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February 2, 2015

HAND DELIVERED
Kenneth Sheehan, Secretary
New Jersey Board of Public Utilities
44 South Clinton Avenue, 9th Floor
P.O. Box 350
Trenton, NJ 08625-0350

Re: Audit of Affiliated Transactions Between New Jersey Natural Gas Company and its Affiliates; and a Comprehensive Management Audit of New Jersey Natural Gas Company
BPU Docket No. GA13010008

Dear Secretary Sheehan:

Please accept for filing an original and ten copies of the Initial Comments of the Division of Rate Counsel ("Rate Counsel") in connection with the above-referenced matter. Please note that a Confidential Supplement to these comments is being filed under separate cover.

We enclose one additional copy. Please date stamp the enclosed extra copy as "filed" and return it to us in the enclosed self-addressed, stamped envelope. Thank you for your consideration and attention to this matter.

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BACKGROUND

The Board of Public Utilities ("BPU") retained NorthStar Consulting ("NorthStar") to perform an audit of the affiliated transactions between New Jersey Natural Gas Company ("NJNG)" or ("the Company") and its related companies as well as perform a comprehensive management audit of NJNG. The audit included the fiscal years 2009 through 2013. The objectives of the audit were to assist the BPU in determining whether or not NJNG is in compliance with the Electric Discount and Energy Competition Act ("EDECA") as specified in N.J.S.A. 48:3-49, and N.J.S.A. 48:3-58, and the Board's Affiliate Relations and Public Utilitiy Holding Company Standards, N.J.A.C. 14:4-3 and N.J.A.C. 14:4-4. NorthStar was also charged with determining if management practices, functions, operational procedures and other internal workings of NJNG are effective. NorthStar issued its report consisting of 311 pages on June 26, 2014. NJNG responded to NorthStar's audit in two parts. An initial response was issued July 25, 2014 and consisted of 83 pages. A supplemental response was issued November 24, 2014 consisting of 95 pages.[1]

Rate Counsel was provided with an opportunity to issue discovery on the audit and issued two sets. The first set, issued October 6, 2014, consisted of 36 questions. The second set, issued December 23, 2014 consisted of 26 questions.

Rate Counsel's comments herein address audit recommendations to which NJNG has noted an exception and/or where Rate Counsel has an additional recommendation regarding an area of agreement, and as to which Rate Counsel has a particular interest on behalf of NJNG's

[1] NorthStar's report will be cited in these comments as the "NorthStar Audit Report." The Company's initial and supplemental responses will be cited, respectively, as the "NJNG Initial Response" and the "NJNG Supplemental Response."

ratepayers. Silence on any one or more issues should not be interpreted as Rate Counsel's agreement with any exceptions of the Company to those issues.

Rate Counsel's comments are divided into two sections. The first section addresses policy and affiliate issues, while the second section addresses engineering matters.

I. AFFILIATE RELATIONSHIPS

These comments address the following areas examined by NorthStar on affiliate matters: (1) a lack of clear boundaries; (2) deficient audits; (3) service agreement deficiencies; (4) NJNG affiliate relationships that do not adequately protect ratepayers; (5) non-competitive service agreements with affiliates; (7) compliance with the board's nondiscrimination rules; (8) shared services; (9) security of confidential information; (10) allocation of IT costs; (11) risk of errors in actual versus budgeted quarterly adjustments; (12) allocation of labor costs; (13) methodology used to allocate lease costs; and (14) work performed by NJNG Gas Supply employees without any costs being charged to New Jersey Resources Energy Services ("NJRES").

A. Executive Management and Organization (Chapter III)

NorthStar examined the oversight and corporate structure of NJNG by the New Jersey Resources ("NJR") and NJNG Boards of Directors ("BODs"). In its findings, NorthStar listed several concerns that are discussed below.

1. Lack of Clear Boundaries (FC III.4)

NorthStar found that the boundaries between NJNG and its affiliates were often not clearly delineated. NorthStar made several observations and recommendations, which Rate Counsel supports and should be adopted by the Board.

First, NorthStar determined that there was a sharing of personnel and resources between the regulated and unregulated companies which has not been closely monitored by the BOD and executive management.[2] Examples of these close ties include: the BODs for NJNG, NJR Clean Energy Ventures ("NJCEV") and NJRES which are made up solely of individuals serving on the NJR Board of Directors. Likewise, NJR's Chairman and CEO, L.M. Downes, serves the same role on all subsidiary Board of Directors.

A lack of separation is also evident in NorthStar's finding that the BODs of NJNG's regulated and unregulated subsidiaries meet concurrently with the NJR BODs. Prior to November 2011, the NJNG BOD met separately but changed to joint meetings because the directors found they were repeating presentations.[3] Interviews also showed a lack of distinction in how the regulated and unregulated companies were managed.[4]

Transactions between affiliated companies do not represent arms-length transactions and, unless closely monitored, can lead to abuses resulting in higher costs for NJNG and its customers. NJR and NJNG maximize, rather than minimize, the use of shared resources, increasing the likelihood of cross-subsidization and necessitating added regulatory oversight. Minimizing the use of shared resources and personnel may help prevent cross-subsidization because it limits the opportunities to engage in such activities. Rate Counsel supports NorthStar's recommendations to test whether or not the provision of joint services provided by affiliates results in cost savings compared to receiving these services from unaffiliated companies.[5]

Second, NorthStar determined that Corporate Governance Guidelines either address only NJR and do not indicate how the NJNG Directors can effectively differentiate their role as NJNG

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[2] NorthStar Audit Report, p. 35.
[3] NorthStar Audit Report, p. 35.
[4] NorthStar Audit Report, p. 36.
[5] NorthStar Audit Report, p. 66.

Directors, or they assume that the perspective of NJNG ratepayers is appropriately recognized in the NJR Board of Directors' discussion.

Specifically, NorthStar found that NJR and NJNG operate more as one entity than separate regulated and unregulated companies. NorthStar further states that there was limited recognition that the regulated utility might have different goals and management needs than its unregulated affiliates.[6] NJNG refutes this finding, stating that NorthStar disregards the interviews of Board members discussing the importance of NJNG and certifications made to the BPU regarding the potential impact of unregulated activities on NJNG to ensure no adverse impacts.[7]

Although the majority of the directors are independent, an examination of NJR's Corporate Governance Guidelines indicates that differences between NJNG and NJR, or how the directors can differentiate their roles as NJNG directors, are not specifically addressed.[8] Furthermore, a Board member may sit on the BOD of any affiliate of the Company as long as, "the member otherwise meets the independence requirements of each such entity."[9] Rate Counsel supports NorthStar's recommendations that NJR establish policies and procedures to create an atmosphere that stresses the need for a separation of duties and responsibilities between NJNG and its unregulated affiliates. In addition, Rate Counsel agrees with NorthStar's recommendation that goals, objectives, and constraints associated with operating a regulated utility be clarified and that the BODs and executive management clearly distinguish their roles and decision making responsibilities for the utility.[10] Rate Counsel further recommends that

[6] NorthStar Audit Report, p. 35.
[7] NJNG Supplemental Response, pp. 3-4.
[8] NorthStar Audit Report, p. 35.
[9] New Jersey Resources, Corporate Governance Guidelines, revised July 16, 2014, p. 3.
[10] NorthStar Audit Report, p. 7.

these clarifications be memorialized in writing for review and comment by the Board and Rate Counsel.

Rate Counsel also recommends that the Board order the Company to reverse the decision to hold joint Board of Directors meetings with both the regulated and unregulated companies. While there is merit in the efficiency of holding only one meeting, Rate Counsel believes that a separation of the Board of Directors meetings helps alleviate concerns about a lack of clear boundaries between regulated and unregulated companies and helps foster an environment where the regulated companies consider themselves to be separate and distinct from the unregulated companies.

