OVERLAND CONSULTING

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December 20, 2010

Records Access Officer
State of New York Department of Public Service
3 Empire State Plaza
Albany, New York 12223-1350

Subject: Proposal to Conduct an Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures, Case 10-M-0451

To Whom it May Concern:

Overland Consulting (Overland) appreciates the opportunity to submit the accompanying proposal to conduct an independent audit of National Grid's affiliate cost allocations, policies and procedures. We believe our proposal brings the following unique strengths to this project:

- Significant affiliate transactions and cost allocations reviews and audits are a core component of Overland's consulting practice. In terms of representation of state commissions in these engagements, we believe that our expertise and experience in this area is unequaled.

- Overland reviewed the affiliate transactions and cost allocations of PHI in our recent audit of Atlantic City Electric (ACE). In addition to affiliate transactions and allocations, we conducted a management review of several of PHI's shared support functions.

- In addition to PHI, in recent years Overland has conducted reviews of the affiliate transactions and shared services cost allocation procedures for a number of the nation's largest utility holding companies and telecommunications companies including Exelon, PSEG, Constellation, Sempra, Verizon and SBC (now AT&T).

- Aside from affiliate transactions and cost allocations reviews arising from rate cases or management audits, Overland has conducted several major focused accounting and financial audits similar to the scope of effort required in the National Grid audit.

- Overland proposes to employ a project team with substantial experience in the scope of work required for this audit. Overland's project team includes members who have extensive experience in conducting similar audits and providing, if necessary, expert testimony in support of our work products.

- The Overland project team includes five CPAs with previous Big Four experience. These individuals have also applied their big firm audit experience to focused or "special procedures" audits at Overland on behalf of our Commission clients.

- Overland has often addressed issues similar to the proposed engagement in major projects as demonstrated in the Experience and Qualifications section of this proposal.

My signature below certifies that all information contained in the proposal is accurate; Overland is committed and able to perform all the work contained in this proposal; we have carefully prepared the proposal in compliance with the RFP; and the proposal is a firm offer for 180 days from this date. As requested in the RFP, we are submitting this proposal and cover letter electronically to the Department of Public Service's Records Access Officer at recordsaccessofficer@dps.state.ny.us and a cover letter only to the Secretary to the Commission at secretary@dps.state.ny.us.

I am the primary contact for this proposal, and my contact information is as follows:

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Email: hlubow@overlandconsulting.com

Thank you in advance for your consideration of our proposal.

Sincerely,

Overland Consulting

Howard E. Lubow
President

Overland
Consulting

In Response to a Request for Proposal to Perform an Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures Case 10-M-0451

Submitted to:

New York Department of Public Service

Submitted by:

Overland Consulting
11551 Ash Street, Suite 215
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(913) 599-3323

December 20, 2010

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1. Introduction

Overland Consulting (Overland) is pleased to submit a proposal to provide consulting services to perform an investigative accounting examination of National Grid USA's (NG USA) New York regulated Utilities' affiliate transactions with the National Grid USA service companies (Case 10-M-0451). The three New York utilities under review are as follows: Niagara Mohawk Power Corporation (NMPC), Brooklyn Union Gas Company, dba KeySpan Energy Delivery New York (KEDNY) and KeySpan Gas East Corporation, dba KeySpan Energy Delivery Long Island (KEDLI) (collectively NG NY utilities). The applicable service companies under review are as follows: National Grid USA Service Company Inc. (NG USA Service), National Grid Corporate Services LLC (NG Corporate Services), National Grid Utility Services LLC (NG Utility Services), National Grid Engineering and Survey Inc. (NG Engineering and Survey) (collectively NG Service Companies).

Our proposal has been prepared according to the specific requirements of the RFP and "The Guide – A Guide for Consultants Submitting Proposals for Management and Operations Audits" issued by the State of New York Department of Public Service and revised November 5, 2010. We believe that our proposal demonstrates a level of expertise and experience required for this project that is unique. This section describes our understanding of the scope and objectives, firm and team strengths and the organization of the proposal.

Scope and Objectives

The focused audit as described in the RFP will be performed in two parts. Part One is comprised of two major tasks, and Part Two, if deemed necessary as a result of Part One's findings, is comprised of the third major task as follows:

Part One:

1. Perform a review of service contracts, accounting procedures, and internal controls relied upon for cost allocations by the NG Service Companies. Review NG NY Utilities' procedures for obtaining goods or services and bills received from the NG Service Companies.

2. Determine whether and to what extent NG Service Company charges to be reflected in electric rates (Case 10-E-0050), reflected in gas earnings (Case 08-G-0609), and included in utility earnings (Cases 06-G-1185 and 06-G-1186) may include material levels of misallocated or inappropriate costs.

Part Two:

3 If as a result of the findings of Part One, included as steps 1 and 2 above, the Commission requests it, Overland will conduct an expanded examination to determine if in the past a material amount of misallocated or inappropriate costs under the NG Service Companies' contracts have been charged to the NG NY Utilities, reflected in utility earnings under sharing mechanisms in current rate plans, or recorded to NG NY Utilities' regulatory assets, regulatory liabilities, or plant in service.

Overland Experience

We believe that our proposal demonstrates a level of expertise and experience required for this project that is unique. Overland has often addressed issues similar to the proposed engagement in major projects as demonstrated in **Section 7. Experience and Qualifications**. Highlights include:

- Significant affiliate transactions and cost allocations reviews and audits are a core component of Overland's consulting practice. In terms of representation of state commissions in these engagements, we believe that our expertise and experience in this area is unequaled.

