June 9, 2003

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

RE: I/M/O the Audits of the Competitive Service Offerings of New Jersey's Electric and Gas Utilities Pursuant to the Electric Discount and Energy Competition Act, *N.J.S.A.* 48:3-56 and 48:3-58
Elizabethtown Gas Company, a Division of NUI Corporation
BPU Dkt. Nos. AA02020094 and GA02020099

Dear Secretary Izzo:

Please accept for filing an original and ten copies of the Division of the Ratepayer Advocate's ("Ratepayer Advocate") comments regarding the above referenced matter.

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 to this matter.

INTRODUCTION

The Ratepayer Advocate is filing these Comments with the New Jersey Board of Public Utilities ("Board" or "BPU") regarding the Audit of the Competitive Service Offerings ("Audit") of Elizabethtown Gas Company ("ETG" or "Company") that was conducted by Overland Consulting ("Overland") for the period October 2000 through September 2002.

The review encompassed the Overland Audit Report, dated March 14, 2003, the Company's March 21, 2003 filed comments, discovery responses, and information obtained from the Company during informal discovery. The analysis was conducted under the presumption that the Findings and Recommendations contained in Overland s Audit Report were accurate and reasonable unless shown otherwise by substantial contrary evidence.

AUDIT RECOMMENDATIONS

A. Affiliate Transactions and Internal Controls

The Overland Audit contains four recommendations that related to the Company's internal controls for affiliate transactions.

Overland's Recommendation

1. The first recommendation concerns the development of itemized statements for inter-company services, and the Company has stated a willingness to do such reporting on a quarterly basis. Such reporting on a quarterly rather than a monthly basis appears reasonable and warranted. Therefore, the Ratepayer Advocate agrees with Overland's recommendation and urges the Board that it be adopted.

Overland's Recommendation

2. The second recommendation involves the development of service agreements with all affiliates providing services to the Company. The Ratepayer Advocate agrees with Overland's recommendation. Further, the Ratepayer Advocate recommends such service agreements should also cover inter-company goods and services received, or provided, by the Company. With such service agreements, all transactions between the Company and its affiliates would be codified, and the basis for associated transactions would be specific as to terms and conditions.

Overland's Recommendation

3. The third recommendation involves the expansion of the Company s policy concerning its asset transfers, leases, and rentals to all inter-company transactions and affiliates. The Company has agreed to expand its policy to "all affiliates providing services to Elizabethtown." The Ratepayer Advocate agrees with Overland's recommendation. Further, the Ratepayer Advocate recommends that in order to be fully compliant with the Audit's recommendation, the Company should also agree to apply the policy to both goods and services transactions between it and its affiliates.

Overland's Recommendation

4. The fourth recommendation involves the Company s failure to "close out" the balances in inter-company accounts. The Company agrees with the requirement to "close out" the balances in its various inter-company accounts, but it takes issue with the companion recommendation to research, or investigate, the existing balances. According to the Company, the Audit's requirement to investigate such balances is not supported by any associated findings. Moreover, there is no indication that historical balances are inaccurate or improper other than with respect to the impact of affiliate-related issues raised in other portions of the Audit Report.

Based upon the Ratepayer Advocate's review, there is, however, some uncertainty as to what constitutes a "close out" of inter-company accounts. According to the Company, NUI Corporation raises external funds that are used for working capital purposes, and the inter-company balances reflect the various affiliates utilization of such funds. If the Audit's recommendation is to eliminate or "zero out" these balances, it would appear that the financing flexibility of all of the affiliates would be constrained.

In the alternative, it would appear feasible to have the working capital funding segregated for regulated vs. unregulated entities, as the Company has stated it is currently considering. This would allow the "close out" of balances between the regulated and unregulated affiliates without eliminating the use of inter-company balances as a working capital mechanism.