In its third finding, NorthStar determined that NJNG shares officers with certain affiliates, which is prohibited by the Board's Affiliate Relations Standards, codified at N.J.A.C. 14:4-3. N.J.A.C. 14:4-3.5(q) specifically speaks to the issue of members of the board of directors and corporate officers:

> An electric and/or gas public utility and the PUHC [Public Utility Holding Company] or related competitive business segments of the public utility holding company, shall not have the same persons serving on the board of directors as corporate officers, except for the following circumstances:
>
> 1. In instances when these standards are applicable to the public utility holding companies, any board member or corporate officer may serve the holding company and with either the electric and/or gas public utility or a related competitive business segment of the public utility holding company, but not both the electric and/or gas public utility holding company and a related competitive business segment of the public utility holding company.[11]

NorthStar found there are a number of officers that are shared between NJNG and either NJR or an affiliate. These include: L. M. Downes who serves as Chairman of the Board/Director of NJR, NJNG, Commercial Reality & Resources ("CR&R") and NJCEV; G. C. Lockwood who

[11] New Jersey Administrative Code 14:4-3.5(q).

serves as Senior Vice President and Chief Financial Officer of NJR, Chief Financial Officer and Treasurer/Director of CR&R, and Chief Financial Officer and Treasurer of NJCEV; M. Dugan who serves as Senior Vice President, General Counsel/Director of NJR, NJNG, CR&R and NJCEV; R.M. Figueroa who serves as Corporate Secretary for NJR, NJNG, CR&R and NJCEV; and P. Migliaccio (8/5/2013) serves as Treasurer of NJR, NJNG, NJNR Pipeline Company, NJCEV, NJRES, NJRSC, and NJR Steckman Ridge Storage Company.[12]

In determining the presence of shared officers that are prohibited, NorthStar included the position of Senior Vice President/Chief Financial Officer because NJNG does not have a Financial and Accounting unit. The SVP/CFO position is included under NJRSC and shared with NJNG and NJR affiliates.[13]

NorthStar recommends that the Company reorganize or reassign the officers currently in violation of the rules.[14] NJNG disputes this recommendation stating that Mr. Downes is not an officer of NJR Home Services nor the CEO of CR&R. Therefore, NJNG asserts that these findings and conclusions should be disregarded.[15]

The Company's statement that Mr. Downes is neither an officer of NJR Home Services nor the CEO of CR&R appears to be true. However, an affiliate relationship does exist as Mr. Downes is the President and Treasurer/Director of NJR Retail Holdings Corporation which owns 100 percent of NJR Home Services and CR&R.[16] Because Mr. Downes is President and Treasurer/Director of NJR Holdings, he essentially has control over NJR Home Services and CR&R in a capacity similar to, or greater than, that of the President of the two companies.

[12] NorthStar Audit Report, pp. 37-38.
[13] NorthStar Audit Report, p. 38.
[14] NorthStar Audit Report, p. 41.
[15] NJNG Supplemental Response, p. 7.
[16] NJNG Response to Rate Counsel Discovery Request RCR-P-32, Attachment Exhibit A, p. 2.

Therefore, Rate Counsel recommends that the Board request further documentation regarding Mr. Downes' relationships with NJR Home Services and CR&R.

2. Deficient Audits (FC III.8)

The Internal Audit Department ("IAD") under the direction of Audit Committee of the NJR Board of Directors conducts audits of transactions between affiliates. NorthStar found these audits for the period 2008-12 to be inadequate, specifically noting that all but one of the audits addressed gas supply transactions between NJNG and NJRES and had no significant findings. While the titles of the audits suggested a broader examination of affiliate matters, none of them did.[17] The one non-gas supply audit, which concerned NJNG's implementation of the Liberty Audit recommendations, was found to be incomplete. Of even more concern is NorthStar's determination that the Company failed to comply with Liberty's recommendations.[18] Given the breadth of NJNG's affiliate relationships, Rate Counsel recommends that the Board require the IAD to place greater emphasis on all affiliates and especially those that have transactions with or share employees with NJNG. Rate Counsel believes that the recommendations offered by NorthStar will help transition the Company towards accountability in implementing its auditors' recommendations. Specifically, Rate Counsel supports NorthStar's recommendation that the Company restructure the IAD process to improve the depth of analysis and to encourage a wider view of potential control, risk and affiliate matters. Rate Counsel also supports NorthStar's recommendation that the internal audit scope be widened to encompass more areas.[19] Likewise, the Board should order the Company to develop a system to implement the audit recommendations. If they are not implemented, sufficient documentation should be available to support the Company's decision.

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[17] NorthStar Audit Report, p. 40.
[18] NorthStar Audit Report, p. 41.
[19] NorthStar Audit Report, p. 42.

B. Affiliate Relationships (Chapter V)

In a situation involving the provision of services between affiliated companies, the associated transactions and costs do not represent arms-length dealings. Cost allocation techniques and methods of charging affiliates should be frequently reviewed and analyzed to ensure that a company's regulated operations are not subsidizing the unregulated operations. Although each of the affiliated companies is a separate entity, relationships between the Company and its affiliates are still close; they all belong to one corporate family. As a result, the arms-length bargaining of a normal competitive environment is not present in NJNG's transactions with its affiliates.

At a minimum, sound business practices would require that the methodologies for cost allocation and pricing be accurately stated and codified so that regulators can evaluate the reasonableness of the allocation methodologies.

1. Service Agreement Deficiencies (FC V.4)

NorthStar found that a number of functions performed by NJRSC for the regulated business units are not covered by service agreements, including: Operations and Special Projects, Records Management, and Quality.[20] NJNG concurred that the last two functions were not identified as services performed by NJRSC and agreed to update its service agreements accordingly. NJNG also noted that Operations and Special Projects is encompassed under Information and Technology ("IT") for NJRSC and therefore no action is required.[21] In response to discovery, the Company indicated that it anticipates making these changes once the Board issues its final order in this matter.[22] In addition, Rate Counsel recommends that for clarity and accuracy, the Company should update its service agreements to identify that Operations and

[20] NorthsStar Audit Report, p. 58.
[21] NJNG Supplemental Response, p. 13.
[22] NJNG Response to Rate Counsel Discovery Request RCR-P-34.

Special Projects is encompassed under IT. Affiliate relationships are often controversial and complicated. Providing additional details in the service agreements would result in fewer questions going forward.

2. **NJNG Affiliate Relationships That do Not Adequately Protect Ratepayers (FC V.7)**

NorthStar's observations about NJNG's organizational structure epitomize the dangers of unmonitored and unrestricted affiliate transactions. In its first finding, NorthStar determined that NJR's organizational structure does not protect ratepayers because NJRSC managers make significant decisions like planning, budgeting, provisioning, and others that impact the Company.[23] Clearly, the unregulated service company should not be in a position of making key decisions that can impact customer rates and the overall profitability of the unregulated entities. Such decisions should be made by the independent management of the regulated utility. Otherwise, the Board cannot be certain that ratepayer interests and that of the regulated utility are adequately represented.

Second, the affiliate service agreements are signed by officers that do not independently represent NJNG. Instead, the signatories are common to the utility and NJNG's affiliates.[24] Such an arrangement can hardly be considered an "arms-length" transaction where ratepayers' interests are adequately protected.

