April 25, 2006

VIA HAND DELIVERY
Hon. Kristi Izzo, Secretary
Board of Public Utilities
Two Gateway Center
Newark, New Jersey 07102

RE: **Focused Audit of Affiliate Transactions and Management Audit of South Jersey Gas Company by The Liberty Consulting Group**
BPU Docket No. AX04040277
Comments on behalf of the Division of the Ratepayer Advocate

Dear Secretary Izzo:

Please accept for filing an original and ten copies of the Division of the Ratepayer Advocate's ("Ratepayer Advocate") comments on the Final Report prepared by The Liberty Consulting Group ("Liberty") concerning its Focused Audit of Affiliated Transactions and Management Audit of South Jersey Gas Company ("SJG" or the "Company"). The Ratepayer Advocate's comments also address the comments contained in SJG's May 23, 2005 and August 2, 2005 letters to the Board of Public Utilities ("BPU" or "Board") identifying the audit recommendations with which SJG disagreed.

Enclosed is one additional copy. Please date stamp the copy as "filed" and return it to the courier. Thank you for your consideration and attention in this matter.

I. PROCEDURAL HISTORY

At its July 7, 2004 Open Public Meeting the Board initiated a Focused Audit of South Jersey Gas Company. The Request for Proposal issued by the Board contemplated the filing of the auditor's final report on January 24, 2005 for the Focused Audit and March 7, 2005 for the Management Audit. At its September 22, 2004 Open Public Meeting the Board selected the Liberty Consulting Group as auditor. On October 1, 2004 the Ratepayer Advocate attended a meeting with representatives of Staff and Liberty in order to provide Liberty with information about issues of concern to our office. The audits were completed in May 2005. Liberty's Final Report consisted of an Executive Summary dated May 5, 2005 and four additional volumes, each covering different functional topics, as follows: Volume One: Gas Supply, dated April 15, 2005; Volume Two: Cost Allocations and Affiliate Relationships, dated April 15, 2005; Volume Three: EDECA Affiliate Standards, dated April 22, 2005; and Volume Four: Management and Operations, dated April 22, 2005. All told, the Final Report contains 136 recommendations for changes in the way that SJG currently conducts its business and/or the way it interacts with its parent, South Jersey Industries, Inc. ("SJI"), and affiliates.

At its February 1, 2006 Open Public Meeting, the Board voted to accept its Staff's recommendation to acknowledge receipt of Liberty's Final Report and to allow public comment until February 24, 2006. Prior to that time, SJG, by a letter dated May 23, 2005 and two letters dated August 2, 2005, provided Liberty and the Board its comments and suggested clarifications and/or exceptions to Liberty's audit recommendations. Thus, the Board's request for additional comments at this time is essentially addressed to the Ratepayer Advocate and other members of the public.

On February 17, 2006, the Ratepayer Advocate requested a 60-day extension of time, until April 25, 2006, in which to file comments in this proceeding. The requested extension was necessitated because the February 24, 2006 deadline established by the Board did not provide sufficient time for the Ratepayer Advocate to conduct a full review of the Final Report, which totaled nearly 600 pages. The requested extension was granted at the Board's April 12, 2006 Open Public Meeting.

II. RATEPAYER ADVOCATE'S COMMENTS

Following are the Ratepayer Advocate's comments concerning Liberty's Final Report and SJG's subsequent requests for clarifications and/or exceptions. The Ratepayer Advocate's comments are arranged as follows. First, these comments address the Ratepayer Advocate's concerns with the audit process. We then discuss the process for assuring the Company's compliance with the audit recommendations. Next, we discuss and respond to several of SJG's suggested clarifications and/or exceptions to Liberty's audit recommendations. Finally, we provide a discussion on issues raised in the Final Report that were not properly or fully resolved by either Liberty or SJG.

A. CONCERNS REGARDING THE AUDIT PROCESS

As a preliminary matter, the Ratepayer Advocate wishes to express concern about the audit process. The current process allows ample opportunity for the Company and Staff to provide input to the auditors, while providing scant for opportunity input from the Ratepayer Advocate and other members of the public. The audit process began in October 2004, and Liberty's final report was completed in early May 2005. During that time the Company and the Board's Audits and Energy Staffs participated in the audit process with the auditors. The

Ratepayer Advocate's participation was limited to attendance at the October 1, 2004 initial meeting with Liberty.