- Overland reviewed the affiliate transactions and cost allocations of PHI in our recent audit of Atlantic City Electric (ACE). In addition to affiliate transactions and allocations, we conducted a management review of several of PHI's shared support functions.

- In addition to PHI, in recent years Overland has conducted reviews of the affiliate transactions and shared services cost allocation procedures for a number of the nation's largest utility holding companies and telecommunications companies including Exelon, PSEG, Constellation, Sempra, Verizon and SBC (now AT&T).

- Aside from affiliate transactions and cost allocations reviews arising from rate cases or management audits, Overland has conducted several major focused accounting and financial audits similar to the scope of effort required in the National Grid audit.

- While Overland primarily represents state commissions, we have also been retained on several occasions to assist utilities in the implementation of proper cost allocation and affiliate transaction policies and procedures. This experience includes the complete development of a Cost Allocation Manual, including policies and procedures followed by a utility holding company and its regulated and unregulated affiliates.

Project Team

Overland proposes to employ a project team with substantial experience in the scope of work required for this audit. Highlights of **Section 5. Project Team and Responsibilities** include:

- Overland's project team includes members who have extensive experience in conducting similar audits and providing, if necessary, expert testimony in support of our work products.

- The project team is comprised of Overland employees who have worked together on many projects over an extended period of time. Unlike many other consulting firms, Overland does not subcontract our core areas of expertise, and as such, no subcontractors are proposed in this engagement.

- Mr. Robert Welchlin is a nationally recognized expert in utility affiliate transactions and cost allocations matters. In the last year alone he had testified in three major proceedings regarding common cost recognition and allocation. Aside from his significant experience at Overland, he was a senior manager at KPMG Peat Marwick LLP for four years.

- The Overland project team includes 4 CPAs with previous Big Four experience. These individuals have also applied their big firm audit experience to focused or "special procedures" audits at Overland on behalf of our Commission clients.

Proposal Organization

We have briefly described the scope and objectives as well as our firm and team qualifications. The balance of the proposal is divided into the following sections:

> **Section 2. Scope and Objectives** – Describes our understanding of the scope and objectives for this audit.
>
> **Section 3. Approach, Methods and Project Management** – Explains our project approach and anticipated deliverables.
>
> **Section 4. Audit Areas and Issues** – Describes the issues under review and presents Overland's preliminary workplan.
>
> **Section 5. Project Team and Responsibilities** – Identifies assigned personnel and their relevant experience, presents an organizational structure for the audit, and presents a team history.
>
> **Section 6. Schedule and Budgets** – Includes our not-to-exceed cost proposal with supporting schedules and a calendar time-line of the project
>
> **Section 7. Experience and Qualifications** - Describes Overland's experience and qualifications, project summaries of relevant experience, firm references and consultant resumes

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2. Scope and Objectives

In this section, Overland describes the scope and objectives, as we understand them, and as they appeared in the RFP and other relevant documents.

Background

On January 29, 2010, NMPC filed a request with the NYPSC to increase its electric delivery rates (Case 10-E-0050).

Through Staff's investigations of the historical test year expenses included in the NMPC - Electric application, problems were uncovered regarding the validity of charges to NMPC - Electric from the NG Service Companies. See below for an abridged listing of these issues:

- Inconsistent allocation methodologies between the NG USA Service Companies;
- Lack of reliable validation procedures concerning the charges made to the utilities from the service companies;
- Lack of an effective audit trail (e.g. lack of service company budgets; lack of breakout for the amounts charged for the various services identified in the service contracts; lack of breakout between how much of the billing to the utilities is convenience payments versus charges for services performed; lack of variance reports);
- Apparent cross-subsidization of NG USA's unregulated affiliates;
- Excessive charges to NMPC - Electric;
- Increases in service company charges despite synergy saving claims by NG USA;
- Large increases in HTY service company charges to NMPC - Electric relative to other NG USA affiliates;
- Lack of independent assessment regarding the need and cost of the service company services provided to the utilities.

Staff requested the Commission to initiate a proceeding to address these issues in-depth. On September 16, 2010, the NYPSC commenced the special investigation into National Grid's affiliate cost allocations, policies and procedures. The RFP was issued on November 18, 2010.

Scope and Objectives

Consistent with the requirements stated in the RFP, the audit of the NG NY utilities' affiliate transactions will consist of at least two steps, with the possibility of a third step. In the discussion below, Overland details its understanding of the scope and objectives of this audit by step.

Step 1 - Examination of Service Contracts and Accounting Procedures.

In Step 1 we will gain an understanding of the affiliate transactions policies in place at the NG NY utilities. This will require the procedures specifically mentioned on pages 6 through 8 of the RFP, including a review of service company contracts and an examination of the internal controls and validation procedures in place.