Rate Counsel supports NorthStar's recommendations that the Company ensure that the information contained in its Affiliate Compliance Plan is correct and complete. In addition, Rate Counsel endorses NorthStar's recommendation that NJNG develop service agreements that

[23] NorthStar Audit Report, p. 60.
[24] NorthStar Audit Report, p. 60.

comply with the Board's Competitive Service Statues, are consistent with the Company's Cost Allocation Manual, and reflect actual services provided between the affiliates.[25]

3. Non-Competitive Service Agreements With Affiliates (FC V.8 and V.9)

NJNG is required to comply with N.J.A.C. 14:4-4.5 in connection with its affiliate relationships. Specifically, sub-sections (g) and (h) require the Company to evaluate whether or not the purchases from its affiliates are less expensive than what it could procure on the open market or provide for itself. Sub-section (i), provides a limited exception for governance and similar functions. Specifically, these sections state:

> (g) An electric or gas public utility shall not purchase or contract for any product or service otherwise covered under a service agreement that the electric or gas public utility can provide for itself or can procure from another company on more advantageous terms. The determination as to whether to refuse to purchase or contract for any product or service covered under the service agreement shall take into account all relevant factors, including, but not limited to, price, qualifications of the alternative provider, contract terms, quality of the product or service provided, and the efficiency, timeliness, and convenience of delivery or provision of the product or service. The determination above as to whether to refuse to purchase or contract for any product or service covered under the service agreement shall in no way limit the Board and/or Board staff from independently reviewing those activities. An electric or gas public utility shall not be required to take action that would result in a conflict of interest, violation of applicable law, or breach of any pre-existing contractual arrangements.
>
> (h) An electric or gas utility or its designee shall review its purchases and contracts for any service under a service agreement beginning every three years after April 6, 2009, for compliance with (g) above. All reviews shall be documented and shall be provided to the Board and/or Board staff upon request.
>
> (i) Nothing in (g) above shall apply to corporate governance or other activities, such as senior management services, treasury/finance functions, legal, system security and shareholder and external relations. These services shall continue to be subject to the review by Board and/or Board staff to ensure just and reasonable rates.[26]

[25] NorthStar Audit Report, p. 65.

[26] New Jersey Administrative Code 14:4-5, Sections (g), (h), and (i).

The Board imposed these requirements for good reason. As indicated earlier, transactions with affiliates may be the subject of controversy, and if not properly monitored can result in subsidization between the regulated and unregulated companies and or operations. Ultimately, such subsidization will result in higher rates to ratepayers and higher profits to stockholders.

NorthStar found that the Company violated the provisions of N.J.A.C: 14:4-4.5 because it failed to appropriately evaluate the charges from its affiliates. In making this finding, NorthStar relied upon N.J.A.C: 14:4-4.5, which it interprets as requiring the Company to obtain competitive bids for services provided by its affiliates, or, alternatively to perform a benchmarking study of services provided by affiliates to demonstrate to the BPU that the charges and quality of services are competitive with other commercial providers.[27] Rate Counsel agrees with NorthStar's interpretation concerning N.J.A.C: 14:4-4.5, because without competitive bids or a benchmarking analysis it would be difficult, if not impossible, for the Company to demonstrate that charges from its affiliates are reasonable.

NorthStar determined that although NJR's purchasing policies and procedures discuss competitive bidding for goods and services, there is no internal requirement that all goods and services be obtained through a competitive bidding process. It also found that the Company had no documentation supporting the requirement that services provided by NJR Service Company to NJNG meet the requirements of N.J.A.C. 14:4-4.5(g).[28]

In response to these NorthStar's findings, the Company states that it is in compliance with N.J.A.C. 14:4-4.5(g) and that it provided the notes and documentation underlying a review process the Company undertook in 2012.[29] However, NorthStar found that NJNG's determination that it complied with N.J.A.C. 14:4-4.5(g) was not based on competitive bidding,

[27] NorthStar Audit Report, pp. 60-61.
[28] NorthStar Audit Report, p. 61.
[29] NJNG Supplemental Response, p. 19.

documented analyses, comparisons of economics, or service quality. The Company could not produce any documentation that showed that the cost of its transactions with its affiliates complied with the provisions of N.J.A.C. 14:4-4.5(g). Specifically, NorthStar found there were no competitive bids or any evaluations associated with the services provided by its affiliates. In addition, the contracts between the Company and its affiliates had no termination dates or term limits.[30]

Further, the agreements themselves are not structured as contracts that would result from competitive procurement and serve essentially as vehicles for allocating costs. The agreements do not address product or service pricing because costs are largely allocated from the respective provider entities. Likewise, volumes, frequency or other fundamental elements of a commercial service agreement were also not mentioned. Agreements between NJNG and NJRSC do not contain specific pricing terms, units provided, or measurement of performance requirements. NJNG was unable to show that the prices resulting from these agreements were less than those available from other sources.[31]

According to one of NorthStar's findings the Company has made a determination that "the services provided to it by NJR Service Company are obtained in a more efficient, effective, and useful manner than an external vendor.[32] In response to a Rate Counsel request for supporting documentation for this determination, NJNG referred Rate Counsel to its response to RCR-P-13.[33] This document contains the Company's 2012 Compliance Plan, consisting of 171 pages, filed annually with the Board regarding the Company's transactions with its affiliates, and compliance with the Board's Affiliate Rules. This document does not contain an analysis that

[30] NorthStar Audit Report, p. 62.
[31] NorthStar Audit Report, p. 62.
[32] NorthStar Audit Report, p. 61.
[33] NJNG Resposne to Rate Counsel Discovery Request RCR-P-37.

demonstrates that the services provided by NJNG's affiliates are more efficient, effective, and useful than an external vendor. Nor does the document contain the information the Company states that it supplied to NorthStar, which were responses to Data Requests 23, 45, and 290. This suggests that such an analysis has not been performed and therefore there has been no showing that services provided by NJRSC are more efficient, effective, and useful than an external vendor.

The Company has not provided any documentation that its agreements with affiliates are consistent with the results that would be obtained in a competitive market. Rate Counsel concurs with NorthStar's conclusion that NJNG's agreements with its affiliates are non-competitive.[34]

NorthStar recommended that NJNG comply with N.J.A.C. 14:4-4.5 (g) which requires an analysis of many factors when evaluating the efficiency of its affiliate transactions. NorthStar further recommended that NJNG obtain competitive bids for services currently provided by its affiliates. In the alternative, NorthStar recommended that the Company perform a benchmarking study of services provided by affiliates to demonstrate that the charges and quality of services are competitive with other commercial providers and comply with N.J.A.C. 14:4-4.5.[35] Rate Counsel supports these recommendations.

4. Compliance with the Board's Nondiscrimination Rules (FC V.10)

The Board's rules on energy competition and affiliate relations have specific provisions prohibiting discriminating against any competitor in favor of a utility's affiliates. Specifically, Section 14:4-3-3 parts (a), (b) and (c) address discriminatory actions that are not permitted.

NorthStar found that the Company was in violation of these provisions when three amendments were added to NJNG's service agreement with NJRHS to provide for extended

[34] NorthStar Audit Report, p. 62.
[35] NorthStar Audit Report, p. 66.

payment options for NJRHS customers.[36] According to the Company, the purpose of the amendments was to help NJRHS customers that were severely impacted by Hurricane Sandy, and needed to replace damaged heating and water heating equipment. NorthStar stated that the Company's actions appear discriminatory in favor of the Company's affiliate, because NJNG does not offer these extended payment options to all appliance providers. Likewise, it determined these extended payment options are not included within NJNG's regulatory web site under Postings, or Notice of Affiliate Transactions. NorthStar could not find where NJNG offered these services in a non-discriminatory manner to non-affiliated entities.[37]

Rate Counsel supports NorthStar's findings. The Company has not demonstrated that it is in compliance with Section 14:4-3.3 (a), (b) and (c), as it does not provide extended payment options for customers of unaffiliated companies. It appears that the Company violated this rule when it offered three extended payment options to customers of its affiliate NJRHS after Hurricane Sandy. Rate Counsel supports NorthStar's recommendation that the Company cease providing extended payment options to NJRHS customers.[38]

5. **Shared Services (FC V.11)**

The Board's Affiliate Relations Standards allow for sharing of certain joint corporate oversight, governance, systems, and personnel. These same rules do not allow for the sharing of marketing functions, as noted under section N.J.A.C. 14:4-3.2:

> "Services that may not be shared" means those services which involve merchant functions, including by way of example: hedging and financial derivatives and arbitrage services, gas and/or electric purchases for resale, purchasing of gas transportation and storage capacity, purchases of electric transmission, system operations, and marketing.