To the degree that inter-company balances are maintained for extended periods of time, such balances could constitute a subsidy between certain affiliates. As noted by the Audit, such inter-company balances are maintained as accounts receivable or payable between the various entities. Generally, such balances should accrue interest if they are not cleared within a specified period. If interest is not accrued for long-term accounts receivable, then the owed entity is effectively subsidizing the owing entity by providing it with cost free financing. The Company has stated that interest is currently accrued on the inter-company balances. Therefore, the Ratepayer Advocate recommends that this practice should be continued if separate regulated and unregulated funding pools were to be established.

B. Common Cost Allocations

In this portion of the Audit, the Company has challenged two of the five Overland Audit recommendations.

1. Overland's Recommendation – Cost Basis for Allocating Common Costs

The first challenge involves the Audit's recommendation to require the adoption of "an attributable cost basis for allocating" common costs. This specific recommendation includes, for example, a provision for cost assignment based on the use of timesheets.

The Company contends that timesheet reporting and the use of “cumbersome and arbitrary ongoing analyses of shared service costs” create “costs and administrative burdens” which outweigh any potential cost allocation benefit (ETG Comments, page 4). The Company also takes issue with the Audit's criticism of its three-factor general allocation formula that utilizes payroll, gross plant, and the number of customers, weighted equally, to assign many shared or common departmental costs.

The Audit Report states that the Company s three-factor methodology is “based on an arbitrary selected set of size-related factors” (Audit Report, page 3-5). In the alternative, the Audit Report recommends an “attributable cost methodology, which attempts to assign and allocate costs based on causation” (Audit Report, page 3-2).

In evaluating the Company s and the Audit Report's positions, the Ratepayer Advocate would like to bring to the Board’s attention several relevant observations. First, while the Company has been utilizing its present, Board approved, cost allocation methodology since 1994, the nature and scope of ETG's and its affiliates operations have changed during the past several years. The partially deregulated and restructured gas market and the diversity of current affiliated businesses have changed the cost relationships between and among the various regulated and non-regulated entities.

Second, while the assignment of common costs is best done on direct cost causation criteria, in practice, many costs are allocated on size or activity-related criteria because of practical and administrative considerations. However, such formula allocation methodologies are somewhat arbitrary and imprecise particularly when dealing with both asset intensive and revenue driven activities. Asset measures assign significant cost levels to utilities, while revenue measures allocate high cost levels to transactional entities involved in activities such as commodity trading.

In the end analysis, the Ratepayer Advocate recommends that two aspects of the Audit Report's recommendations should be implemented. First, the Company should be required to utilize more direct cost assignment procedures as specified on pages 3-2 and 3-3 of the Audit Report. However, in accomplishing this, the Company should be able to utilize cost pools where warranted in terms of administrative considerations. Thus, the Company should reevaluate its cost allocation methodology and, by using more direct cost assignments, including the use of timesheet reporting in appropriate circumstances, it should fully assign all common or shared costs.

As for the composition of any general allocation formula, the major issue appears to be the utilization and weighting of various size measures. Since both the Company and the Audit Report have utilized a three-factor methodology that includes labor or employees as one factor, it would appear that a combination of both formulas would be reasonable. Accordingly, the Ratepayer Advocate recommends that the formula be based on direct payroll, assets and revenues. Such a formula incorporates the major size-related factors utilized by both the Company and the Audit Report.

2. Overland's Recommendation – Assignment of Common Costs to Individual Departments

The second cost allocation recommendation involves the assignment of all common costs to individual departments within each business unit. The Company has agreed with this recommendation and will submit an appropriate proposal as part of its compliance filing. The Ratepayer Advocate also agrees with Overland's recommendation.

3. Overland's Recommendation – Union Facility Rental Costs

The Company challenges the third cost allocation recommendation, which relates to the rental costs associated with the Union facility, where it is located. The Company asserts that the existing lease arrangement, which was revised in April 2000, reflects market rates and is therefore reasonable. Without restating all of the history and details of the lease arrangement, it is sufficient to note that there are material factual differences between the Company s and the Audit Report's positions.