Further, although the Final Report was competed in May 2005, it was not accepted by the Board and released for public comment until nearly nine months later, on February 1, 2006. At that time, the Board's Audits Staff recommended, and the Board adopted, a deadline of February 24, 2006 for public comment on the report. This deadline would have allowed only three weeks for the Ratepayer Advocate to retain a consultant, and for the consultant to review and provide an analysis of a 600-page report. The deadline was later extended to April 25, 2006 at the Ratepayer Advocate's request. The extended comment period has provided enough time to review the report, but not enough time to allow for discovery and a more comprehensive review, including review of the materials relied upon by Liberty for its findings and recommendations.

Moreover, there has been no Board Order or letter from the Board's Secretary to memorialize either the Board's February 1, 2006 decision to acknowledge receipt of Liberty's Final Report and to allow public comment until February 24, 2006, or its April 12, 2006 decision to extent the deadline for comments until April 25, 2006. Although a redacted version of the Final Report has been posted on the Board's website, the website gives no indication that there is an opportunity for public comment. The Ratepayer Advocate is not aware of any other efforts to advise interested parties that they may comment on the Final Report. The discussions at the Board's February 1 and April 12, 2006 Open Public Meetings appear to have been the only form of public notice of the comment period.

The Ratepayer Advocate is submitting its comments in compliance with the current April 25, 2006 deadline in order to avoid further delays in implementing the audit recommendations, which, as noted, have already been pending since early May 2005. Nevertheless, the Ratepayer

Advocate respectfully maintains that our office could have provided more helpful input had our office been involved at an earlier stage, *i.e.* during the audit process, or, when draft reports were provided to the Company and Staff, or, at the latest, when the Final Report was completed.

The Ratepayer Advocate notes further that the current process does not appear to comply with the requirements of the Electric Discount and Energy Competition Act ("EDECA") as it applies to the competitive services audits mandated for natural gas utilities under *N.J.S.A.* 48:3-58(k). Specifically, *N.J.S.A.* 48:3-58(k)(3) explicitly states that "[t]he public utility and *an intervenor* shall have the right to contest the methodology and rebut the findings of an audit performed pursuant to this subsection, in a filing with the board." *Id.* (emphasis supplied).

Given that the Ratepayer Advocate is a statutory intervenor on behalf of New Jersey ratepayers in all public utility matters before the Board, EDECA requires our office to be afforded the opportunity to conduct a meaningful review of both the methodology and findings of the audits mandated by EDECA. Such a review clearly requires the opportunity to engage in discovery, in order to explore the methodology used by the auditors and to examine the basis for the findings set forth in the auditors' report. Moreover, *N.J.S.A.* 48:3-58(q) specifically provides that the Board "shall render a decision, *after notice and hearing,* on any further restrictions required for any or all non-safety related competitive services offered by a gas utility in addition to the provisions of this section…" *Id.* (emphasis supplied). This statutory language requires the Board to provide adequate notice and hearings prior to any final resolution of competitive services audits of natural gas utilities.

As stated by President Fox at the Board's April 12, 2006 Open Public Meeting, the Board's Audits Staff has been directed to work with the Board's Chief Financial Officer to conduct a comprehensive review of the Board's audit process. Transcript of 4-12-06 BPU

Meeting, Item 8B, p. 8 (copy attached as Exhibit A hereto). The Ratepayer Advocate is hopeful that this review will result in an audit process that allows for more timely and meaningful input by the Ratepayer Advocate and other interested parties.

B. THE AUDIT COMPLIANCE PROCESS

As noted, the Final Report contained 136 recommendations for changes in the way the Company and its affiliates conduct their business. Liberty has conducted a comprehensive audit, which has uncovered a number of serious issues that affect the Company's rates, quality of service and financial viability. The Ratepayer Advocate fully supports these recommendations (with a few modifications, discussed below), and is concerned that they be fully and timely implemented. In order to protect ratepayers' interest in the timely and complete implementation of Liberty's recommendations, the Ratepayer Advocate should be part of the audit implementation process.

The following are just a few examples of the numerous audit findings that are of critical interest to SJG's ratepayers:

- The Company's Gas Supply Department ("GSD") lacks personnel with the skills to properly assess the Company's peak day capacity requirements and to evaluate alternatives for filling those requirements. As a result, the GSD's capacity "analysis" is limited to receiving estimates of capacity needs from the Budget Department, and identifying capacity addition projects offered by the interstate gas pipeline companies. *Final Report,* vol. 1, p. 16-17.
- The GSD's focus on interstate pipeline capacity, without consideration of alternatives such as expansion of the Company's on-system peaking capacity and demand-side measures, has resulted in costly distribution system investments to move gas from the

northwest side of SJG's service territory, where the interstate pipelines have their delivery points, to markets on the opposite side of the Company's system. *Id.*, vol. 1, p. 42. Liberty examined in detail the GSD's recent decision to acquire capacity on Transco's Trenton-Woodbury Lateral, and found that the Company had failed to adequately consider the alternatives before committing to this project. *Id.,* vol. 1, p. 42-44.

