benefits from the conservative business profile of PHI, which is expected to generate approximately 75% of consolidated EBITDA from three regulated utility subsidiaries. However, ACE's ratings also recognize Conectiv's participation in the wholesale energy business. A further ratings consideration is the revenue pressure resulting from required rate reductions. Since August 1999, rates have been reduced by approximately 10% and will remain frozen until August 2003...

*Because of the inherent risks associated with non-regulated power generation and marketing, ACE is indirectly exposed to future unanticipated equity contributions by Conectiv to support CEH.... Conectiv is not part of the PHI credit agreement and, because its commercial paper program has been eliminated, it is expected that the future liquidity needs of Conectiv will be funded through upstream dividends from its utility subsidiaries and borrowings from PHI.*²⁵³

PHI did not provide Moody's rating reports issued since the consummation of the PHI/Conectiv merger. However, the Standard and Poor's and Fitch reports provide ample description and clarify regarding the determinants of ACE's current credit ratings.

5. Guarantees and Credit Exposures

In gaining approval from the SEC for the merger, PHI requested and was granted the ability to issue guarantees by the new holding company, Pepco, CEH, Conectiv, and the "Nonutility Subsidiaries" in an amount not to exceed \$3.5 billion in aggregate.²⁵⁴ In addition, the SEC

²⁵² Standard and Poor's Rating Report on PHI, May 14, 2002.

²⁵³ Fitch Ratings Report on ACE, October 30, 2002.

²⁵⁴ PHI SEC Form U-1.



established a sub-limit on new guarantees to the marketing and trading subsidiaries of \$1.75 billion in aggregate.

At November 30, 2002, PHI reports that the total of PHI's consolidated corporate guarantees under the SEC total-guarantee limit are about \$762.8 million, and about \$214 million for the trading-company sub-limit.²⁵⁵ PHI identified the components of its corporate guarantees as \$214 million in trading guarantees, \$133 million of performance guarantees (mostly energy-related), \$29 million of payment guarantees, \$131 million in letters of credit, and \$254 million in guarantees to money-pool depositors.²⁵⁶

While PHI provided Liberty with a detailed list of the PHI corporate guarantees with financial obligations as quantified above, there are additional credit support obligations in the PHI holding-company family. For instance, while PHI is guaranteeing all new debt of PCI, Pepco has had a "Subscription Agreement" with PCI for many years that is, in essence, a promise by Pepco that PCI will maintain a positive net worth.²⁵⁷ As a result, in this audit Liberty may not have identified all credit influences of Conectiv or Pepco entities that could indirectly affect ACE's credit.

PHI's board of directors took actions in 2002 aimed at reducing the risks of further credit downgrades. On April 8, 2002 the board passed a resolution that stated its intention to deem CEH as a "non-core business as that term is used in the credit quality analysis conducted by Standard and Poor's" The board also passed resolutions limiting additional funding to CEH and its subsidiaries at \$275 million, and limiting the provision of guarantees or letters of credit in support of CEH construction and energy trading to \$400 million.²⁵⁸ As of November 30, 2002, PHI reported exposure to CEH guarantees of \$281.4 million.²⁵⁹

D. Conclusions

a. ACE's participation in the PHI money pool is not fully protected.

There are no restrictions on how ACE invests in PHI's money pool, which can cause two potential problems. First, ACE's participation as an investor in the money pool with the other PHI utilities expands the amount of low-cost funds available to PHI's non-regulated businesses. This means that ACE could borrow more money than it needs, using its commercial paper, while simultaneously investing in the money pool, thereby providing inexpensive funds for PHI's non-regulated money-pool borrowers. While this scenario is currently a possibility, ACE emphasizes that the Company has never borrowed in short-term debt markets for the purpose of investing in the money pool.

²⁵⁵ DR #225.

²⁵⁶ DR #225.

²⁵⁷ DR #227.

²⁵⁸ DR #227.

²⁵⁹ DR #225.



Second, ACE can participate in the money pool even if other money-pool participants do not have investment-grade ratings. In contrast, Jersey Central Power & Light (JCP&L) cannot make such investments because of restrictions that the Board imposed on it.

