June 9, 2003

<u>VIA HAND DELIVERY</u>

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

RE: I/M/O the Audits of the Competitive Services 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
New Jersey Natural Gas Company
BPU Dkt. Nos. AA02020094 and GA02020100

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 in this matter.

<u>INTRODUCTION</u>

Pursuant to a Request For Proposal ("RFP") issued by the Board of Public Utilities ("BPU") on March 20, 2002, Overland Consulting was engaged by the BPU in July 2002 to conduct a comprehensive audit of New Jersey Natural Gas Company's ("NJNG") competitive service offerings. The general purpose of this audit was to insure that NJNG and its affiliates offering competitive retail services do not enjoy any unfair competitive advantage over other non-affiliated purveyors of competitive retail services. The scope of the audit included a review of competitive services offerings, affiliate relationships and other interrelated transactions, incorporating the following specific audit objectives:

- Whether there is strict separation or allocation of utility revenues, costs, assets, risks and functions from those of its competitive service segments;
- Whether the degree of separation is reasonable under the BPU's recently re-adopted Affiliate Standards;
- Whether there is cross-subsidization between the utility and competitive service segments;
- The impact on ratepayers of using utility assets to provide competitive services;
- The impact of competitive services on utility workers;
- The impact of utility practices on the market for competitive services; and
- Whether recommendations from the previous competitive services audit have been fully implemented.

On March 14, 2003, Overland Consulting submitted its Final Report ("Final Report") regarding NJNG's competitive services. This Final Report contained ten (10) major recommendations for change, as well as numerous other observations regarding NJNG's competitive services offerings and affiliate relationships.

By letter dated March 25, 2003, NJNG submitted its comments ("NJNG Comments") and clarifications regarding the Final Report by Overland Consulting. In these comments, the Company agreed with 7 and disagreed with 3 of Overland's 10 audit recommendations and submitted several additional comments and clarifications.

The Ratepayer Advocate conducted a detailed review and analysis of the un-redacted version of the Final Report and NJNG's Comments. A total of 28 data requests were issued, 16 to NJNG and 12 to Overland, and the responses to these requests were reviewed and analyzed as well. Based on the above-described review and analysis, the Ratepayer Advocate submits the comments presented below.

COMMENTS

Based on our review and analysis of all of the filed material and responses to data requests series RAR-N and RAR-O, the Ratepayer Advocate is of the opinion that Overland's audit review adequately covered all of the audit objectives established by the Board in its March 20, 2002 RFP. The Ratepayer Advocate is in general agreement with each of the ten (10) audit recommendations (A1-A3; B1-B4; and C1-C3) that are summarized on pages 1-7 through 1-12 of the Final Report.

Further, the Ratepayer Advocate submits that the Company's arguments in its NJNG Comments that the BPU should reject three of Overland's audit recommendations (B2, B3 and B4) do not have merit. Rather, the Ratepayer Advocate recommends that the BPU adopts these three Overland audit recommendations. The reasons for the Ratepayer Advocate's support of these three Overland audit recommendations and disagreement with the Company's arguments against them will be discussed in more detail below.

The Ratepayer Advocate also suggests that clarifications and additional written commitments on the part of the Company are necessary with regard to NJNG's "agreements" to two of Overland's audit recommendations (A1 and B1). This will also be discussed in more detail below.

USE OF THE EQUITY ALLOCATOR

Overland's audit recommendation No. B2 concerns the discontinuance of the Company's use of the Equity Allocator. Overland's recommendation is stated as follows on page 1-9 of the Final Report:

> *Discontinue the use of the equity allocator, retain at NJR the executive and other corporate costs associated with non-utility corporate development and allocate remaining "residual" or "unattributable" costs in proportion with costs directly assigned and attributed [Finding 3-II-D].*

Instead of using the Equity Allocator, Overland recommends that NJR Corporate executive and other costs currently included in the Equity Allocator pool should first be divided into two categories: (1) costs relating to potential future operations (i.e., costs caused by corporate development efforts, including projects not currently producing revenue); and (2) costs of conducting current operations of the corporation as a whole (e.g., NJR Board meetings, annual audits, directors fees, etc.). The category (1) costs should either be retained by NJR or they should be assigned to the subsidiary most likely to draw revenue when and if development efforts come to fruition. Category (2) costs should be allocated to NJR's subsidiaries in proportion with all other costs more directly assigned and allocated.