- The Company's capacity portfolio is unbalanced. SJG is over-subscribed to pipeline capacity, while maintaining too little on-system peaking capacity and storage. *Id.,* vol. 1, p. 50.
- SJG has an unusually high level of capacity releases and off-system sales, as a result of its practice of maintaining capacity to provide for turn-backs of customers by third party suppliers. *Id.,* vol. 1, p. 59. As the Board is aware, SJG profits from these transactions under the Company's margin sharing program.
- SJG's system-supply customers have subsidized the development of competition in the Company's service territory as a result of the Company's practice of providing for marketer turn-backs of customers. *Id.,* vol. 1, p. 69. A SJG affiliate, South Jersey Energy ("SJE") was "unusually successful in gaining market share in SJG's territory," and thus was a primary beneficiary of the subsidy. *Id.,* vol. 1, p. 92. The practice of maintaining back-up supply allowed SJE to turn back 8,000 customers to SJG when market conditions became unfavorable. *Id.,* vol. 1, p. 83.
- The Company undercharges its unregulated affiliates for leases of office space and rentals of tools and equipment, and for services provided by SJG employees. *Id.,* vol. 2, p. 10-13.

- SJG has outsourced utility functions to affiliates, without competitive bidding or arms-length negotiations. *Id.,* vol. 2, p. 24-25.
- The Company has used utility assets and resources to provide marketing and business development assistance to affiliates. *Id.,* vol. 3, p. 43, 87-88.
- As the Board is aware, SJG recovers costs incurred for environmental remediation of its former manufactured gas plants on a "pass through" basis under the Company's Remediation Adjustment Clause ("RAC"). Until December 2003, SJG owned eight air monitoring stations used in remediation activities. Until that date, AirLogics, LLC, an SJI affiliate engaged in providing remediation services, leased this equipment from SJG for a rental fee of $250 per unit per month. The equipment was sold to AirLogics in December, 2003 for $300,000. SJG initially failed to report either the lease or the sale to AirLogics to Liberty. *Id.,* vol. 3, p. 100-01. Liberty found that both the lease and the sale were entered into without a prior examination of book value or market price, and that both transactions were at less than market price. *Id.,* vol. 3, p. 104.
- The Company's parent, SJI, has directors that either have or are seeking business relationships with SJI and its affiliates. *Id.,* vol. 4, p. 28.
- SJG has provided credit support for affiliates without adequate compensation. *Id.,* vol. 4, p. 115-116.

The above examples demonstrate the seriousness of the deficiencies found by the auditors, and their importance to SJG's ratepayers. SJG's ratepayers have a strong interest in assuring that Liberty's recommendations for resolving the many deficiencies found in the audit are implemented fully, and on a timely basis. The Ratepayer Advocate, as the statutory

representative of SJG's ratepayers, should be involved in the process of establishing and enforcing appropriate time frames for the Company's full compliance with the important recommendations contained in Liberty's Final Report.

The Board should require SJG to file, with a copy to the Ratepayer Advocate, a detailed compliance plan that outlines, by recommendation, SJG's specific plans to implement each recommendation. These plans should discuss how SJG intends to implement each recommendation, the steps that need to be taken to implement each recommendation, and the timeframe for SJG's compliance. The Board should also direct SJG to make periodic and final compliance filings, with copies to the Ratepayer Advocate, so that both the Board's Staff and the Ratepayer Advocate can be advised of SJG's progress towards compliance with Liberty's recommendations. The Ratepayer Advocate should be included in any negotiations between the Company and Staff with regard to the content of the compliance plan and the Company's progress toward implementing the plan.

C. COMMENTS ON SJG'S CLARIFICATIONS AND/OR EXCEPTIONS

As was mentioned previously, Liberty's Final Report consists of nearly 600 pages and contains 136 recommendations. SJG's August 2, 2005 letter to Secretary Izzo entitled "Audit Recommendations with which the Company Respectfully Disagrees" stated that SJG accepted 118 of Liberty's recommendations "and agrees to take actions necessary to implement those accepted recommendations." Thus, the Ratepayer Advocate urges the Board to adopt each of Liberty's 118 uncontested audit recommendations and to compel SJG's timely compliance with all of them.