Since 2007, National Grid has utilized a line of business operating model (LOB), which has effectively centralized management of the NG USA utilities in New England. The importance of this issue was made clear on page 8 of the ALJs' Recommended Decision in the current electric rate case which states: "[T]his aspect of the company's organizational structure lies at the heart of the matter. National Grid has organized its management along Lines of Business, served by shared service companies. This structure may be effective for accountability to the corporate parent, but it does not appear to have taken into account the requirements of state regulators whose duty it is to protect ratepayers." Overland believes that the NG organizational structure may be the crux of many of the issues Staff identified in the current rate case. While National Grid can organize its business as it sees fit, it should be able to demonstrate an audit trail and provide financial information required by the Commission. The lack of an effective audit trail in the current rate case appears to have caused a significant amount of work on the part of the Staff, and was the main reason why Staff was forced to propose a $26 million "macro" adjustment related to service company charges. The fact that National Grid utilizes a LOB model does not itself necessarily lead to the problems recently encountered by Staff in reviewing affiliate transactions and cost allocations. Such deficiencies are an indication of weak internal controls and / or inadequate policies and procedures.

Our key objectives in Step 1 will be to determine what recommendations are necessary to allow for a more efficient and effective review of cost allocation procedures in the future and to develop an understanding of the current cost allocation procedures at a level sufficient to perform the detail testing necessary in Step 2.

Step 2 - Examination of Service Charges in Rates

In Step 2 we will use testing procedures to determine the extent, if any, there are materially misallocated or inappropriate charges from the NG service companies to NG’s New York utilities and the extent to which such charges have affected utility rates and/or the utility's earnings sharing mechanism.

Within this step the consultant will have to manage testing at three different utilities, four separate service companies and over a minimum of three different time periods (possibly four). Additionally, the volume of invoices produced by the service companies (over 500,000 annually) means that the consultant will have to consider audit tests that consider a large number of transactions. This will require the stratification of transactions, based on materiality and risk, into manageable testing segments.

Additionally, although the company seems to have been cooperative with Staff in the current rate case, Overland recognizes the potential logistical difficulties of making requests over the different entities and time periods. We are also aware of the need to provide thorough documentation and the potential requirement for testimony supporting any material adjustments made in these procedures.

Overland will perform testing procedures on all of the NG NY utilities to quantify misallocated or inappropriate costs charged to the NG NY utilities. Due to the different objectives and time periods requested for review, we have organized our discussion below into separate sections based on each utility.

NMPC - Electric

Our objective in the procedures performed on NMPC - Electric in Step 2 will be to identify and quantify the service company charges that may be erroneously charged to NMPC - Electric (either through the allocation or normalization process). The relevant time period for the analysis will be the year ended September 30, 2009. This represents the historic test year used in the current rate case. As part of Step 2, Overland will examine the service company charges reflected in the O&M expenses of the NMPC - Electric rate filing, as well as service company charges made to the utility's Construction Work in Progress (CWIP) accounts. Our examination will include procedures to determine whether any costs have been misallocated or inappropriately charged, and this will also examine the normalized historic test year NG service company charges. We understand that the potential normalization adjustments for NMPC - Electric could be comparable to, if not greater than, adjustments relating to potential allocation errors.[1] As such, we recognize the need to devote an appropriate amount of time and resources to this effort.

NMPC - Gas

The relevant time period for the analysis of the NMPC - Gas procedures will be the year ended May 31, 2010. This represents the rate year for NMPC - Gas. As part of Step 2, Overland will examine the service company charges reflected in the O&M expenses of the NMPC - Gas earnings, as well as service company charges made to the utility's CWIP accounts. The results of this analysis will first be used to determine to what extent, if any, erroneous service company charges have affected the earnings reported under the earnings sharing mechanism of this utility's rate plan.

While our examination for NMPC - Gas will initially be limited to the year ended May 31, 2010, we recognize that the results of this analysis could potentially be used as a basis for the Department to order additional testing to be performed for the year ending 12/31/2007 (i.e. the test year that was used to set NMPC - Gas rates).

KEDNY and KEDLI

The relevant time period for the analysis of KEDNY and KEDLI will be the year ended December 31, 2009. This represents the rate year for KEDNY and KEDLI. As part of Step 2, Overland will examine the service company charges reflected in the O&M expenses of the KEDNY and KEDLI earnings, as well as service company charges made to the utilities' CWIP accounts. The results of this analysis will first be used to determine to what extent, if any, erroneous service company charges have affected the earnings reported under the earnings sharing mechanism of each utility's rate plan. However, since the rates currently in effect at KEDNY and KEDLI were established pre-merger, the historic test year for KEDNY and KEDLI will not be tested.

[1] Overland notes that Staff estimated 20-40% of its proposed macro adjustment may be attributable to normalization failures.

Step 3 - Expanded Examination of NG Service Company Charges Recorded to Regulatory Assets, Regulatory Liabilities, Plant in Service, and NG NY Utilities' Earnings

If audit testing performed in Steps 1 and 2 determine that there have been material errors in the amounts reflected in utility rates and earning mechanisms, the NYPSC may decide to expand the investigation to additional periods. It is expected that any additional testing performed on the utilities will be based on materiality. Overland expects to work with the Staff to define the size and scope of this step. Specifically, Overland would expect to review the additional costs of performing the expanded work (e.g. consulting fees and any assistance Staff provides) with the potential benefits (i.e. effects on the separate utilities' earnings sharing mechanisms) to determine whether additional work is needed, and if so, the extent of such work.

The potential review periods for Step 3 are defined in the RFP as all rate years for the applicable utility beginning after it was acquired by National Grid. This would include the following periods[2,3]:

- NMPC - Electric: Calendar year 2002 through 2010
- NMPC - Gas: Year ended May 31, 2011;
- KEDNY and KEDLI: Calendar year 2008-2009, 2011-2012.