[36] NorthStar Audit Report, p. 62.
[37] NorthStar Audit Report, pp. 62-63.
[38] NorthStar Audit Report, p. 66.

It is for good reason that the Board's rules do not allow for shared marketing functions. If they did, the regulated utility could provide confidential customer-specific information to their unregulated affiliates, thereby giving these unregulated affiliates an unfair advantage over competitors.

NorthStar found that NJRSC performs a shared marketing and corporate communications function in violation of the Affiliate Standards.[39] Thus, NorthStar recommended that the Company perform its own marketing and communications functions exclusively, and discontinue services shared with its affiliates. The Company states that Corporate Communications is located in NJRSC, however, there is no marketing function performed by NJRSC.[40] Rate Counsel asked the Company to provide a detailed description of the services provided by Corporate Communications and the documentation provided to NorthStar, which the Company states NorthStar ignored. NJNG responded to Rate Counsel's data request as follows:

> Corporate Communications provides a wide range of writing, editing, design, public relations and media support to all NJR subsidiaries and is responsible for corporate branding, internal and external communications, web content, media relations, employee communication and crafting company messaging to reflect NJR's vision, mission and values.
>
> The detailed explanations were orally provided to NS during on-site interviews given well over a year ago. The Company is unable to replicate those discussions in a written format.[41]

Branding, public relations, media relations, and crafting company messaging to reflect NJR's vision, mission, and values are closely aligned with marketing and could easily be considered a marketing function. In fact, many utility commissions, including the Board,[42] do

[39] NorthStar Audit Report, p. 63.
[40] NJNG Supplemental Response, p. 24.
[41] NJNG Response to Rate Counsel Discovery Request RCR-P-41.
[42] In The Matter of the Verified Petition of Jersey Central Power & Light Company for Review and Approval of an Increase in and Adjustments to Its Unbundled Rates and Charges for Electric Service, and for Approval of Other Proposed Tariff Revisions in Connection Therewith; In The Matter of the Verified Petition of Jersey Central Power & Light Company for Review and Approval of Its Deferred Balances Relating to the Market Transition Charge and

not allow certain public and media relations expenses in the cost of service because they are considered marketing and such costs are more properly borne by stockholders.

NorthStar recommended that NJNG perform its own Marketing and Communications functions exclusively and discontinue any services sharing with affiliates. Rate Counsel supports this recommendation. Furthermore, in the absence of additional documentation, Rate Counsel recommends that the Board address this matter in the Company's next rate case. In that venue, all parties will have an opportunity to examine the documentation and thoroughly investigate the nature of the costs in question. This allows the Board and other parties to make a more informed decision.

6. Security of Confidential Information (FC V.12)

NJNG maintains propriety information about its customers, including name, address and usage characteristics. NorthStar determined that NJNG could not confirm that its utility systems are secure so as to prevent unauthorized access. Liberty had previously made the same finding in its prior audit.[43]

NorthStar recommended that NJNG take steps to confirm that it has secure systems in place and also ensure only designated individuals have access to specific types of information. NJNG should be able to provide its auditors with uncontroverted information to show that its systems cannot be accessed by unauthorized individuals.

Societal Benefits Charge; In The Matter of the Consumer Education Program on Electric Rate Discounts and Energy Competition - Jersey Central Power & Light Company's Verified Petition for Declaratory Ruling; In The Matter of the Verified Petition of Jersey Central Power & Light Company for Review and Approval of Costs Incurred for Environmental Remediation of Manufactured Gas Plant Sites and for an Increase in the Remediation Adjustment Clause of Its Filed Tariff in Connection Therewith; In The Matter of Jersey Central Power & Light Company for Increases in Its Levelized Energy Adjustment Clause Charge and Demand Side Factor, BPU Docket Nos. ER02080506, ER02080507, EO02070417, ER02030173, and ER95120633, Order Dated May 17, 2004, pp. 48-49; In The Matter of the Petition Of Middlesex Water Company for Approval of an Increase in Its Rates for Water Service and Other Tariff Changes, BPU Docket No. WR00060362, OAL Docket No. PUC 4879-00S, Order Dated June 6, 2001, p. 24.

[43] NorthStar Audit Report, p. 65.

NorthStar found that the Company should develop, maintain and control access to NJNG databases and systems. In addition, NorthStar recommended that the Company report a list of employees that have access to the database and systems to the BPU on a semi-annual basis.[44]

Rate Counsel asked if the Company implemented the previous recommendation of Liberty and the Company responded that it had not.[45] The Company states that "access is controlled by the security authorized within those applications."[46] NJNG did not explain what it meant by "within those applications," but it may be that only certain persons can access the information with a password or other tool. Rate Counsel, Liberty, and NorthStar believe that NJNG should maintain a list of employees authorized to access the Company's systems and databases. This would facilitate better control over access to databases and systems which could contain sensitive information. Given that two auditors have come to the same conclusion and that the recommendations have merit, Rate Counsel believes that the Board should order the Company to implement this recommendation.

C. Accounting and Cost Allocation Methodologies (Chapter VI)

1. Allocation of IT Costs (FC VI.5)

One of the basic documents for allocating and assigning costs between affiliated companies is a utility's Cost Allocation Manual ("CAM"). The CAM provides the foundation, rules, details, and methodology for the allocation and assignment of costs between affiliated companies. Therefore, it is very important that the CAM contain accurate and updated information.

NorthStar found that NJNG's CAM does not accurately address the provision of certain IT costs. Specifically, NorthStar found there is no NJNG department or staff that provides

[44] NorthStar Audit Report, p. 66.
[45] NJNG Response to Rate Counsel Discovery Request RCR-P-43.
[46] NJNG Supplemental Response, p. 25.

application, development, and hardware/software maintenance services to affiliates. NorthStar also noted that labor costs are not always assigned based on causal factors or accurately charged to the appropriate affiliates. These errors resulted in erroneous time charges.[47]

The Company refutes these recommendations stating that NorthStar did not understand the methodology it explained to them. According to NJNG, IT labor charges originate at NJRSC, while vouchers, invoices, accruals, etc., originate at NJNG. During the closing process, all labor charges, including the IT labor charges that originated at NJRSC, are captured in the NJNG pool accounts. Therefore, IT labor and NJNG vouchers are allocated out of the NJNG pool to NJNG and its affiliates. In other words, the Company asserts that all of the costs in question are eventually captured in NJNG's accounts and allocated to affiliates from that point forward.[48] Therefore, Rate Counsel agrees that there was an interpretation error between NJNG and NorthStar. Nevertheless, Rate Counsel recommends that the Company clarify and codify this process and include it in its CAM for future reference.

2. Risk of Errors in Actual Versus Budgeted Quarterly Adjustments (FC VI.4).

NorthStar examined a number of transactions between NJNG and its affiliates to determine the validity of the accounting information used in these transactions.[49] Given the complexity of affiliate transactions, testing for accuracy and soundness of the accounting information is an important part of an evaluation of the charges that are eventually passed on to ratepayers. As part of its examination, NorthStar found supporting documentation and transactions were readily available. NorthStar also found that the NJRSC's staff was knowledgeable concerning the operations of the accounting system.