Of the remaining 18 recommendations, SJG, in its August 2, 2005 letter entitled "Audit Recommendation Suggested Clarifications and/or Exceptions," accepted 15 of these recommendations "in concept with clarifications and/or exceptions." Thus, SJG wholly disagreed with only three of Liberty's recommendations. Following are the Ratepayer Advocate's comments concerning several of Liberty's recommendations that SJG either disagreed with completely, or agreed with in concept but felt it necessary to seek clarification and/or exception. It should be noted that the Ratepayer Advocate is not commenting on all of SJG's responses. In several of SJG's responses the Company noted that it agreed with or was implementing Liberty's recommendation in a different time frame than Liberty originally recommended. The timing of SJG's compliance should be addressed as part of the audit compliance process, discussed above.

Volume ONE: Gas Supply

GS-20 Establish a mechanism for making marketer assets available to continue serving customers upon market exit or bankruptcy.

SJG RESPONSE: Apparently, SJG does not disagree with this Liberty recommendation. However, SJG believes that the recommendation should have been directed to the Board as a generic policy matter affecting all gas utilities and third-party gas supply market participants within the state, rather than solely to SJG. SJG agreed to participate in an investigation conducted by the Board.

RATEPAYER ADVOCATE COMMENT: The Ratepayer Advocate agrees with Liberty's recommendation, and disagrees with the Company's suggestion that it be considered only as part of generic proceedings. Liberty has raised an issue of particular concern to SJG's customers. As discussed above, SJG has followed a practice of maintaining capacity for turn-backs of off-system customers as part of its gas capacity planning process—a practice that has burdened on-system customers with the costs of subsidies for non-utility marketers including a SJG affiliate. The above recommendations represents one option for placing the burden of customer turn-backs where it belongs, on non-utility marketers. The practice of maintaining significant levels of capacity to provide for customer turn-backs is, the Ratepayer Advocate believes, unique to SJG among New Jersey's four natural gas utilities. It is therefore appropriate to address this issue for SJG specifically.

GS-22 Develop procedures and ground rules for negotiating flex-rate contracts.

SJG RESPONSE: SJG agrees with the concept of the recommendation. SJG, however, believes that written procedures and guidelines will serve little to no benefit to the negotiation of flex-rate contracts. SJG believes that each flex-rate contract is so unique that they do not lend themselves to a common set of procedures or guidelines beyond those that already exist in SJG's Tariff.

RATEPAYER ADVOCATE COMMENT: The Ratepayer Advocate finds considerable merit in Liberty's recommendation. It is appropriate for SJG to carefully document the Board's and the utility's general policy and framework for evaluating requests for new flex-rate contracts and for renegotiating existing contracts. An organized, central policy document would facilitate the utility's review of requests for new flex-rate contracts and would also assist the Ratepayer Advocate and the Board in reviewing SJG's responses to new requests. While it would be nearly impossible to foresee all of the various types of hardships that customers requesting flexible rates might claim, it is nevertheless possible and appropriate for SJG to document the general guidelines that it, the Ratepayer Advocate, and the Board will use when evaluating requests for flexible rates.

Volume TWO: Cost Allocations and Affiliate Relations

CA-4 Distribute the tax benefits that SJI realizes from the ESOP and 401(k) plan in a manner that reflects which entities caused the benefit and by how much, and revise SJG's books for 2004 accordingly.

SJG RESPONSE: SJG agreed with Liberty's conclusion that SJI erred in not sharing tax benefits with its subsidiaries, and agreed to implement the recommendation on a going-forward basis. SJG, however, did not agree to restate the Company's financial statements for 2004 to reflect the change.

RATEPAYER ADVOCATE COMMENT: Restatement of SJG's 2004 financial statements would not result in any immediate impacts on rates and thus may not be necessary at this time. However, in the event the Board does not require the recommended adjustment, SJG should retain the information and data that would allow the Company to restate the Company's financial statements for 2004 should it be found desirable or necessary to do so within a reasonable period of time.

Volume THREE: EDECA Affiliate Standards

ED-1 Treat SJE energy services, HVAC installations by SJESP, energy product development and plant management and operation by Marina, meter reading services by Millennium and air monitoring services by AirLogics as SJI holding company RCBSs for purposes of applying the standards.

SJG RESPONSE: The Company disagreed with this recommendation. SJG has consistently objected to the Board Staff's interpretation of the applicability of the RCBS designation to several of SJI's companies.

SJG's response to this recommendation does not address either SJE or SJESP. Thus, the Company apparently does not dispute that SJE and SJESP are RCBSs of SJI.

While not conceding its legal argument regarding the definition of an RCBS, SJG will, as a matter of practice, agree to treat Millennium and AirLogics as within the scope of the RCBS requirements on a going forward basis.