The procedures in this step will be similar to the detail testing procedures discussed in Step 2. However, we would also expect the need to perform some incremental analysis similar to Step 1, to the extent that service company contracts have changed over the relevant test period.

[2] Overland has excluded the rate years that we would have tested in Step 2 for NMPC - Gas, KEDNY and KEDLI. Similarly, we plan to leverage our testing performed in Step 2 for NMPC - Electric to minimize the necessary testing performed in this step.

[3] Although not explicitly stated in the RFP, Overland notes that any analysis performed over subsequent periods would be subject to their availability at, or near, the time Step 3 commenced.

3. Approach, Methods and Project Management

This section of our proposal provides a detailed description of our audit approach – how we intend to conduct the audit within the defined parameters and procedures contained in the RFP, as well as procedures we impose in the conduct of all Overland Consulting engagements.

The audit objectives and project scope are summarized in the Scope and Objectives section and will be further detailed in the Audit Areas and Issues section of this proposal. This section of the proposal describes the management and administration of the engagement as it relates to: the phases of our work; our project management and quality control procedures; the project timeline; and the deliverables we anticipate based on the RFP. Our management of this project incorporates the following key elements:

- An organized, phased approach
- Ongoing communication with the Staff
- Protocols to govern the format and processing of data gathered
- Comprehensive, systematic information gathering
- Use of an automated data management system
- Use of proven project administrative systems
- Assignment of project tasks to experienced personnel
- Use of well-defined and thorough quality review and control processes
- Thorough documentation of report analyses, findings, and recommendations
- Review of relevant deliverables with Staff and NG NY Utilities

Project Approach

Overland will conduct an investigative accounting examination of the NG NY utilities' affiliate transactions in accordance with the standards adopted by National Association of Regulatory Utility Commissioners (NARUC) Consultant Standards and Ethics for the Performance of Management Analysis including:

- Staffing the engagement with qualified auditors and properly supervising the work of the auditors assigned to the project,

- Gathering sufficient, competent evidence to support all findings, conclusions, and recommendations necessary and relevant to accomplishing the project objectives, and

- Documenting the basis for those findings, conclusions and recommendations in an organized set of working papers and communicating the results of the audit in a meaningful audit report.

We will assess the NG Service Companies and the NG NY Utilities' policies and procedures in each of the areas identified and addressed in the Commission's RFP. Our goal will be to perform the audit in a cooperative environment with the utilities' management, recognizing the requirements of the audit, but also minimizing any undue burden on company personnel caused by discovery, interviews and other technical elements of the audit process. Our proposed audit includes the following principal elements:

1. Performing a detailed review of service contracts, accounting procedures, and internal controls relied upon for cost allocations by the NG Service Companies. Determining the appropriateness of such policies and making recommendations for improvement.

2. Determining if and to what extent invalid service company charges have affected the earnings and relevant balance sheet accounts of the NG NY Utilities.[1] Specifically analyzing the affect on the NMPC - electric rates proposed in the current rate case, as well as the most recently completed rate years for NMPC - gas, KEDNY and KEDLI.

3. Performing additional testing, if necessary, to determine how erroneous service company charges incurred in prior periods has affected NG NY Utilities' rates.

4. Coordinating written discovery and interview requirements with the Staff Project Manager and company personnel to assure compliance with the project timeline.

5. Providing regular briefings to Staff on the progress of the examination and identifying any emerging issues as the examination progresses.

6. Developing a report that addresses all requirements of the RFP in a clear and unambiguous manner.

The personnel assigned to this project include qualified, experienced expert witnesses in the subject matter of the audit. Should testimony and hearings be required, Overland is fully prepared and committed to defending the audit report in administrative proceedings before the Commission.

Entrance Conference

At such time designated by the Staff Project Manager, Overland will meet with the Staff involved with or interested in the project. This meeting will focus on the detailed workplan, discovery procedures, and other administrative matters associated with the project. This will also be an opportunity for Staff to address their views and objectives implicit in the various audit tasks identified in the RFP.

Orientation and Preliminary Review

The primary objective during the initial phase of an audit is to determine, as quickly and efficiently as possible, what information is relevant to review, where it can be obtained and who can provide it. Overland believes that this initial task will occur efficiently, over a short period of time. Overland expects to gain a more detailed understanding of the Companies and their operating environments through a review of responses to the initial data request issued shortly after a notice of contract award. It will also be important to reach a consensus with Staff regarding the proper approach to the audit at a more detailed level

[1] Relevant balance sheet accounts would be any accounts that affect the ratemaking process (e.g. regulatory assets, liabilities, etc.)

than is possible in the RFP or this proposal. Key tasks during the orientation and preliminary review phase will include:

- Review current financial and operating reports available from NG Service Companies and NG NY Utilities.
- Identify management personnel to be interviewed, and schedule initial trip to company or affiliate offices.
- Meet with the Project Manager to identify the individual or individuals responsible for coordinating discovery and interview requests.
- Identify and agree upon the timing, format and location of company management interviews.
- Provide NG Service Companies' and NG NY Utilities' management an opportunity for a kick-off meeting presentation to address their view of matters to be addressed in the audit.
- Establish agreed-upon guidelines for the processing of discovery requests, treatment of confidential materials, and procedures for the transmittal of electronic files.