In disagreeing with Overland's audit recommendation No. B2, the Company presents the following arguments in its NJNG Comments:

1. NJNG's Use of the Equity Allocator When Common Costs Are Not Otherwise Directly Assignable Is a Long-Standing BPU-Approved Method of Allocating Such Costs

As shown in paragraph 5 on page 3 of the NJNG Comments, the Company refers to the Board's Order dated December 15, 1988, BPU Docket No. GE88050620 in support of this argument. The Ratepayer Advocate has carefully reviewed this Board Order[1] and has not found any reference in this Order stating that "the use of the equity allocator when common costs are not otherwise directly assignable is a long-standing BPU-approved method of allocating such costs." The Ratepayer Advocate also notes that even

[1] A copy of this Board Order was provided by NJNG in response to data request RAR-N-7.

if this allocation method is a long-standing BPU-approved policy, this would not mean that the Board could not change this allocation method in favor of a different process if warranted by changed circumstances or other appropriate reasons.

2. The Final Report Offers No Compelling Reason for NJNG to Change the Equity Allocator Method

The Ratepayer Advocate disagrees with this conclusion. Beginning at the bottom half of page 3-5 of the Final Report and continuing on the top half of page 3-6, Overland lists five reasons in support of this recommended change in allocation methods for NJR Corporate costs. The Ratepayer Advocate agrees with each of these supporting reasons and considers them to be sufficiently compelling for the Company to change the equity allocator method.

3. The Final Report Does Not Provide Any Support for the Reasonableness of the Alternative Allocation Method Suggested

When the Company was asked in data request RAR-N-10 to elaborate on this conclusion, it explained that "the Final Report provides no quantitative support for the reasonableness of applying this alternative method." In other words, because Overland did not conduct a "test" showing what the actual dollar allocations would be under their suggested alternative allocation method, NJNG concludes that Overland's alternative method is unreasonable. The Ratepayer Advocate is quite puzzled by this argument and disagrees with the underlying reasoning. The appropriateness of a cost allocation method should predominantly be dictated by cost causation and logical reasoning, not by end results.

4. NJNG's Preliminary Assessment of the Alternative Method Suggests That More (Not Fewer) Costs Would be Assigned to NJNG If That Alternative Method Were Used Than Are Currently Assigned to NJNG Under the Equity Allocator Approach (See Paragraph 5 on Page 3 of NJNG Comments)

In data request RAR-N-11, the Company was asked to provide all documentation and calculations used in support of this conclusion and to calculate the NJR Corporate costs allocations to NJNG for 2000, 2001 and 2002 based on Overland's recommended alternative allocation method as compared to the currently used Equity Allocator method. As shown in the response to this data request, the Company's own calculations show the following results:

	NJNG Cost Allocation		
	Equity Allocator Allocation Method	Overland's Alternative Allocation Method	Alternative Method vs. Equity Method
2000	$9,113,770	$7,784,142	($1,329,628)
2001	$7,623,582	$7,614,591	($8,992)
2002	$5,977,680	$6,017,606	$39,927
Cumulative			($1,298,693)

Thus, based on the above-listed results, during two out of the three most recent three years, the NJR Corporate costs allocated to NJNG were less under the alternative allocation method as compared to the current Equity Allocator method; and on a cumulative basis, the alternative method allocated almost $1.3 million less Corporate costs to NJNG. The Company also notes in its response to RAR-N-11 that its conclusion that the alternative method would assign more (not fewer) NJR Corporation costs to NJNG under the alternative allocation method is based on a "preliminary, high level review." Based on the previously discussed findings, the Ratepayer Advocate concludes that the Company's claim that the alternative method would assign more costs to NJNG than the current Equity method is without merit, unreliable, and unsupported by NJNG's own "preliminary, high level" calculations.

In summary, the Ratepayer Advocate agrees with Overland's recommended change in allocation methods of NJR Corporation costs and recommends that the Board order the Company to implement the specific allocation approach suggested by Overland.

With regard to the general subject of common cost allocators, the Ratepayer Advocate additionally recommends that, at an appropriate time in the future, the Board initiate a review of all of the allocation factors used by NJNG in its affiliate relationships and transactions.