[47] NorthStar Audit Report, pp. 76-77.
[48] NJNG Supplemental Response, pp. 27-28.
[49] NorthStar Audit Report, p. 75.

However, NorthStar determined that quarterly adjustments used by NJNG and its affiliates to recognize actual, rather than budgeted, labor amounts charged each month, are labor intensive and there is significant risk of error.[50] It would appear from NorthStar's brief description that these quarterly adjustments are performed manually rather than through use of a computer and thus are more likely to result in an error. Although NorthStar did not identify the number of errors that did or may have occurred, it did note that only one of these was subsequently identified and corrected by management.[51]

The Company disputed this finding indicating that NorthStar provided no substantiation or examples to support its statement. In addition, the Company states that NorthStar did not bring any errors or omissions to light during the audit.[52] NJNG concurs that the process is labor intensive, but it believes the risk associated with such a process has the proper level of review and that the risk is limited and not as significant as portrayed by NorthStar.

To correct for the problems it identified, NorthStar recommended that NJNG implement a validity check for time inputting to verify the appropriateness of work orders.[53] The Company objects to this recommendation stating that NorthStar presented no factual support to substantiate the allegation that the current process is inadequate or improper. In response to data request RCR-P-44, the Company indicated that the misapplied time charges are rare and when identified are corrected.[54]

In its response, NJNG also provided a list of procedures that it has in place to identify and remedy mischarges between NJNG and its affiliates, all of which are part of its normal accounting and auditing, and are not specific to the concerns raised by NorthStar. The Company

[50] NorthStar Audit Report, p. 77.
[51] NorthStar Audit Report, p. 78.
[52] NJNG Supplemental Response, p. 27.
[53] NorthStar Audit Report, p.81.
[54] NJNG Response to Rate Counsel Discovery Request RCR-P-44.

points to the following items to support its contention: the monthly financial statement closing process, including a review of services provided by and between NJNG and its affiliates; compliance with Administrative Policy and Procedure 93; Internal financial reporting committee reviews of quarterly and annual financial statements and related disclosures; External Independent Auditor's review of financial procedures for quarterly and annual certifications of the NJR and NJNG financial statement; Internal Sarbanes-Oxley testing; Internal Auditor annual review of affiliate transactions; and the NJR Code of Conduct training for all employees that includes the required account of all affiliates.[55]

The Company's response did not directly identify any policies or procedures that would prevent the errors identified by NorthStar. In the absence of additional information, and given the nature of the transactions, Rate Counsel recommends that the Board order the Company to evaluate NorthStar's recommendation and provide it with additional information on the costs and benefits associated with this recommendation.

3. Allocation of Labor Costs (FC VI.6)

Transactions between affiliates are often complex, controversial, and subject to scrutiny in rate cases. The accuracy of the assignment and allocation process is of utmost importance, as it ultimately impacts customers' rates. In its report, NorthStar found that affiliate labor costs are not always assigned based on causal factors, that costs are not accurately charged to the appropriate affiliate, and that controls are lacking, resulting in erroneous time charges.[56] NorthStar recommended that the Company revise the instructions for "Work with Time Sheets"[57]

[55] NJNG Response to Rate Counsel Discovery Request RCR-P-44.
[56] NorthStar Audit Report, p. 77.
[57] Employees who frequently charge time to affiliates use a secondary time sheet entered through a screen in J.D. Edwards Oracle Enterprises Resource Planning Software System ("JDE") called "Work with Time Sheets". Employees record the time actually worked for affiliate and for NJNG in this screen. Each month, the preset hours are charged to the affiliates, with actuals reconciled at the end of the period.

to include more information on the circumstances that would lead to an employee entering charges to affiliates. In addition, NorthStar suggested that NJNG implement a validity check for time inputting to verify the appropriateness of work orders.[58]

While Rate Counsel has not reviewed the instructions, Rate Counsel agrees that positive time reporting and providing complete instructions concerning what circumstances would generate a charge to an affiliate should be documented in detail. Positive time reporting is preferable to the alternative of exception time reporting (only associated with exceptions, i.e., only when working for an affiliate), because it requires employees to affirmatively report all time and helps avoid situations where small amounts of time working for an affiliate are overlooked under the exception approach to time recording. Detailed examples should also be provided to help employees make informed and sometimes difficult decisions on how time should be charged.

Rate Counsel also recommends that the Board order NJNG to implement a validity check as suggested by NorthStar. As noted earlier, transactions with affiliates can be controversial and complex. Adding a validity check to the charges from affiliates may help reduce controversy in future rate cases and in the Company's next affiliate audit.

4. Methodology Used to Allocate Lease Costs (FC VI.7, VI.8 and V.9)

There are multiple leasing arrangements between NJNG and its affiliates. Because the Company's affiliates share office space and therefore lease costs with NJNG, it is important that arrangements are properly documented and correctly charged to the affiliates of NJNG.

The approximately 157,000 square feet headquarters building located at 1415 Wycoff Road, Wall, NJ is leased by NJNG and sub-leased to CR&R, which then arranges to lease its space to other affiliates including NJRES and NJCEV. In connection with this arrangement,

[58] NorthStar Audit Report, p. 81.

CR&R sub-leased 31,596 gross square feet of the headquarters building from NJNG for the period December 21, 1995 to June 2021.[59]

NorthStar's Findings and Conclusion 7 states that the Company's method to allocate lease costs is inconsistent with the associated lease agreements.[60] Specifically, NorthStar found: 1) rent paid by CR&R and other affiliates was incorrect and inconsistent with the terms of the lease; 2) the share of occupancy costs paid by CR&R and other affiliates was incorrect; and 3) Sub-sub-lease payments were made to NJNG, not CR&R.[61]

NorthStar specifically determined that:

> The lease between CR&R and NJNG specifies the amount of the required payment. In actuality, CR&R and the other affiliates pay a proportional share of the costs NJNG pays for the lease, based on the square footage they actually occupy. As the square footage occupied by CR&R and the sub-sub-leases had dropped, they pay a lower portion of the costs regardless of the lease terms. While an algorithm based on net space occupied could be a fair way to allocate costs, it is not consistent with the legal documents entered into by NJNG and its affiliates and it is also not computed correctly as noted in Exhibit VI-6.[62]

NorthStar stated that the costs charged to unregulated affiliates is understated by $208,290.[63]

NorthStar also found that the costs allocated to NJRES and NJCEV were incorrect. Specifically, NJRES signed a sub-sub-lease with CR&R in 2005 and extended it in 2010. The sub-sub lease was for 7,521 gross square feet--equating to 6,540 net square feet, after excluding common space, like bathrooms and stairwells. However, the expense allocation developed by NJNG uses only 5,696 square feet.[64] In addition, NorthStar determined that the rent was paid by

[59] NorthStar Audit Report, p. 78.
[60] NorthStar Audit Report, p. 78.
[61] NorthStar Audit Report, p. 78.
[62] NorthStar Audit Report, p. 79.
[63] NorthStar Audit Report, p. 79.
[64] NorthStar Audit Report, pp. 79-80.

NJRES and NJRCEV to NJNG, not by CR&R as indicated in the lease. The Company claims that the charge is acceptable, because:

> The current agreement states that NJNG is to charge CR&R for costs to ensure that NJNG will not subsidize the non-NJNG space. The lease between CR&R equates to an approximate price of $31/sq. ft. The current market price for similar real estate in the area is approximately $28/sq. ft. Thus, there is no subsidy from NJNG to CR&R.[65]

The Board should reject the Company's suggestion that it should use an unsupported "current market rate." Rate Counsel supports NorthStar's findings and conclusions that the Company should charge its affiliates in accordance with the terms and condition of the lease agreement. In an arms-length transaction, it is unlikely that a lessor would agree to reduce a tenant's rent merely because the tenant requires less square footage then originally negotiated. In these situations, once a building is leased, the risk associated with the square footage leased is borne by the lessee not the lessor.