Technical Analysis

A significant portion of the technical analysis phase of the project will take place on-site at company offices. The analysis phase involves the identification and acquisition of documents needed to complete the tasks listed in the work plan. Document review will be supplemented by interviews of managers, directors, and others relevant to the audit. The scheduling of interviews will be coordinated with Staff so that they will be able to attend interviews of interest. Data requests will be used to obtain written documentation of policies and procedures, when required, and to solicit data necessary to conduct our analytical review. Key project objectives during the technical analysis phase of work include:

- Fully developing all significant elements of the project objectives as detailed in the audit work plan.
- Conducting management and analytical reviews to put relevant evidence into a meaningful conceptual framework, consistent with project objectives.
- Obtaining an understanding of facts sufficient to permit conclusions, recommendations, and action plans.
- Thoroughly documenting all findings and developing conclusions regarding each identified audit issue, and communicating the preliminary audit results to Staff.

Overland's emphasis during this phase of work will be the development of practical recommendations that will benefit NG NY Utilities and their customers. In this process, we will verify compliance with applicable state and federal statutes, DPS requirements and other regulatory policies that govern utility operations within the scope of this review.

Testing Methodology

Overland will provide a detail of our testing methodology in our initial workplan submitted to Staff. We will include reasoning for why we have chosen certain testing approaches over others so that Staff can become comfortable with the methodology we have chosen. Overland will also address the discussion regarding the large population of potential testing transactions in the RFP which states: "...the consultant may test representative samples of such service company charge transactions as part of its investigation process." Overland considers it likely that statistical sampling will need to be employed during this audit.

Our project team is staffed with personnel knowledgeable of a variety of proven and accepted audit sampling techniques. These include several variations of attribute sampling (which determine the rate of errors in a given population, thus most appropriate for internal controls testing), variable sampling (generally used to estimate the average or total value of a population), and monetary unit sampling (which is often used to quantify projected misstatements). These sampling methodologies require different inputs and often rely on different assumptions about the characteristics of the population. During the review of our initial workplan, and prior to any detailed testing, we intend to confirm with Staff a mutual understanding of what should be considered an exception, what should be considered material, etc. Additionally, we will discuss with Staff our decisions for what sampling techniques are most appropriate, as well as the level of confidence we would recommend for these substantives tests.[2]

Report Preparation

Overland expects the audit report to be organized as follows:

- Summary Report – The Summary Report will contain a project summary describing the audit, the people involved, the interviews conducted and provide an overview of the company and the progress of the audit from beginning to end. It will also include a summary of all audit recommendations. This will describe the recommendations, why they are being presented, how they will produce improvements and will define all benefit components and quantify, when applicable, the cost savings expected from implementation. Recommendation summaries will be packaged into groups of similar recommendations for purposes of this summary.

In addition to the Summary Report volume, we expect the audit report will contain the following:

- Executive Summary – The Executive Summary typically provides a high-level overview of the project, which would include: a summary of the audit objectives; a brief statement of the scope of our work; a statement of our major findings and conclusions; and a listing of our recommendations. Any major impediments to

[2] Our determination of the level of confidence at which to perform our testing will be based on, among other things, our review of the company's internal control environment and the degree to which we are able to rely on the company's internal controls.

our work (if any), that could materially impact or limit any material element of our review would also be disclosed in this section.

- Project Summary – This section typically provides an overall description of the project. It would include: a summary of the major elements of the work plan tasks; a description of the discovery and interview process; the major sources and nature of documents that we relied upon in performing the audit; a description of the interview process; and a statement of any material limitations on the audit.

- Audit Investigation Results – A detailed discussion of audit tasks, findings, conclusions, and recommendations will be developed in individual chapters of the audit report. The specific content and organization of this material cannot be accurately identified at this time. However, it is expected that the report will, at a minimum, cover the following subject areas:

    - Affiliate Transactions. Analysis of procurement activities with affiliates; impact of holding company and affiliates on utility operations; and reasonableness of cost allocation methods.
    - Analysis of Accounting and Financial Policies and Procedures. Adequacy of systems necessary to process and report accounting and financial information consistent with regulatory requirements.
    - Internal Control Procedures. Assessment of effectiveness in compliance with stated policies and procedures, and remediation of weaknesses in internal controls or abuse of policies.

The actual format and content of the report will depend on the results of our technical analysis. We will provide Staff with a draft outline of the report as the audit sufficiently develops, and upon completion and review of the reports. Overland will coordinate the development of the draft report with Staff, and incorporate comments and address any concerns, as appropriate.

Exit Conference and Draft Report Review

Prior to release of a final report, Overland will provide a draft report to Staff for review and comment. We will meet with Staff to discuss audit findings and the contents of the document as a whole. If deemed appropriate by Staff, we will also provide a copy of our audit to the company. Upon approval by Staff, we will issue a final report for Part One.

Work Papers

Overland has a policy of fully documenting its findings and recommendations through the process of referencing the report to the discovery produced in the audit, to relevant Orders issued by the Commission or other agencies, and to other documents that may be relied upon. This process is reflected in a fully footnoted report document. This process is generally consistent with the request of the Commission to provide work papers in support of our report. Our work papers will include interview summaries, although we do not directly rely on interviews as a basis for our analysis or recommendations. In the absence of independent written documentation, Overland will issue formal written discovery requests to confirm any information to be relied upon that was obtained from interviews.