SJG does not agree that Marina Energy, LLC should be considered an RCBS. SJG does not believe that Marina Energy, LLC is providing or offering "competitive services to retail customers in New Jersey."

In the case of Marina, several officers also hold positions in SJI and SJG. This is not permitted under the Affiliate Relations standards. SJG requests that the Board specifically exempt the Company from the requirement of N.J.A.C. 14:4-5.5(q) as it pertains to the sharing of officers with Marina.

RATEPAYER ADVOCATE COMMENT: The Ratepayer Advocate agrees with Liberty's recommendations. SJG should be required to comply with the Board's Affiliate Relations standards as they apply to all of the competitive services provided by SJI affiliates. The Board should take this opportunity to issue a definitive ruling that Marina, Millennium, and AirLogics are RCBSs of SJI.

As noted in SJG's May 23, 2005 letter and one of its August 2, 2005 letters to the Board, the RCBS designation of some of SJG's affiliates has been a matter of dispute between SJG and the Board's Staff for some time. SJG's correspondence refers to a legal opinion letter dated March 19, 2003 (previously filed as part of SJG's comments in Docket No. GA02020101) as stating the basis for its arguments that the Affiliate Relations standards do not apply to these three entities.

The March 19, 2003 opinion letter, at pages 3 through 7, argued that Affiliate Relations standards relating to pricing in transactions between utilities and RCBSs did not apply to Millennium for two reasons: (1) the pricing provisions were contained in *N.J.A.C.* 14:4-5.3 through -5.5, which, under *N.J.A.C.* 14:4-5.1(a)(1) apply only to affiliates providing services to retail customers and (2) meter reading is not a competitive service, because the Board has not declared it to be so. Both arguments should be rejected by the Board.

With regard to the first argument, Liberty notes that this argument was addressed in detail in Liberty's Final Report on its competitive services audit of Atlantic City Electric Company in Docket No. EA02020095. *Final Report,* vol. 3, p. 8. The Ratepayer Advocate supports Liberty's interpretation of the Affiliate Relations standards, which would define retail sales as all sales other than sales for resale. Thus, a sale to a purchaser that then bundles the product or service with other products or services is a retail sale. As noted in the Final Report in this matter, the services provided by Millennium, AirLogics, and Marina all are competitive services as so defined, as all of them provide "retail service in markets where third parties compete to service similar end users." *Id.*

With regard to the second argument, the Ratepayer Advocate notes that, under both EDECA and the Board's Affiliate Relations standards, the term "competitive service" is not limited to a service that has been specifically determined by the Board to be competitive. Both definitions also encompasses services that are "not regulated by the Board," thus including all services provided by unregulated affiliates in the competitive market. *N.J.S.A.* 48:3-51; *N.J.A.C.* 14:4-5.2.

As Liberty observed in the Final Report, SJG's proposed interpretation is contrary to the Affiliate Relations standards' objective of preventing utilities from subsidizing and showing favoritism to their affiliates. SJG's proposed interpretation would "substantially diminish" the effectiveness of the standards by making them apply "only where a holding company chose to make the same products and services available both through utility and non-utility affiliates." This would allow the use of "utility operations to favor or subsidize a non-utility affiliate simply by discontinuing or never initiating similar services through its utility." *Final Report,* vol. 3, p. 7. The Ratepayer Advocate agrees with Liberty that SJG's proposed interpretation is contrary to the intent of the Affiliate Relations standards.

In its comments on Final Report, SJG has conceded that Millennium and AirLogics—both of which are now providing at a profit services that were previously provided by the utility at cost—warrant "a higher level of scrutiny" by the Board. The Company has therefore agreed to apply the Affiliate Relations standards to these two entities as a matter of practice. May 23, 2005 letter at 3; August 2, 2005 letter entitled "Audit Recommendations with which the Company Respectfully Disagrees" at 3. While this concession represents an improvement over SJG's past practice, the Ratepayer Advocate notes that the Company has not agreed that it should be subject to the sanctions provided by the Affiliate Relations standards if it fails to comply with any of the applicable requirements. A determination by the Board that Millennium and AirLogics are RCBSs is necessary to remedy this deficiency.