NorthStar found that some of the methods NJNG's used to allocate lease costs created market advantages for the unregulated companies which is in violation of the Board's Rules. Specifically, NorthStar found that the method of allocating costs based upon net space omits the open space surrounding the executive offices, as well as several offices used on a temporary basis and conference rooms from the allocation to NJR. The exclusion of the open space reduces the amount of building costs charged to NJR by more than 50 percent (7,670 square feet of open space removed from the allocation to NJR leaving only 5,375 for specific named offices). According to NorthStar, this favors NJR because other areas of the buildings do not have such large open spaces.[66]

[65] NJNG Supplemental Response, p. 32.
[66] NorthStar Audit Report, p, 80-81.

In addition, NorthStar determined that by charging CR&R, NJCEV and NJRES for the amount of space used rather than the amount contracted for, NJNG essentially provides its unregulated affiliates a market advantage. This advantage allows flexible space availability and cost without commitment, a benefit unlikely to occur in a competitive market.[67]

The Board should reject the Company's argument that the use of net space is the appropriate methodology for charging its affiliates for space they utilized. As NorthStar found, this methodology unfairly favors the unregulated affiliates. Rate Counsel recommends that the Board order the Company to use gross square footage when allocating lease costs to CR&R, NJCEV and NJRES.

5. **Work Performed by NJNG Gas Supply Employees Without any Costs Being Charged to NJRES. (FC VI.19)**

NorthStar found that in certain instances the Company has used allocation methods that provide an advantage to its unregulated affiliates that is likely not available to competitors. Likewise, costs associated with the provision of certain services are charged entirely to the Company's captive gas customers despite the fact that the unregulated operations receive benefits from the services provided.

NorthStar found that analyses developed by NJNG's personnel were shared with NJRES, at no cost. Specifically, NJNG's Manager Transportation & Exchange ("T&E") provided information and analysis regarding marketers and pipelines to NJRES procurement personnel, but charged the time involved solely to NJNG. This individual also maintained some pipeline data files in the Gas Management System ("GMS") used by both entities to record gas trades, yet again the time was charged solely to NJNG.[68]

[67] NorthStar Audit Report, p. 81.
[68] NorthStar Audit Report, p. 120.

In another situation, an NJNG Energy Analyst reviewed and analyzed Federal Energy Regulatory Commission ("FERC") filings made by pipelines serving both NJNG and NJRES. This analyst represents "the Company" at the American Gas Association ("AGA") and other industry meetings. Although the results of the meetings and information obtained at the meetings are provided to both NJNG and NJRES, the time is charged only to NJNG. Similarly, this individual also maintains GMS data files for both companies. Yet, the person's time is only charged to NJNG.[69]

Concerning these findings, NorthStar recommended that the companies either cease sharing analyses, results, and support activities that have been conducted by NJNG personnel with NJRES, or implement a process and methodology, to be approved by the BPU, to allocate the fully-loaded costs associated with these activities to NJRES.[70] Rate Counsel supports these recommendations.

II. ENGINEERING ISSUES

The engineering comments address the following areas: (1) NJNG's leak backlog; (2) excavation damages; (3) quality inspections of the alliance contractor construction activities; (4) NJNG's Pipeline Construction; and (5) Alliance Contract Expenditures.

A. Distribution and Operations Management (Chapter XI)

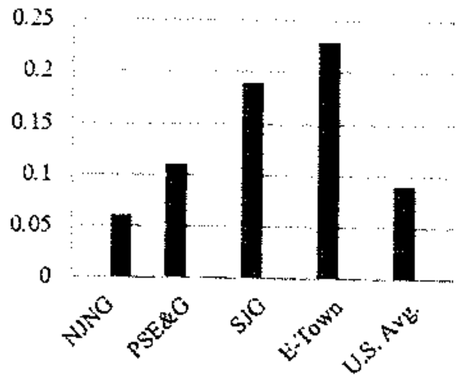
1. Leak Backlog (FC XI.1)

NorthStar compared NJNG's leak rates and number of outstanding leaks against New York State utilities, noting the Company's leaks were higher. The Company has stated that: "Overall, [NorthStar] relies on numerous instances of patently incorrect information in this Chapter, all of

[69] NorthStar Audit Report, p. 120.
[70] NorthStar Audit Report, pp. 126-127.

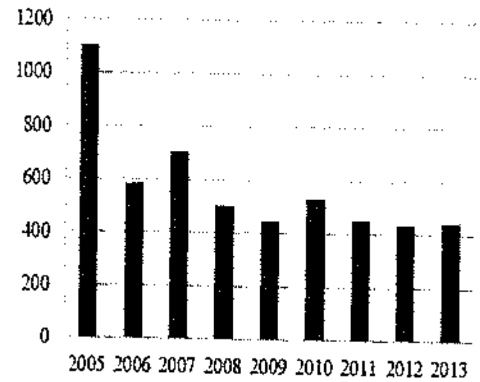
which can be refuted with either NJNG data or national information". [71] The Company has provided the following quantitative leak information:

Figure 1: Leak Rates Pre-Sandy (Leaks/Mile)



Source: New Jersey Natural Gas Company, Initial Response to NorthStar Audit Report, p. 46

Figure 2: Number of Outstanding Leaks NJNG (2005-2013)



Source: NJNG annual distribution reports to PHMSA, Form F 7100.1-1; Years 2005-2013.

The above charts show that the Company's leak rates prior to Hurricane Sandy were the lowest in New Jersey, and that the leak backlog has been slowly declining. The Company has also provided supporting data from the AGA Best Practices report for 2013, in response to RCR-ENG-3, which confirms that NJNG's leak rate and leak backlog are substantially below the median levels for AGA survey participants for 2013. The Company's total leaks, repaired and pending, per mile of piping is 0.18 leaks per mile compared to 0.37 for AGA participants.

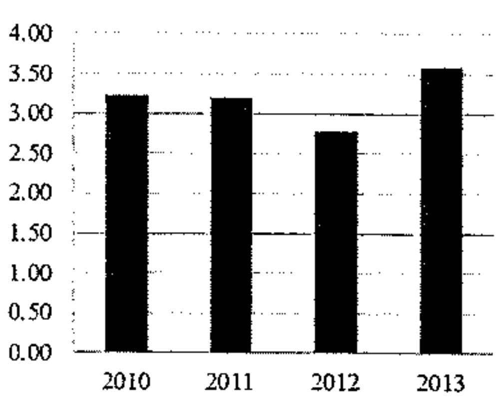
Leak backlogs refer to the number of outstanding leaks on a given day (e.g., December 31). This is always a positive number since leaks cannot be scheduled for repair immediately. The above chart for leak backlogs at NJNG shows that they are only slightly declining in recent years. However, it is important to recognize that this does not mean these leaks are not being repaired. The leaks reported outstanding for one year are, in general, not the same leaks reported outstanding for the next year. The leaks are repaired during the year, but new leaks are reported continuously.

[71] New Jersey Natural Gas Company, Initial Response to NorthStar Audit, p. 46.

2. Excavation Damages (FC XI.2)

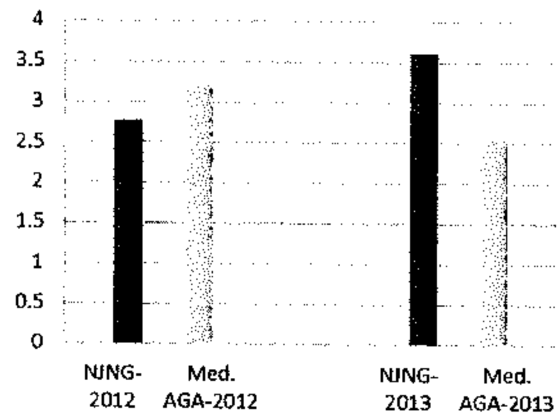
Again NorthStar benchmarked the Company's performance in the excavation damage area against statistics from New York State utilities and noted the Company's damage rate was higher. The Company has provided the following quantitative information concerning excavation damages.