Some material aspects of the renegotiated lease do not appear to be in contention. The original lease on the Union facility was reviewed in 1988 and was subject to validation through the use of independent appraisers. In the 2000 renegotiation, an independent appraisal was not obtained because the Company claimed it "would not have served any practical purpose" (Response RAR-E-7). While the original lease was for 160,000 square feet, the renegotiated lease covered the facility's total 200,000 square feet, with ETG becoming responsible for leasing the incremental space.

The Audit Report states that ETG is a related party since Liberty Hall is owned in part by entities which share common ownership with ETG. Accordingly, the Audit found that the lease renewal constituted de facto self-dealing. Moreover, there were numerous alternative real estate opportunities other than one involving principals of its own company. Because of the related ownership, the terms and conditions of the lease renegotiation were properly examined as part of the Overland Audit.

However, the Audit Report's recommendation to "limit ETG's charge for the direct and NUIHQ-allocated rental costs of the Union facility to the market price for efficiently-used space in the facility" does not appear to be within the scope of the Audit. As stated in ETG's comments, transactions with Liberty Hall are not subject to the Board's affiliate regulations, and the Company has recently completed a base rate proceeding in which the lease payments were included within the cost of service. Given these facts, the Ratepayer Advocate believes that the issue concerning the Union facility should be left to the scheduled focused audit or the next base rate case.

4. Overland's Recommendation – Appliance Service Business ("ASB")

The fourth allocation related Audit recommendation concerned the appropriateness of a charge to the ASB for its use of the Rahway operations center. ETG has not been charging the ASB rent for the use of its Rahway operations center. While the Company agreed to charge an appropriate rent for the facility if it continues to be used by the ASB, it disagreed with the Audit finding that its past failure to charge ASB a rental fee constituted a subsidy of the ASB by ETG. The Company s disagreement concerning any subsidy is based on the possibility that other cost allocations might have over-allocated costs to the ASB, thereby offsetting the omission of any rent for the Rahway facility. However, the Company has not provided any evidence of any alleged over allocation.

It is difficult to understand how the Company can seek to justify its failure to charge its affiliate an appropriate rent for its use of a facility which is paid for by its ratepayers. The Company s failure to charge for Rahway must be seen as either an indication of an inadequate system of inter-company accounting or a surprising oversight concerning its non-regulated affiliate. This Audit finding, along with others, appears to justify the Board's initiation of a focused audit for the Company. The Ratepayer Advocate agrees with Overland's recommendation regarding charging rent to the ASB and such recommendation should be adopted by the Board.

5. Overland's Recommendation – Cost Allocations

The fifth and last Audit recommendation, related to cost allocations, involves supporting documentation for the allocation of insurance costs to the various NUI entities. The Audit states that such insurance allocations are based on the insurance companies evaluation of the individual entities risk, and it noted that the Company neither reviews the basis for such allocations nor does it even obtain full documentation from its insurance companies. In response to this Audit recommendation, the Company stated in its comments "that it will attempt to obtain back-up data where it is cost effective to do so" (ETG Comments, page 13). Assuming that ETG's insurance carriers do assess the risks and assign insurance costs by business unit, it is not clear why obtaining such backup information would increase costs. The Ratepayer Advocate agrees with Overland's recommendation and therefore recommends that the Audit recommendation should be adopted and that if it fails to obtain such information, the Company should provide specific details of the circumstances and evidence of incremental costs involved.

It is also appropriate to note that the Audit found that the allocation of insurance costs was deficient (Audit Report at page 3-13). The deficiencies include undocumented allocations of general liability and workers compensation insurance. In addition, although not covered by any Audit Report recommendation, Overland alleged that New Jersey property insurance is being allocated solely to ETG and it is implied, in the Audit, that these charges are not subsequently assigned to affiliates either directly or through any triple-net lease provisions. Therefore, the Ratepayer Advocate further recommends that the Company should be directed to fully document its allocation of all its property insurance costs to the NUI entities based on their utilization of insured properties.

C. Appliance Service Business ("ASB") Floor Costs

The Overland Audit has only a single recommendation related to the ASB. The Audit recommends that the Company update the floor prices for services using fully allocated costs and that appliance service tariffs be modified to reflect these new floor prices. The recommendation is based, in part, on the Audit's finding that the current floor prices do not include fully allocated costs and are outdated. The Audit also notes that in order to ensure fully allocated costs, floor prices must be based on total income statement expenses rather than on an “add up” calculation of hourly costs (Audit Report, page 1-11).