Liberty apparently sees merit in the Board considering SJG's request for an exception to the EDECA requirements for the three overlapping officer positions in question (CEO, CFO and general counsel) provided that the exception be for a limited time and that the Company can make a prior showing of usefulness to the utility. The Ratepayer Advocate believes that the current interlocking directorates involve serious conflicts and potential conflicts of interest to the detriment of SJG's ratepayers. One such conflict is apparent from Liberty's descriptions of Marina's business activities. According to the Final Report, Marina is engaged in "developing, owning and operating projects that supply thermal and electrical energy to large commercial and industrial end-users." *Final Report*, vol. 3, p. 5. These operations include "significant gas supply operations" for a large thermal energy complex in Atlantic City. *Id.,* vol. 1, p. 133, 138. Marina is currently purchasing gas supply for this facility from SJE which, as discussed above, has been the beneficiary of significant ratepayer-provided subsidies. Thus, Marina and SJG's ratepayers have conflicting interests in the terms of Marina's gas supply arrangements. Separate directors for SJI and SJG are needed to assure that such gas supply arrangements are on terms that are fair to SJG's ratepayers.

ED-2: <u>Cease the practice of deeming retail activities permissible because the BPU has not specifically declared them to be "competitive," and make the change clear to employees through an immediate, supplemental communications program.</u>

SJG RESPONSE: SJG disagrees with this recommendation. The Company believes it has a well-founded legal right under New Jersey Statues, and regulations and case law to deem certain activities as outside the scope of the Affiliate Relations standards."

RATEPAYER ADVOCATE COMMENT: Because the Ratepayer Advocate cannot agree with SJG's legal interpretation regarding what constitutes an RCBS within EDECA, the Ratepayer Advocate also does not agree that the Company has the legal right to deem certain activities as outside the scope of the Affiliate Relations standards simply because the BPU has not specifically declared them to be "competitive." See Ratepayer Advocate Comment regarding Liberty Recommendation ED-1. Liberty's recommendation ED-2 should be adopted by the Board.

Volume FOUR: Management and Operations

MO-2 Eliminate the requirement that the Nominating and Governance Committee take counsel from inside directors in recommending committee chairs to the full board.

SJG RESPONSE: SJG agrees with the intent of this recommendation. SJG, however, states that the Chairman and CEO need to be part of the process of the selection of Committee chairs.

RATEPAYER ADVOCATE COMMENT: The Ratepayer Advocate does not see how SJG can endorse the intent of this recommendation by Liberty on one hand, yet still advocate a collaborative process involving the Nominating and Governance Committee, the Chairman and the CEO for recommending committee chairs to the full board. As pointed out by Liberty in the Final Report, the Nominating and Governance Committee can, on its own, seek counsel from whomever in the Company it deems necessary to recommend the best candidates for committee chairs to be recommend to the full board. Nothing in Liberty's recommendation precludes the Nominating and Governance Committee from seeking counsel in this regard from either the Chairman or the CEO. Liberty recommends, however, that the Nominating and Governance Committee be autonomous from influence by the Chairman or the CEO, should it chose to be so. SJG apparently does not disagree with the autonomy recommended by Liberty. Therefore, Liberty's recommendation should be adopted as written and SJG's requested clarification should be denied.

MO-7 Adopt a lower threshold for the level of business dealings that may be permitted enterprises that board members are associated with, on the one hand, and SJI entities, on the other hand.

SJG RESPONSE: SJG disagrees with this recommendation. SJG believes that the independence standards set by the New York Stock Exchange are the appropriate measure for establishing thresholds regarding transactions between directors and the Company.

RATEPAYER ADVOCATE COMMENTS: The Ratepayer Advocate supports this recommendation by Liberty. During the audit, Liberty found several instances where "independent" directors either had or was trying to secure significant business arrangements with SJI and affiliates. Among the business arrangements where directors were involved were banking and lending services to SJI, bidding on pension fund custodian services, and other significant business relationships with SJE and Marina. While SJG's comments claim that it meets the standards set by the New York Stock Exchange, it never describes how the instances identified in Liberty's audit meet the NYSE's rules that requires "no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship

with the company)." *NYSE Rule 303A.02.* In fact, as pointed out in the Final Report, Institutional Investors Services, a leading provider of proxy voting and corporate governance services, considered one of SJI's outside directors to be "affiliated" because the director's employer provided banking and lending services to SJI.

The reasons for the prohibition against "affiliated" outside directors are manifest. SJI's and SJG's interests are not properly considered and protected if its directors own businesses that have a material interest in an SJI affiliate. Clearly, if the NYSE rules permit an affiliated "outside" director to sit on SJI's board, NYSE rules are not strict enough to protect SJG's and its ratepayers' interests. The Board should require SJI/SJG to establish appropriate thresholds regarding transactions between directors and the Company.

D. COMMENTS ON OTHER AUDIT ISSUES

Volume ONE: Gas Supply

GS-12 Require SJG to demonstrate the cost-effectiveness of the Transco Lateral expansion through the BGSS process.