Figure 3: NJNG Excavation Damages Per 1,000 Tickets (2010-2013)



Source: NJNG annual distribution reports to PHMSA, Form F 7100.1-1; years 2010-2013.

Figure 4: Excavation Damages (Damages/1,000 Tickets)



Source: New Jersey Natural Gas Company, Initial Response to NorthStar Audit Report, p. 47

The above charts show that the Company's excavation damage rates, prior to Hurricane Sandy, were relatively flat year-to-year from 2010 through 2012. They were also lower than the median excavation damage rate incurred by AGA companies during 2012, but above the AGA median in the year following Sandy.

NorthStar made a recommendation, Recommendation 48, to "Develop a comprehensive program to address the leak backlog and mitigate excavation damages."[72] The Company states they are already addressing the leak and excavation damage issues through a number of replacement programs. Rate Counsel agrees that sufficient attention is being given to leaks and disagrees with the recommendation to mount additional programs.

[72] NorthStar Audit Report, p. 175.

A. Contractor Performance (Chapter XII)

1. Quality Inspections of the Alliance Contractor Construction Activities. (FC XII.4)

NorthStar found that NJNG lacked an effective process to perform quality inspections of Alliance Contractor construction activities.[73] NJNG disagrees with NorthStar's finding that stating, that it "is based on a cursory comparison of definitions, and do[es] not appear to be based on documents, records, or interviews that clearly indicate that the Construction Coordinator's primary role is to perform quality control inspections of our outside contractors."[74] The Company believes that, while their training program was developed and is conducted internally, it more than adequately prepares the Construction Coordinators for their primary responsibility of conducting inspections.[75] The Company has identified in response to Data Request 659 the training that Construction Coordinators receive:

> Most training is completed in-house and on-the-job, with the area supervisor or more experienced colleagues acting in the trainer/mentor role, with our Standards manual used as a guide. Throughout the year, the primary training topics include [twenty-one construction topics.]
>
> For outside training, these employees periodically attend the Northeast Gas Association's Gas Operations School. The workers are also annually trained and qualified on various [High Density Polyethylene] ("HDPE") plastic fusion procedures by an outside vendor (JanX).[76]

NorthStar has made a recommendation, Recommendation 56, to improve processes and procedures to perform independent quality inspections of the Alliance contractors' work. Rate Counsel notes that the list of 21 topics that are included in the training for Construction Coordinators appears to be comprehensive. It includes the major tasks that a contractor performs, as well as related items that a Coordinator should review on-site to insure the performance of the

[73] NorthStar Audit Report, pp. 181-182.
[74] NJNG Supplemental Response, p. 65
[75] NJNG Supplemental Response, p. 66.
[76] NJNG Response to NorthStar Data Request 659.

contractor fulfills Company requirements and objectives.[77] If the Company had in-house construction crews, the same topics would be taught to these employees. Therefore the same training program would have equipped the Company's in-house crew members with the same theoretical capabilities.

The Company crews, however, would also have the practical advantage of having actually applied this training, over and over again, in the course of their everyday activities. This advantage would seem to be a plus in the ability of the Construction Coordinators to judge the quality of construction performed by Alliance contractors, as well as the construction performed by outside bid contractors. This appears to be one example of how processes and procedures to perform independent quality inspections of the Alliance contractors' work could be improved. For this reason, Rate Counsel supports the recommendation to improve processes and procedures to perform independent quality inspections of the Alliance contractors' work.

2. NJNG's Pipeline Construction (FC XII. 14 to XII.20)

NorthStar found that NJNG's pipeline construction is predominantly performed by two contractors, under a long-term relationship without the benefit of competitive bidding or internal competition. According to NorthStar, such an arrangement fails to account for changes in the business environment and effectively eliminates market forces and contractor competition.[78] NorthStar contends that the Alliance contractor partnership should be more limited, and portions of their work be accomplished by either Company in-house crews or by outside contractors that are not Alliance partners.

[77] NJNG Resposne to NorthStar Data Request 659.
[78] NorthStar Audit Report, p. 167-170.

NorthStar recommends, in Recommendation 53, that the Company should:

Conduct pipeline construction in a competitive manner. (Refers to Conclusions 14 through 20)

- Limit the Alliance program to half of NJNG's construction work (or other proportion as agreed to with the BPU) until the Alliance program costs and benefits can be independently verified by the BPU.
- NJNG resources could be used to perform comparable pipeline construction workload as a benchmark against Alliance contractors.
- Use contractors other than Alliance contractors to competitively bid and perform pipeline construction work as a benchmark for comparison.
- Annually document, through relevant benchmarking comparisons, the installed cost of mains and services for various types of work and service territory geography of work performed by the Alliance contractors and other contractors. The analysis should be performed by an external third party that is not one of the Alliance contractors, with the results provided directly to the BPU.[79]

The Company has stated that the extremely high costs to NJNG, and eventually to customers, associated with bringing a portion of the construction work in-house for benchmark purposes makes poor business sense.[80] However, certain jobs are routinely bid to outside contractors outside the Alliance Partnership. Rate Counsel supports NorthStar's recommendation to benchmark the construction work against the costs of other contractors as it appears it could be readily implemented and would serve as a helpful cost guide. The Company has provided some comparative construction cost information, in Discovery responses RCR-ENG-4 and RCR-ENG-2 respectively, that it has summarized from two benchmarking studies:

1) The 2013 New Jersey Peer Panel Review (27 local distribution companies ("LDCs") including all NJ utilities)

2) The 2013 AGA Best Practices Program

Rate Counsel considers the information shown in the above studies to be contradictory and insufficient to base a conclusion regarding comparable construction costs. For instance the

[79] NorthStar Audit Report, pp. 175-176.
[80] NJNG Initial Response, p. 81.

NJ study shows NJNG's replacement costs per foot of main to be much lower, 69% lower, than those of the other LDCs. However, the same study indicates NJNG's new mains installation costs per foot of main to be 22% higher than those of the other LDCs.[81] This apparent discrepancy may indicate the information needs to be adjusted for sizes (diameters and lengths) of the mains included.

The AGA Best Practices study has been adjusted for diameters. This study indicates that NJNG's construction costs for new two-inch diameter mains are much higher, 85% higher, than those of the other AGA LDCs. However, this study, since it contains information for companies across the U.S., would need to be adjusted for soil conditions, terrain, housing density, etc. For the above reasons, Rate Counsel believes a benchmarking study of work performed by NJNG's non-Alliance contractors would be useful.

However, the portion of NorthStar's recommendation that would limit the Alliance program to half of NJNG's construction work (or other proportion as agreed to with the BPU) until the Alliance program costs and benefits can be independently verified by the BPU, may be premature. As discussed above no directly comparable evidence has been presented that outside contractors would have more competitive costs. In addition, the Company has presented, as Confidential Attachment A to is initial response to the NorthStar audit, evidence that the costs for the Alliance contractors are lower than the costs that that would be incurred if the company were to engage in competitive bidding or develop an in-house construction program.[82] The information contained in the Company's Confidential attachment is discussed in the separately filed Confidential Supplement to these comments. Accordingly, Rate Counsel believes it would

[81] NJNG Response to Rate Counsel Discovery Request RCR-ENG-2.
[82] NJNG Initial Response, p. 80.

be prudent to postpone decisions regarding the proper proportion of Alliance work until the benchmarks have been made and analyzed.