ALLOCATION OF AS400 COMPUTER COSTS

Overland's audit recommendation No. B3 concerns the allocation of all common costs related to each NJNG function that is shared with Home Services. Overland's recommendation is stated as follows on page 1-10 of the Final Report:

> *For each NJNG function shared with Home Services or another affiliate, identify, document, pool and allocate all common costs related to the function [Finding 3-II-E and 4-II-H].*

With regard to this audit recommendation, Overland concludes that the Company failed to fully allocate the costs of the AS400 computer on which both NJNG and Home Services customer accounts are maintained. Specifically, Overland has concluded that the costs associated with the maintenance of NJNG's AS400 computer database system (which is shared with Home Services) are not included in the cost pools for the shared customer service, billing, remittance processing, dispatch, or vehicle maintenance functions and are charged entirely to NJNG without any proportionate allocation to Home Services. Overland also concludes that the impact of not allocating Home Services its attributable share of AS400 costs is approximately $100,000 annually, based on an estimated $500,000 AS400 customer inquiry cost pool.[2] Overland recommends that all costs associated with the AS400 computer that are attributable to Home Services be allocated to Home Services.

In disagreeing with the above-discussed Overland audit recommendation, the Company presents the following arguments in its NJNG Comments:

<u>1. NJNG Already Identifies and Allocates All Common Costs Related to Each NJNG Function Shared with Home Services</u>

Based on other information available with regard to this NJNG claim, the Ratepayer Advocate is of the opinion that this claim appears to be incorrect. A careful reading of paragraph 6 of the NJNG Comments and the response to RAR-N-12 would indicate that the above-quoted claim refers to costs associated with Home Services' *direct usage* of NJNG's AS400 computer system, not indirect common costs such as, for example, the maintenance of the AS400 computer. In its response to RAR-O-9, Overland also concludes that the above-quoted claim appears to be incorrect as it is inconsistent with their audit findings that "NJNG strips any AS400 computer costs out of the departmental costs before allocating to Home Services."

In its response to RAR-O-9, Overland also points out that the Company's Comment that… "NJNG respectfully disagrees with the suggestion, however, that NJNG should identify and allocate <u>additional O&M costs</u>[3] relating to the AS400 system to Home Services" seems to imply that some AS400 costs associated with customer service and dispatch are currently being allocated to Home Services. Overland again re-affirms that this is inconsistent with its audit findings.

---

[2] See Final Report page 3-2, paragraph "E".
[3] Emphasis supplied.

2. "The AS400 Computer System Was Designed to Provide a Complex Variety of BPU-Mandated Customer Service Options for Use by NJNG to Better Serve Its Customers; However, Since Home Services Neither Needs Nor Is Provided With the Same Number of Customer Features, It Would Be Unreasonable to Allocate Additional O&M Costs Relating to the AS400 System to Home Services"[4]

The Ratepayer Advocate is in full agreement with Overland's counter-argument – as expressed in the response to RAR-O-9 - that Home Services should not be exempted from customer service and dispatch function AS400 computer costs just because it uses fewer "features" than NJNG. The overriding point should be that Home Services uses and benefits from the essential features of NJNG's customer service system, including maintenance of customer records with name, location and phone number and the ability to enter and track service orders, services provided, amounts owed and payment history. Provision of these features is directly dependent on the computer and the associated costs should be allocated to all subsidiaries using the system.

In summary, the Ratepayer Advocate agrees with Overland's audit recommendation that all common costs associated with the AS400 computer that are attributable to Home Services be allocated to Home Services and recommends that the Board order the Company to implement this audit recommendation.

ALLOCATION OF COST OF CREDIT, COLLECTION AND BAD DEBTS

Overland's audit recommendation No. B4 concerns the allocation of NJNG's costs of credit, collection and bad debts properly attributable to Home Services. Overland's recommendation is stated as follows on page 1-11 of the Final Report:

> *Adjust the discount applied to Home Services receivables (purchased by NJNG) to properly reflect the entire cost of credit, collections and bad debts [Finding 3-II-F].*

[4] See NJNG Comments, page 3, paragraph 6.