In response, the Company states that the current ASB floor costs were revised, in accordance with EDECA provisions, in 2000, and the resulting prices were approved by the Board in August 2001 in Docket No. GR00060385 (ETG Comments, page 13). The Company further comments that it is currently updating its floor prices, in part to incorporate charges for the Rahway facility and the new ASB call center. The Company concludes by saying that “until a complete floor price filing is made, summary modifications to the Company s formula based upon the auditors subjective recommendations are not appropriate.” (ETG Comments, page 14).

The Ratepayer Advocate disagrees with the Company s position. The Company has admitted that it is currently in the process of evaluating an update to its floor costs. It is therefore disingenuous to characterize the auditors recommendation as “subjective” when the Company itself acknowledges its failure to charge costs related to the Rahway facility to the ASB. The Ratepayer Advocate agrees with Overlands’ recommendation. Accordingly, the Ratepayer Advocate recommends that the Board order the Company to update the floor costs and associated prices of the

ASB within a specified period of time and that such prices should incorporate other related Audit recommendations, not the least of which is the correction of the Rahway cost omission.

The ASB issue indicates a disconnect between the Audit's recommendations and the rates charged by ETG's ratepayers. For the ASB, although the Audit recommendation addresses the floor pricing issue, adoption of the recommendation will not remedy the fact that in the Company s recent base rate case ETG's cost of service included all costs associated with Rahway. The Union rent issue represents the opposite situation. For the first time, the revised lease places occupancy risk on ETG. However, the economics of this lease provision can only potentially impact ratepayers in the next ETG base rate proceeding. Should occupancy decrease prior to the next such rate proceeding, NUI stockholders, not ratepayers, will bear the economic consequences. Thus, while there are cost misallocations between ETG and its affiliates, the ability to reallocate ETG's cost of service would appear to be limited.

D. Energy Brokers Relationship with ETG and Energy

NUI Energy Brokers is ETG's gas procurement agent. The Audit Report recommends that Energy Brokers be prohibited from selling gas or supply capacity to ETG except in emergency circumstances, and in such cases, the transactions should be priced at cost.

In response to this Audit recommendation, the Company states that "there is no reason why the Board should impose a blanket prohibition on Energy Brokers sales to Elizabethtown" (ETG Comments, page 15). This statement is made despite the fact that the Company s acknowledgment that Energy Brokers has made gas sales to the Company upon which Energy Brokers can realize and retain a profit. While the Company claims that such sales by Energy Brokers are made in competitive, blind, on-line reverse auctions, it is unclear whether all Energy Brokers sales to ETG are made under such sale conditions.

However, based upon the Company s response to Request RAR-E-9, Energy Brokers receives no compensation from ETG for providing services under the Gas Supply Agency Agreement. Additionally, as stated in its response to Request RAR-E-11, and as affirmed during discovery, Energy Brokers only utilizes ETG's gas supply and capacity resources for ETG transactions, and it does not retain any margins or credits on such capacity transactions. It therefore appears that Energy Brokers is subsidizing ETG in performing associated agency services without either direct or indirect compensation.

As to the specifics of the Audit recommendation, while it would be desirable for ETG to purchase its gas supplies from entities other than Energy Brokers, there appears to be no reason why it cannot continue to do so as long as such purchases can be shown to be competitively obtained. In that regard, the Company has stated that it does not purchase gas from Energy Brokers unless there is at least one competitive bid from a non-affiliated supplier. Additionally, as noted in the Company s comments to the Audit Report, “all such purchases can be reviewed by the Board in Elizabethtown's annual Basic Gas Supply Service (“BGSS”) proceeding” (ETG Comments, pages 14-15).