SJG RESPONSE: SJG accepted this recommendation by Liberty.

RATEPAYER ADVOCATE COMMENT: The Ratepayer Advocate supports this recommendation, and wishes only to note that, although the recently approved Global Settlement involving SJG addressed the Transco Lateral expansion project, that settlement did not fully resolve Liberty's recommendation GS-12. As part of that settlement, the parties agreed that SJG could recover the demand charges associated with this project, and that they would not challenge SJG's initial decision to participate in this project. This agreement, however, was "based on [SJG's] representation that its participation in the Project will enable the Company to restructure is overall gas capacity and supply portfolio to the benefit of the Company's BGSS customers." Global Settlement approved March 27, 2006 in Docket Nos. GR03080683 *et al.*, par. II. The Global Stipulation further provides as follows:

> The adequacy of the measures undertaken by the Company to restructure its portfolio (such as, for example, temporary or permanent capacity release and termination and replacement of entitlements) and to market capacity that is not needed currently to meet the needs of the Company's customers, as well as the appropriate sharing of the costs savings, margins and other benefits resulting from such measures, shall be subject to discovery, review, and determination by the Office of the Administrative Law and the board in the Company's 2005-06 BGSS proceeding, Docket No. GR05060496, and future BGSS proceedings.

Id. Liberty's recommendation should be modified to reflect the above-quoted provision in Global Settlement.

In addition, the Global Settlement does not resolve what Liberty characterized as "the long-standing need to complete an unbiased, analytically sound analysis of the option of adding supply capacity on the east or south side of its service territory," or the need for consideration of demand-side measures as an alternative to acquisitions of new capacity. *Final Report,* vol. 3, p. 46-47. The Board's Order adopting the Final Report should make it clear that SJG is required to perform the recommended comprehensive analyses of capacity alternatives.

Volume TWO: Cost Allocations and Affiliate Relationships

III. B. The Corporate and Fiscal Expense and Management Service Fee

3. Conclusions

a. The composition and application of the three-factor allocator are reasonable, and the method used for making the calculations needs only minor corrections.

RATEPAYER ADVOCATE RESPONSE: Liberty observed that SJI uses a three-part allocation factor to allocate indirect costs among affiliates that cannot be directly charged to the affiliates. SJI calculates the three-part factor by equally weighting the subsidiaries' assets, payroll, and margin. Liberty concluded that "the method of using the average of three measures demonstrates substantial improvement over SJI's past practice of using assets alone as the allocation factor." Liberty also concludes that "the measures of size that SJI has chosen are fair and similar to those used by other utility holding companies."

The Ratepayer Advocate agrees that it is appropriate for SJI to use an equally weighted three-part factor to allocate certain indirect costs among affiliates where there is no actual cost-causative basis for allocating such costs to the affiliates. The Ratepayer Advocate also believes that the three measures should each be broad measures of business activity for all of the affiliates. Indeed, the Board has accepted affiliate service agreements for several of the State's electric utilities that each contain a three-part factor for allocating certain indirect costs. In none of those instances, however, was "margin" allowed to be used as one of the factors within the three-part formula. Margin is a crude measure of subsidiary profitability. Whether an affiliate should be allocated corporate overhead indirect costs, however, should not depend on its profitability. By participating in the entire family of affiliates, each affiliate is responsible for paying for a fair share of indirect overhead costs regardless of its level of profitability, or even if it does not earn a profit (*i.e.,* negative margin). More typically, Board-approved management service agreements have relied on some variation of the "Modified Massachusetts Formula" which establishes a three-part factor using assets, payroll (labor), and gross revenue, rather than margin. A company's revenue is a better measure of overall business activity and does not allow an affiliate to escape or lessen its cost responsibility simply because it is not profitable. Therefore, the Ratepayer Advocate recommends that SJG and SJI

modify its three-part allocation factor to exclude margin as one of the three measures, and to include a factor representing revenue in its place. The Ratepayer Advocate believes this revenue is a much better measure of relative business activity among the affiliates and is more consistent with what the Board has required for other jurisdictional utilities.

Volume THREE: EDECA Affiliate Standards

Sanctions for violations

RATEPAYER ADVOCATE COMMENT: In Volume Three of the final Report Liberty found numerous violations of the Board's Affiliate Relations standards under EDECA. Liberty's recommendations do not, however, address sanctions for these violations. Under *N.J.A.C.* 14:4-5.8 (a), for violations determined not to be substantial the Board may impose a penalty of up to $10,000 for each violation. For violations determined to be substantial, *N.J.A.C.* 14:4-5.8 (b) authorizes the Board, after notice and hearing, to (1) impose a penalty of up to $10,000 for each violation, (2) order appropriate reimbursement of the utility's ratepayers, including interest, and, (3) order the utility to cease some or all competitive service offerings and/or impose structural remedies. The Ratepayer Advocate urges the Board to consider imposing sanctions for the numerous violations found by Liberty. In the two sections appearing immediately below, the Ratepayer Advocate notes two areas in which reimbursement would be particularly appropriate, as the Company's violations affected costs that are recovered from ratepayers on a "pass-through" basis.