With regard to this audit recommendation, Overland concludes that the current discount applied to receivables NJNG purchases from Home Services (which is ½ cent on the dollar for accounts receivables) is insufficient to cover the costs of credit, collection and bad debts incurred by NJNG on behalf of Home Services. Overland recommends that if the practice of purchasing receivables continues, the Company should identify and pool all of the costs of credit, collections and bad debts, determine Home Services' share based on relative amounts of appliance services and utility account receivables, and develop an appropriate discount rate. Overland believes that the resulting discount rate is likely to be approximately 1.5 percent, rather than 0.5 percent.[5]

The Company disagrees with this Overland audit recommendation based on the following arguments, as expressed on page 3, paragraph 7 of the NJNG Comments:

1. "During the Time Period in Which the BPU Approved the Transfer of NJNG's Appliance Service Accounts to Home Services, NJNG Charged Marketers and Brokers One-Half of One Percent for Credit, Collection and Bad Debt Services. It Was Accordingly Reasonable for NJNG to Apply the Very Same Discount Rate to Home Services' Receivables Purchased by NJNG."

The Ratepayer Advocate submits that this rationale has no merit. The fact that NJNG charged the non-affiliated marketers and brokers ½ of one percent of their receivables for credit, collection and bad debt services does not automatically support or justify the same approach for the receivables of Home Services. There is nothing in the record of this proceeding indicating that the ½ of one percent receivables factor charged by NJNG to the non-affiliated marketers and brokers prior to the transfer of NJNG's appliance business to Home Services was based on a study of the actual credit, collection and bad debt costs incurred by NJNG on behalf the marketers and brokers or was sufficient to cover these costs. On the other hand, as described on pages 3-9 through 3-12

---

[5] Final Report page 1-11.

and Attachment 3-1 of the Final Report, Overland did actually review and estimate the costs associated with NJNG's credit, collection and bad debt services and, as a result of this review, concluded that the ½ of one percent receivables factor is insufficient to cover the collections and bad debt costs imposed by Home Services.

2. NJNG Believes That the Discount Rate of 99.5% of Home Services Receivables Continues to Be Reasonably Reflective of Its Costs of Providing Credit, Collections and Bad Debt Services

The Ratepayer Advocate initially notes with regard to this claim that the Company has not provided any cost analyses or other quantitative evidence in support of this generalized statement. The Ratepayer Advocate, therefore, finds the above-quoted claim to be unreliable and unsupported. Further, the Company's claim is also refuted by evidence presented by Overland in the Final Report. Specifically, on Attachment 3-1 of the Final Report, Overland has presented a detailed "Home Service 2002 Credit and Collection Analysis" which estimates that the credit, collection and bad debt service costs attributable to Home Services for the year 2002 amount to approximately $230,000, or almost three times as high as the $86,000 costs allocated in 2002 to Home Services for credit, collection and bad debt services based on the ½ of one percent receivable factoring method.

In summary, the Ratepayer Advocate agrees with Overland's audit recommendation to appropriately increase the discount applied to Home Services receivables to properly reflect the entire cost of credit, collections and bad debts attributable to Home Services, and recommends that the Board order the Company to implement this audit recommendation.

SERVICE AGREEMENTS

Overland's audit recommendation No. A1 concerns the development of service agreements. Overland's recommendation is stated as follows on page 1-7 of the Final Report:

> *Develop service agreements between NJNG and each individual affiliate that describe the nature, terms and prices to be charged for inter-company services [Finding 2-II-A].* (emphasis supplied)

In response to this audit recommendation, the Company, on page 2 of the NJNG Comments, states that "NJNG agrees to work on such agreements." In data request RAR-N-5, the Ratepayer Advocate requested the Company to elaborate on this response and to provide a list and description of each of the tasks and end products within this audit recommendation that NJNG commits to develop and complete. The Company's response to this request is as follows:

> Overland's audit recommendation No. A1 states that NJNG should develop service agreements between NJNG and each individual affiliate that describe the nature, terms and prices to be charged for inter-company services.
> Inasmuch as Overland was informed during the audit process that NJNG already utilizes such service agreements, it is reasonable to assume that Overland's recommendation in this regard is not directed so much toward NJNG's developing new service agreements as it is toward NJNG's expanding upon and improving the form and content of its existing service agreements. In that regard, NJNG had hoped to receive specific guidance from Overland about the nature of the tasks and end products that, in Overland's view and based on Overland's experience, could lead to such improvements. In the absence of such specific guidance, however, it is NJNG's intention to continue to work cooperatively with the Board's Audit Staff and with the Ratepayer Advocate to develop such improvements to its service agreements as are reasonable and appropriate.