With respect to the Audit recommendation that Energy Brokers provide gas supply to ETG only in “emergency circumstances when gas, transportation or storage capacity cannot be economically procured from third parties”, the recommendation overlooks one major consideration. The Agency Agreement between Energy Brokers and ETG does not contain any full requirements obligation. Consequently, if Energy Brokers must provide emergency gas supply to ETG at cost, it is probable that Energy Brokers will not make supply available to ETG. It is quite probable that in an emergency, Energy Brokers could sell available capacity at a premium in the marketplace, so it would logically not sell to ETG at cost. To do otherwise could give rise to a substantial subsidy of ETG by Energy Brokers. If affiliate transactions are to be made at competitive market prices, all such transactions should be made competitive, including Energy Brokers gas sales to ETG.

Accordingly, the Ratepayer Advocate disagrees with the Audit recommendation concerning a prohibition on Energy Brokers sales to ETG and the provision for emergency sales at cost. However, ETG should be required to continue to show that all its gas purchases were made at competitive rates and were prudent. In this regard, the recently agreed upon Minimum Filing Requirements for BGSS filings appear to address the Audit's concern and recommendations.

E. Purchases from Utility Business Services ("UBS")

The Audit Report contains three basic recommendations concerning ETG's purchases from UBS. However, two of these three recommendations have multiple requirements. The first recommendation requires that:

- UBS provide supporting documentation for services provided to ETG;
- There should be annual agreements covering UBS services and charges;
- UBS not be allowed to charge unrecovered third party expenses to its affiliates; and
- Absent compliance with such requirements, all of UBS's charges for operations and applications services should be recorded by ETG below-the-line.

In support of these requirements, the Audit Report states that, without detailed accounting for UBS charges, it is impossible to determine the nature and the benefit associated with UBS activities (Audit Report, page 1-12).

The Company, in response to this recommendation and its various findings and conclusions, agrees only to the need for improved documentation for services provided, including the use of time sheets where appropriate (ETG Comments, page 15). As to the other findings and conclusions in the first recommendation, the Company contests each of them on the basis that they are unsubstantiated and incorrect.

The Company objects principally to the Audit's claim that ETG subsidizes UBS and the recommendation that the Company record all UBS charges below-the-line. The Ratepayer Advocate recommends two actions that will adequately address the UBS-related recommendation. First, the Company should be required to enter into annual service agreements with UBS for all UBS services and charges and UBS must provide to ETG full expense documentation by work activity. Second, absent such service agreements and documentation, UBS charges should be subject to disallowance in setting ETG's base rates. This second action effectively enforces the Audit's recommendation but recognizes that recording UBS charges below-the-line will have no impact on rates until the Company s next base rate case.

The Audit's second recommendation involves far more troubling findings and conclusions. The Audit Report states that “evidence suggests that ETG and other NUI utilities helped fund or completely funded the development of at least two UBS products” (Audit Report, page 1-13). The report further states that “ETG should not be paying the costs of developing UBS products intended for the marketplace.” In support of the Audit's position, the Auditor notes that:

- There is a possibility that UBS is using NUI Utilities to recover costs that UBS cannot otherwise recover from the marketplace;
- Evidence indicates that NUI Utilities funded the development of UBS's Wins Fieldbook; and
- It appears that NUI Utilities paid for some or all of the cost for a gas version of Wins CIS.

(Audit Report, page 6-2)

In its comments, ETG claims that the Audit's recommendation "is predicated upon a factual finding that has not been and cannot be substantiated" (ETG Comments, page 16). In addressing the development of the Wins Fieldbook, the Company states that the Audit's "evidence proves nothing. At most it can be said to create an issue" (ETG Comments, page 17). In a very real sense, the Company s statement summarizes the current status of the Audit's second UBS recommendation. The Audit has raised valid concerns based upon limited evidence. The Company, for its part, claims that it paid market rates for the UBS service provided and that it did not fund development for products that were sold to other UBS clients.

It appears that ETG has paid for services that may have contributed to products or services which have commercial value. However, absent a specific service contract between ETG and UBS, it is not possible to determine whether ETG should properly have an equity interest in the product or services or whether it should be entitled to credits or royalties from subsequent commercial sales. That having been said, it must be concluded that ETG was at fault for failing to develop a service contract for UBS, particularly when the service provider was an affiliated entity.