The absence of these limitations on ACE's investments in the money pool exposes ACE to the credit risk of its non-regulated affiliates, and could allow ACE to subsidize the borrowing costs of those non-regulated companies.

b. Standard and Poor's lowering of ACE's credit rating is at least partially due to its exposure to PHI's non-utility business risks.

Several positive and negative factors have influenced ACE's credit quality during the past few years. The removal of the generation business and its direct credit risks through electric-industry restructuring generally had a positive effect on the credit quality of the remaining T&D entities. On the other hand, ACE's rate reduction of about 10 percent, also due to restructuring, had a negative effect on its credit quality.

Standard and Poor's change to using a *consolidating methodology* in determining the credit quality of all subsidiaries in holding companies has had a distinct negative credit effect on the strongest members of holding-company families. The increasing risks of the non-regulated businesses of PHI, especially in the producing, marketing, and trading of energy in wholesale markets, and other non-utility businesses, has increased this negative credit effect. In the case of PHI, the resolution by the holding company's board of directors to limit its exposure to CEH was an offsetting positive factor, and probably was required to prevent further erosion of the credit ratings of the *equalized* holding company.

ACE's credit rating has declined one ratings *notch*, attributable to both the positive and negative factors mentioned. It would take an effort beyond the scope of this audit to determine the magnitude of individual influences on ACE's credit. It is likely, however, that ACE's affiliation with PHI was the main contributor to the reduction in ACE's credit rating.

c. The high level of SEC authorization for PHI's guarantees denotes the potential for future negative effects on ACE's credit quality.

PHI has the SEC's approval to provide *additional guarantees*, letters of credit, and other forms of credit support to its subsidiaries and third parties up to an aggregate limit of \$3.5 billion. Further, the SEC also approved an aggregate sub-limit of \$1.75 billion in *additional credit support* for the marketing and trading entities of PHI.

While PHI's current exposure to these guarantees does not approach the SEC limits, the potential growth in these types of commitments is an area suggesting watchfulness regarding ACE's credit quality. The provision of a guarantee or other form of credit support by PHI signals that additional risk is being undertaken within the holding-company structure. While the holding-company parent corporation bears this risk directly, it may indirectly affect the credit quality of all entities in the holding company. The magnitude of the potential future effect on ACE's credit of high additional levels of PHI guarantees or credit support is impossible to gauge, but there is no doubt that it would not be positive.



E. Recommendations

30. Demonstrate the adequacy of steps to protect the utility from the negative effects of affiliation with unregulated businesses and the continuing sufficiency of utility spending.

ACE's credit standing has already been negatively affected way by holding company non-utility businesses. Further, it is possible that the quality of ACE's credit could be further reduced if the unregulated activities are expanded or have additional financial problems. At small to moderate levels, the resulting effects can likely be confined to measurable incremental costs of utility capital, where it is necessary to calculate that cost for ratemaking purposes. At greater levels, however, such impacts can restrict capital market access sufficiently to make it difficult to meet the aggregate of utility capital needs, investor expectations, and non-utility goals and requirements. A principal concern when such a point is reached is whether investment in utility infrastructure and expenditures on operations and maintenance will continue at acceptable levels. Liberty has seen occasions where utility investment and O&M spending have dropped below appropriate levels in the wake of growing financial difficulties.

Liberty has not concluded that this point has been reached. However, Liberty does believe that it is appropriate under the circumstances found to ask that ACE make to the Board an affirmative and convincing demonstration that the holding company has taken steps to assure a continuing ability of the utility to gain access to capital markets even should the risks involved in non-utility operations come to pass. This demonstration should be made on a recurring basis. In addition, ACE should provide clear and convincing evidence that its investment in electricity transmission and delivery plant and its expenditures for O&M continue to fully support service quality and reliability. A particularly difficult problem for regulators in monitoring reliability is that deferred capital and O&M spending often do not produce noticeable reliability problems for a number of years, and when they arrive, those problems can be severe. Liberty emphasizes that it has not made any findings that ACE utility spending is in any way inadequate or influenced by financial conditions imposed by non-utility operations. The scope of this study did not include an examination of such utility management and operations issues. Liberty intends no more than to say that providing assurances that utility investment and spending continue to be sufficient is a prudent precaution in the wake of experience with other utilities in other jurisdictions.

31. Place restrictions on ACE investments in the money pool similar to those required by the Board for JCP&L.