V.M. Customer Enrollment, Marketing and Business Development

4. Conclusions

a. SJG provided material customer enrollment, marketing and business development assistance to SJE and SJESP in violation of the requirements of Section 14:4-5.3(m)

RATEPAYER ADVOCATE RESPONSE: As discussed above, Liberty found that SJE was "unusually successful in gaining market share in SJG's territory," and thus was a primary beneficiary of the subsidy created by the Company's practice of providing for customer turn-backs as part of its capacity planning process. *Final Report,* vol. 1, p. 92. Based on the above conclusion, it appears that this may have occurred in part due to SJG's improper use of utility resources to promote SJE's marketing activities. Thus, the Ratepayer Advocate believes that it would be appropriate to compensate SJG's BGSS customers for some of the contribution to the costs of capacity that were lost to the BGSS Clause as a result of customer migration to SJE. Although these SJE customers have now been returned to SJG, SJE benefited from a ratepayer-provided subsidy while their customers remained as supply customers of SJE.

VII.U. Utility Asset Transfers

4. Conclusions

d. SJG leased equipment to AirLogics and later sold the equipment to this affiliate without a prior examination of either the book or market price.

e. SJG leased equipment to AirLogics and later sold the equipment to this affiliate at less than market price.

RATEPAYER ADVOCATE RESPONSE: Liberty's recommendations ED-31 through ED-35 include a number of measures to assure that future inter-affiliate transfers of goods and services are charged at the proper costs under the Board's Affiliate Relations standards. As discussed above, the costs of the air monitoring equipment referred to in the above two Conclusions was funded by SJG's ratepayers on a "pass-through" basis through the Company's Remediation Adjustment Clause ("RAC"). The Company should be required to determine the proper costs for the sale and lease transactions involving the air monitoring equipment, and to demonstrate that these amounts have been reflected in the Company's RAC accounts for the benefit of ratepayers.

Volume FOUR: Management and Operations

MO-29 Require all employees, except for senior officers to routinely complete time sheets.

SJG RESPONSE: SJG accepted this recommendation by Liberty.

RATEPAYER ADVOCATE COMMENT: Liberty correctly noted that it is necessary for all employees to fill out a time sheet "as an affirmation of time worked." Without explanation, however, Liberty exempted senior officials from the time sheet requirement. Moreover, Liberty did not make clear in the Final Report that SJG/SJI's current practice of *Exception Time Reporting* does not allow for an accurate affirmation of time worked and should not be permitted to continue.

Like all other workers, SJI and SJG's senior officials spend identifiable amounts of time working on assignments related to a single affiliate or groups of affiliates. Charges for that time should be directly assigned to the appropriate affiliates. Appropriate charging of affiliates cannot be done, however, if accurate time records are not being kept by senior officers. Moreover, it is not an unreasonable burden for senior officers to keep accurate time sheets. In fact, other New Jersey jurisdictional utilities and their holding company officers are required to keep accurate, positive records of their time.

The Board should also require that SJI/SJG discontinue its current practice of *Exception Time Reporting*. Under the current practice, payroll assumes that all of an individual's time is associated with one project or one affiliate, unless notified by an exception. This type of practice can lead to mis-assignment of cost responsibility simply because an employee decided that it was not worth his or her effort to note an exception. The Ratepayer Advocate is not aware of any other jurisdictional utility within the state that

uses *Exception Time Reporting.* All other utilities and their holding companies require positive time reporting. The Board should require positive time reporting for SJG as well.

III. CONCLUSION

For the foregoing reasons, the Ratepayer Advocate urges the Board to accept the recommendations contained in Liberty's Final Report, with the modifications and additions discussed above, and to require the Company to move expeditiously to implement those recommendations, in cooperation with the Board's Staff and the Ratepayer Advocate.

Respectfully submitted,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By_____
Sarah H. Steindel, Esq.
Assistant Deputy Ratepayer Advocate

c: Service list
President Jeanne M. Fox
Commissioner Frederick E. Butler
Commissioner Connie O. Hughes
Commissioner Joseph L. Fiordaliso
Commissioner Christine V. Bator