5. Alliance Contract Expenditures (FC XII.16)

NorthStar's finding and conclusion is primarily concerned with insuring that Alliance contractor costs are as low as costs that might be obtained from other contractors. The Company believes construction costs are lower under the Alliance partnership. They have produced Confidential Attachment A to demonstrate this belief quantitatively, as shown above. Additionally, the benefits of having an Alliance Contract are, according to the Company:

- safety,
- reliability,
- known work quality,
- the security of knowing that the contractors will be available when needed,
- agreed-upon costs, and
- the ability to audit the expenditures far outweighs any perceived drawback .[83]

The Company lists safety as the first benefit above (outside the cost advantage).

In NorthStar's Summary of Findings and Conclusions in its audit report, its key findings in the Distribution and Operations Management and Contractor Oversight section, page 6, included:

> The Alliance contractors do not compete against each other or internal NJNG resources for construction jobs. Although NJNG believes the Alliance contracts have resulted in a high degree of responsiveness and construction quality ... there is an absence of a baseline against which to determine the relative cost-effectiveness of the arrangements.[84]

NorthStar has advanced a recommendation, Recommendation 53, which is directed toward obtaining a cost comparison between Alliance program construction costs and a benchmark comparison against a contractor such as NJR or an outside non-Alliance contractor. A cost comparison would be helpful, as is shown in the preceding section of this report. However

[83] NJNG Initial Response, p. 80.
[84] NorthStar Audit Report, p. 6.

cost considerations should always be secondary to safety considerations. An inexpensive construction performance is of no importance if the quality does not meet standards. Therefore, cost evaluations cannot be made in isolation from quality and safety evaluations. NorthStar acknowledges this in their Summary of Findings and Conclusions.

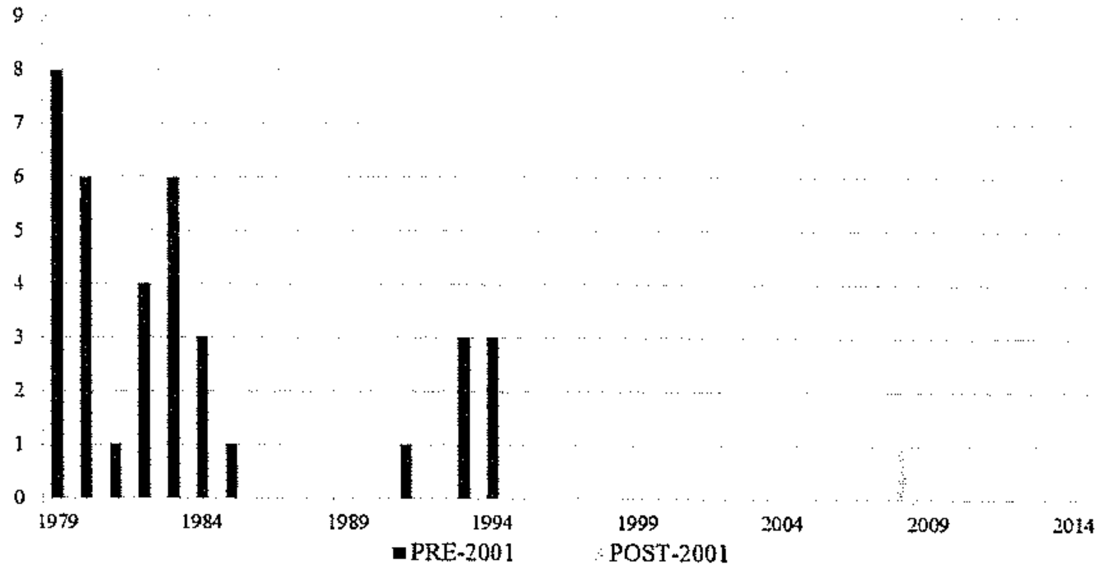
Rate Counsel notes that the ultimate measures of quality are the results which can be evaluated in the gas utility business through safety performance. Accordingly, a comparison has been made of NJNG's safety record for the period since the Alliance program was established, in 2001, against NJNG's earlier safety record, prior to 2001, and when NJR, as well as contractors selected through a bidding process, carried out construction activities at the Company. This affords one type of benchmark that NorthStar has recommended. NJNG's safety record for both time periods was obtained through a comparison of PHMSA's records of reportable incidents.[85]

Rate Counsel examined all records of reportable incidents occurring since the beginning of 1979. To date, through September 2014, 37 incidents have been reported to PHMSA by NJNG. These 37 incidents included 17 serious injuries, 4 fatalities, and property damages of $1.2 Million.

The following chart shows the downward trend in reportable incidents at NJNG that has occurred since 1979. Incidents that occurred prior to 2001 (when the Alliance Program was started) are shown in black. Incidents occurring after 2001 are shown in green.

[85] Reportable Incidents are defined by 49 C.F.R. sec. 191.3; they include gas accidents resulting in either: serious injuries, fatalities, or loss of property.

Figure 5: NJNG Number of Reportable Incidents Per Year (1979-2013)



Source: PHMSA Form F 7100.2; 1979-2013.

The above graph indicates that the frequency of incidents during the Alliance period (2001 to present) has been substantially below its level in prior periods when NJR and bidding contractors performed construction procedures.

Note, the graph above does not agree completely with the Company's response to Rate Counsel's Discovery Request ENG-1. The reportable incident in 2008, in which 2 personal injuries and $500,000 in damages occurred, was acknowledged by the Company. However, the Company points out that even though this incident occurred during the time period of the Alliance Partnership, and occurred on a construction job performed by an Alliance Partner, J.F. Kiely, the incident occurred on a job that had been won through an open bidding process by Kiely, and was not a job performed under the terms of the Alliance.

Additionally, the Company's response to Discovery Request ENG-1 indicated only one reportable incident during the ten year period prior to the Alliance period, and that it occurred in 1994. The above chart shows seven reportable incidents during this period, 1 in 1991, 3 in 1993, and 3 in 1994. PHMSA records show that the 2 other incidents reported by the Company during

1994 were later found by the Company to not meet the criteria for a reportable incident. The incident in 1991 however, and the three incidents in 1993, do not indicate that they were later identified as non-reportable. Together these 4 reportable incidents accounted for 6 injuries, 3 fatalities, and $730,000 in damages.[86]

The ultimate test of performance by contractors, and the ultimate test of whether or not the Company's Construction Coordinators are doing their job lies in the safety performance of the Company's infrastructure. The above incident table illustrates that safety has improved at NJNG during the Alliance contracting period. Rate Counsel acknowledges that safety improvements are also a result of performance by groups other than pipeline replacement contractors, such as the Company's leak-prevention programs, mark-out contractors, and third parties such as other utilities, or their contractors are considered important participants in the Company's safety record.

Based on the Company's incident performance, Rate Counsel concludes that the use of Alliance partners, and the use of Company Construction Coordinators to inspect their performance have not led to any observable deterioration in NJNG's incident record, which is a key safety criterion.

For these reasons, Rate Counsel believes that the need to limit the Alliance program to half of NJNG's construction work, as outlined in the previous section of this report cannot be judged until the conclusion of a benchmarking study.

CONCLUSION

Rate Counsel respectfully submits the above comments and the separately filed Confidential Supplement for the Board's consideration. Rate Counsel also respectfully request the right to submit reply comments to any responses received from NorthStar or NJNG

[86] PHMSA Reportable Incident Reports for New Jersey Natural Gas Company, Form F 7100.2, 1979-2013.

concerning the Audit Report or filed comments. Finally, Rate Counsel also reserves its right to raise issues presented in the Audit Repot in other proceedings, and, by filing these comments, does not waive any rights, claims of positions in such other proceedings.

Respectfully submitted,

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