A complete, indexed set of work papers will be released with our audit report or shortly thereafter. As our audit develops, Staff shall have access to our work papers as it may request to assist in the project oversight and assessment of our task reports. These will be available in an organized electronic format.

Overland has a retention policy of not less than five years. Aside from the work papers, interview summaries, and references to other sources of material, we also include formal project files that include our database of discovery requests and responses; copies of correspondence, including status reports; and the project billing detail, with comparisons to budget. Our work papers, at a minimum, will identify the following types of information:

- Source of information presented.
- Nature and extent of work performed.
- Appropriate cross-references to an indexed copy of the report and other working papers.
- Conclusions reached.
- Indications of review and quantitative checks.

Quality Control Over the Project Process

Overland will apply quality control measures at all stages of the audit process. At a minimum, any factual or technical errors will be detected and corrected through our audit control procedures. Overland's Project Manager will review work as it progresses. A second level of review consists of two separate but related reviews. A detailed, technical review of all work papers and analyses is conducted. This review includes an independent check of the accuracy of all analyses and recommendations, as well as verification to all source documents. It also includes verification of referencing of all materials in support of the audit report. Overland's Project Manager will also determine whether the proposed findings and recommendations are properly and completely developed and are consistent with the overall development of the audit. Finally, we anticipate a third level of review will be conducted by the Project Director, and ultimately the Staff to determine whether proposed findings and recommendations are properly supported and fully address all audit matters identified in the proposed scope of work and related work plans. Overland's Technical Managers will also review and comment on the technical and overall quality of the final report, testimony (if necessary), or other project deliverables.

Use of Computer Applications for Analysis and Work Management

Overland uses a network-based computer system and customized project management applications to facilitate consulting projects and focused audits. We use the network to centralize electronic project data, ensure daily backup, and for communication within the project team. We use a customized database application to manage data requests and responses. An Overland Staff Consultant is assigned the responsibility of overseeing and maintaining the database application and organizing project data on the network. Our discovery database is available to the Staff and the utilities should the availability of this information to these parties help facilitate the audit.

Project Deliverables

n compliance with the requirements of the RFP, as well as in conformity with standard project management practices, our work products will include the following:

- Workplan – Overland will confer with Staff when creating the initial work plan. The drafts will include greater detail of the scope and methods to be used in the engagement as well as a detailed schedule with milestones. Approval of the final draft by Staff will indicate approval to proceed with the engagement.
- Briefings - Overland will provide regular verbal briefings to Staff on the progress of the examination and will identify emerging issues as the engagement progresses.
- Interviews and Site Visits – A report of intended interviews and site visits scheduled for the following week will be submitted weekly. As this report is updated, it will serve as a report of interviews conducted.
- Interview summaries – These will include name, title and organization of interviewee, name of interviewer, listing of observations and conclusions, any new issues raised, data requests generated, and any follow-up that may be required.
- Person-Days Expended Report- This monthly report of person-days expended by activity in each task area will compare progress relative to the time-line schedule and will track original estimates and actual work, estimated time to complete and percent completed. Major variations in actual versus planned work tasks will be identified and addressed, as needed, in the status reports.
- Document Request Log – This report showing documents requested and date received will be submitted weekly. The log will also be kept on-site at the applicable utility.
- Emerging Issues/Conclusions – Prior to the submission of our initial draft audit report, and no later than mid-point in the audit, we will prepare written summaries of emerging issues for Staff review.
- Draft Audit Report – This report will represent our final work product, and we will submit to Staff for review. After receiving comments from Staff, we will present a revised draft report to Staff.
- Final Report - Twelve hard copies will be overnight expressed to the Commission, and a PDF e-mail file will be supplied as well.
- Work Papers – All work papers, interview notes, statistical analyses, and other supporting documents developed or obtained during the course of the audit will be made available to Staff in an organized electronic format. If requested, a complete indexed set of work papers supporting the audit report shall be delivered on or about the time of the final audit report.

- Presentation of Evidence and Testimony***.*** Overland understands that information developed during this investigation may be relevant to several cases before the Commission. If required, Overland project personnel will prepare and submit testimony describing our investigation, the evidence developed, and our findings in support of our audit report. However, none of this work has been incorporated into our not-to-exceed bid, and if requested, would be provided at standard hourly rates.

- Part 2 Report and Deliverables- Should Part 2 of the engagement be required, a final report will be prepared, and if necessary, testimony will be prepared and submitted as in Part One.

Contract Management

Major elements of contract administration include:

- Invoices will be submitted electronically once a month, and contain a detail of work by workplan task area, by person.

- Should any areas of analysis be deemed out-of-scope, or if Overland believes that any factors outside of its control are potentially impacting the project cost or schedule (i.e. material delays in production of required discovery responses), Overland will immediately bring such matters to the attention of Staff. Overland will discuss and estimate the impact such conditions will have on the work, the project cost, and the project schedule. *Overland will not assume any changes to the project workplan, the project schedule, or project costs unless or until all appropriate documents and contract amendments are properly agreed upon and executed.*

- Aside from the above reports, Overland will keep Staff informed with verbal communications on a weekly basis during the technical phase, and as appropriate during the report development phase of effort.