Based on these considerations and the fact that conclusive evidence has not been presented, the Ratepayer Advocate recommends that the Board ensure that the UBS issues be specifically addressed and resolved within the context of the pending focused audit.

The final UBS related recommendation involves whether or not UBS should be considered to be a "retail" entity and therefore subject to BPU affiliate standards. The Audit Report's recommendation is predicated upon the fact that the BPU Staff apparently believes that South Jersey's Millennium meter reading joint venture with Conectiv is a retail affiliate which is subject to the standards.

For its part, the Company discriminates between Millennium and UBS on the grounds that Millennium provides wholesale services solely to affiliates and UBS provides wholesale services to both affiliates and non-affiliates. Accordingly, the Ratepayer Advocate relies upon its legal position in the Comments submitted concerning its review of the South Jersey Gas Company's Competitive Service Offerings Audit, BPU Docket No. GA02020101.

F. Purchases from NUI Telecom

In many ways, the Audit Report's findings for transactions with NUI Telecom ("Telecom") mirror those associated with UBS. The Audit Report's recommendation states that ETG needs to develop a complete inventory of all telecommunications facilities and services it receives from Telecom in order to reconcile charges with services received. It also would require that unreconcilable charges should be recorded below-the-line.

Despite attempts to obtain documentation concerning the Telecom charges, Overland concluded that it was possible that ETG was paying for communications services used by its non-regulated affiliates and that the documentation provided by ETG provided no assurance that ETG was being properly billed by Telecom (Audit Report, pages 1-13 and 1-14). In response, ETG asserts that it has developed an inventory of facilities and services received from Telecom and that the documentation of the Telecom charges was not adequately communicated to Overland (ETG Comments, page 19).

Affiliate issues related to ETG and Telecom remain unresolved. Overland did not receive adequate documentation within the timeframe of the audit to resolve pending questions. Given this situation, the Ratepayer Advocate recommends that the Board include the Telecom related issues as part of the upcoming focused audit.

CONCLUSION

In light of the pending focused audit of ETG, pursuant to Board Docket No. GA03030213, the Competitive Service Audit takes on added significance. The current audit has exposed several areas where there have been either violations of affiliate standards or, at a minimum, the appearance of negligence in the Company's accounting for its affiliate transactions.

Ratepayers, historically, have been captive customers of established utilities such as ETG. Indeed, given the lack of alternative suppliers entering the market, it appears that they will continue to rely on their embedded utilities to receive essential services. Traditionally, the regulated utilities have been required to provide safe and adequate service at a reasonable cost. However, in cases where the utility or its parent company chooses to pursue non-regulated activities, there is a real risk that the regulated utility could face adverse economic consequences and a diversion of management attention away from the basic utility function.

In the case of ETG, such risks have arisen and ratepayers stand to lose as a result. The Ratepayer Advocate believes that the findings and recommendations contained in the Competitive Service Audit provide a regulatory wake-up call for action to ensure that ETG's provision of utility service is not impaired by the activities of non-regulated affiliated entities.

Most local gas distribution companies manage their own gas supply, business services, telecommunications needs, and customer billing. This raises the obvious question of whether contracting out such activities is driven by a desire to improve service levels and reduce costs or whether the major objective is to gain incremental profits for shareholders, potentially to the detriment of utility ratepayers.

Therefore, for the reasons set forth above, the Ratepayer Advocate respectfully recommends that:

- Concerning the Competitive Service Audit, the Board adopt the specified Audit recommendations and the additional recommendations of the Ratepayer Advocate; and
- In instances where the issues have not been resolved, that they be incorporated into the focused audit for additional investigation and resolution.

Respectfully submitted,

Seema M. Singh, Esq.
Ratepayer Advocate

By:______________________________
Felicia Thomas-Friel, Esq.
Deputy Ratepayer Advocate

cc: Jeanne M. Fox, President *via hand delivery*
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