This response would appear to be completely at odds with Overland's findings and conclusions in the Final Report. For example, on page 1-4 of the Final Report, paragraph B.4, Overland references its finding that there is “a lack of inter-company service agreements between NJNG and specific affiliates.” In addition, starting at the bottom of page 1-7 of the Final Report, Overland concludes that,

> Inter-company services should be provided in accordance with agreed-upon terms and prices. Written inter-company service agreements should specify the nature of services to be provided, the transfer pricing basis for the service consistent with Affiliate Standards, and the terms under which service is to be provided and recompensed. Separate agreements should be established for each inter-company service relationship. One agreement between and among all subsidiaries, such as the facsimile contract in NJR’s current Compliance Plan, is of little or no value. When executed, the agreements should be included in the Compliance Plan.

Furthermore, in Overland’s Summary of Audit Findings on page 2-1 of the Final Report, the following finding is presented:

> <u>There are currently no service agreements between affiliates</u> describing the services or the terms under which they are to be provided or the duties of parties on either side of the transaction. A facsimile contract included in Exhibit I to the NJNG Compliance Plan is too generic and far-reaching to be effective. [emphasis supplied]

The above-quoted findings and conclusions from the Final Report clearly indicate that, at least at the time the Report was written, Overland found that no service agreements between NJNG and each individual affiliate exist. For that reason, Overland recommended that such service agreements must be developed. The Ratepayer Advocate has found nothing in the Final Report indicating that “NJNG already utilizes such service agreements.” Furthermore, the Ratepayer Advocate believes that the Final Report is quite specific in its provision of specific guidelines about the nature and purpose of the service agreements to be developed. Evidence of this can be found, for example, in the Overland findings quoted above.

In summary, the Ratepayer Advocate recommends that the Board order the Company to properly and fully implement Overland's audit recommendation No. A1.

PROCEDURAL DOCUMENTATION AND WORKPAPERS – SHARED SERVICES

Overland's audit recommendation No. B1 concerns the improvement of procedural documentation for shared services between NJNG and the Service Corporation. Overland's recommendation is stated as follows on page 1-8 of the Final Report:

> *Improve procedural documentation and workpaper support for Service Corp and NJNG shared function cost allocations[Finding 2-II-A, Finding 3-II-C].*

In response to this audit recommendation, the Company, on page 2 of the NJNG Comments, states that "NJNG agrees to work on such improvements." In data request RAR-N-6, the Ratepayer Advocate requested the Company to elaborate on this response and to confirm whether this means that the Company will actually implement all of the cost allocation documentation and support enhancements listed by Overland on pages 1-8 (at bottom) and through 1-9 of the Final Report. In its response to this data request, the Company states that, in its view, it has already met and satisfied the recommended tasks and end products identified on pages 1-8 and 1-9 of the Final Report, but that "such documentation and support could potentially be enhanced in the future."

Clearly, Overland would not have included the various cost allocation documentation and support enhancements listed on pages 1-8 and 1-9 of the Final Report had it been of the opinion that the Company has already met and satisfied all of these recommended enhancements. Therefore, the Ratepayer Advocate recommends that the

Board order the Company to properly and fully implement Overland's audit recommendation No. B1.

CONCLUSION

For all the reasons set forth above, the Ratepayer Advocate respectfully recommends that the Board :

- adopt Overland's recommendations A1 through A3; B1 through B4; and C1 through C3;
- order NJNG to clarify its commitments concerning Overland's audit recommendations A1 and B1; and
- consider whether to initiate a review of all of the allocation factors used by NJNG in its affiliate relationships and transactions.

Respectfully submitted,

Seema M. Singh, Esq.
Ratepayer Advocate

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

cc: Jeanne M. Fox, President *via hand delivery*
Frederick F. Butler, Commissioner *via hand delivery*
Connie O. Hughes, Commissioner *via hand delivery*
Carol J. Murphy, Commissioner *via hand delivery*
Jack Alter, Commissioner *via hand delivery*
Service List *via hand delivery or overnight delivery*