Timeline

Overland has reviewed the RFP proposed schedule, and based on the proposed scope of work and deliverables required, the schedule provides a reasonable period of time to complete all required tasks. The proposed project timeline is shown on Exhibit 6-5. Based upon the information contained in the RFP, the following key milestone dates are either identified or can reasonably be assumed:

Commence Audit	March 2011
Begin On-Site Work; Orientation meetings	March 2011
Submit Draft Workplan to Staff	March 2011
Workplan Approved by Staff	April 2011
Midpoint Status Meeting	July 2011
Submit Weekly/Monthly Reports	Various
Draft Report for Part One Submitted to Staff	September 2011
Final Report for Part One Submitted to DPS	November 2011
Part Two Report, if necessary	TBD 2012

4. Audit Areas, Issues and Workplan

Audit Issues Under Review

NG USA, like many multi-state utility holding companies, believes that it can effectively cut costs by consolidating support services into a service companies. The costs incurred by these service companies are allocated to its affiliates in a manner defined by the companies and generally reviewed by regulatory authorities.

In the NG USA system, there are four different service companies under review that provide services to a total of 62 affiliates. Three service companies were acquired through National Grid's acquisition of KeySpan in 2007: NG Corporate Services; NG Utility Services LLC; and NG Engineering and Survey. The fourth service company is a legacy National Grid company: NG USA Service. [1]

NG USA Service provides a range of support services including accounting and auditing, as well as construction and engineering services. The legacy KeySpan service companies have been structured to provide a comparable level of service in aggregate.

The way in which costs are assigned varies between the legacy National Grid service company and the legacy KeySpan service companies. NG USA Service charges are either directly charged or aggregated into bill pools and allocated to each affiliate benefiting from the service. The cost allocation is performed by using cost drivers or through a general allocator. The legacy KeySpan service companies initially record all incurred costs on their books and then allocate the costs through a process known as "mass allocations".

In filings made in its current rate case, NG USA maintained that its approach to allocating service company charges is equitable to all affiliates. The company testified that whenever a service is performed on behalf of a single affiliate, direct charges are made. It stated that when charges can not be directly assessed, allocation is made based on cost drivers. Where it is not possible to use either of these two methods, the company stated that it allocates charges using a general allocator. Many utility-industry service companies in the U.S. state that their procedures following this direct-to-general cost allocation hierarchy.[2]

The issues surrounding incorrect service company charges were described in the ALJs' recommended decision in the current rate case. These issues stem from three types of adjustments:

1. *Expenses improperly assigned to regulated affiliates.* Staff noted in its testimony that increases in service company charges to National Grid's regulated affiliates

[1] In the Direct Testimony of Andrew Sloey submitted in Case 10-E-0050, Mr. Sloey states that the NG USA has committed to combine three of the four service companies, excluding NG Engineering and Survey. As such, part of the review in Part One of Overland's analysis will involve gaining an understanding of how the cost allocation methodologies may change when these companies are operated on a consolidated basis.

[2] This cost allocation hierarchy is intended to maximize the extent to which costs are distributed using "cost-causative" procedures. By itself it is vague, and is more a statement of objectives than an actual recipe for allocating costs. Overland has found that while most utility service companies adopt the hierarchy as their official policy, the degree to which it is actually employed varies widely.

increased at a rate dramatically different than the unregulated affiliated. Staff's detailed testing confirmed that there were instances in which regulated affiliates were incorrectly assigned costs, but the company has maintained that these errors were unintentional.

Among the errors were expenses incurred for the international relocation of employees. The company agreed that many of these expenses were inappropriate. In lieu of quantifying the inappropriate charges, the company withdrew their entire request related to these items. This resulted in a downward adjustment of approximately $4.3 million.

2. *Legitimate expenses improperly allocated among affiliates.* Companies have an increased incentive to misallocate costs to regulated affiliates during periods that will be used to calculate the utility's revenue requirement. Staff performed a diagnostic reasonableness test in which it compared the increase in service company charges for NMPC, relative to other affiliates. The results showed that service company costs increased nearly 33% for NMPC, but only by about 17% for the other affiliates.[3] These results suggested NMPC was being allocated a disproportionate share of these costs. The company believes that it has performed adequate procedures over the validity of this increase, but Staff has found errors in the company's testing results. Furthermore, while testing the charges based on National Grid's current allocation methodology is necessary, it is not necessarily sufficient, by itself, to determine whether an affiliate has been charged a disproportionate amount. As such, in addition to detailed testing, we will assess whether National Grid has developed its cost allocation procedures in an appropriate manner.[4]

3. *Failure to normalize expenses incurred during the historic test year.* While not an issue of misallocation, the normalization of service company charges is another issue within the scope of the current proceeding. The extent of these normalization errors is not yet known, but the ALJs viewed normalization errors as potentially more material than those due to misallocations.

These issues, and the general uncertainty surrounding NMPC's service company charges, caused Staff to propose a "macro adjustment" of $26 million.[5]

In their recommended decision, the ALJs did not adopt Staff's recommendation to implement a macro adjustment. Instead, the ALJs felt that implementing temporary rates in the amount of $50 million was reasonable.[6]

As described in Section 2 of this proposal, the scope of this audit has been set to incorporate both the specific concerns at issue in the current rate case, as well as the structural issues and policies that direct the allocation of costs to all NG USA affiliates.

[3] The company believed the correct figure of this NMPC's increase was 27.7%.
[4] This analysis will include, but not be limited to, potential recommendations regarding the disproportionate allocation of benefits resulting from economies of scale.
[5] Staff later reduced this amount to $20 million based on adjustments accepted by the company.
[6] The ALJs set these temporary rates at a level they believed adequately balanced the objectives to be large enough to capture the potential adjustments that may be required, but not large enough to unnecessarily impact the company's credit rating.

Preliminary Workplan

Our preliminary workplan focuses on Part One and Part Two of this proceeding. Although the scope of potential testing in Part Two is unclear at this time, our preliminary workplan demonstrates the procedures that would likely be necessary if material levels of misallocated or inappropriate service company costs were detected in the testing period.

The basis for this proceeding was summarized by Mr. Garry Brown, Chairman of the NYPSC, in his prepared remarks at a public hearing regarding this matter in October, 2010: "The bottom line question...is the extent to which these potential problems have resulted in higher than necessary customer bills. It is a legitimate question that the investigation will examine for both the electric and gas operations, both retrospectively and prospectively."[7]

The preliminary workplan below describes the tasks that Overland believes will answer this question for the Commission.

Part One

Step 1 - Examination of Service Contracts and Accounting Procedures
In this step we will perform a comprehensive review of the accounting procedures and policies in place at the National Grid service companies. We will determine whether there are deficiencies in the National Grid service companies' internal controls, and, if so, we will present recommendations on how the company can improve its controls. We will also determine in this step whether the additional filing requirements recommended by Staff in the current rate case should be adopted or modified. The tasks for this step are listed below.

I. Orientation and Project Mobilization

Meet with Department Staff

- Consult with Staff to obtain background on relevant issues and concerns.
- Confirm project objectives and timeline
- Discuss any other company-specific issues relevant to the current proceedings.

Review Existing Documents

- Review prior Commission decisions, reports and testimony from the rate cases as it pertains to cost allocations and affiliate transactions.
- Establish an understanding of National Grid's New York operations and the division of operations between the utilities and their affiliates.

Finalize Workplan with Staff

- Submit draft workplan to Staff.
- Address all Department Staff comments/concerns of draft workplan prior to beginning substantive analysis.

[7] Testimony of Garry Brown to the New York Senate - Standing Committee on Energy and Telecommunications, October 19, 2010.

II. Review of Service Company Organization and Accounting Procedures

Organizational Review - Obtain an understanding of the organization structure from a management and accounting (cost flow) perspective.

- Perform a review of the management structure of National Grid. Determine potential overlap in functions / services provided by the legacy National Grid Service Company and the legacy KeySpan Service Companies.
- Determine subsidiaries served and related changes since 2005 for Service Company. Determine the impact of the KeySpan acquisition on the service company allocation process and the subsidiary charges from the service companies, in particular the mix of functions and amounts of services provided to each NY utility.
- Determine the functional alignments between the service companies. Determine how much progress has been made, and what remains to be done, to eliminate potential functional overlaps among the service companies.

Accounting Procedures - Obtain an understanding of the accounting systems and procedures to budget, record and allocate costs.

- Gain an understanding of the enterprise accounting systems at each service company and utility. Analyze any differences between accounting procedures of the service companies, especially those with a potential impact on costs allocated to utilities.
- Determine the accounting structure at each service company (data fields, chart of accounts, etc.).
- Evaluate the budgeting and reporting processes at each service company (e.g. budget variance reporting).
- Determine the processes used to bill each service company to charge each subsidiary, including direct charges, allocations and convenience payments.
- Determine the methods used to pay for services rendered (cash, use of intercompany receivable & payable offsets, use of money pools, etc.) and for reimbursed (convenience payment) items.

Quantification of Service Company Charges - Obtain an understanding of the scope and scale of transactions between the service companies and the utilities, and between the utilities and other affiliated companies.

- Assess the regulatory environment in which the utilities operate (including a review of any federal or state affiliate transaction and cost allocation rules and requirements).
- Review service company charges to each subsidiary, by category (direct charges, allocations, convenience payments), for the period 2005-2010.

- Review charges between the utilities and other affiliates (i.e. affiliate transactions other than service company charges).

- Review service company charges to determine whether there have been sufficient adjustments to normalize the level of expenses.[8]

III. Review of the Internal Control Environment

<u>Examination of the budgeting and management processes in place.</u>

- Review the budgeting procedures in place for service company charges. This will include an assessment of the use / non-use of zero based budgets, degree to which "inflation" is built in to the budgets, the degree of budgetary control and responsibility vested at the functional level, and the depth of analysis and immediacy of follow-up for variances.

- Determine the extent to which external benchmarking and best practices are used to set and monitor operational and budget goals.

- Determine the incentives available to managers to exercise budgetary controls and implement operational improvements.

- Review the controlling documents that govern the cost allocation process, including the cost allocation manuals, the service agreements and the service level agreements referenced in the current NMPC - electric rate case.[9]

<u>Subsidiary participation in determining the types and level of services provided by each service company</u>

- Assess the extent to which service company “customers” (especially the utilities) have input into the budgeting and planning processes by which overall service levels are determined.

- Evaluate which of the service companies has the "best practice" for each documented item and determine whether the other service companies are moving to implement these practices.

- Assess the level of subsidiary input into the determination of how services will be measured for the purposes of charging, and how they will be priced if they are charged based on usage.

- Determine subsidiary control over the quantity of usage-based services purchased and the design and use of certain allocators.

[8] This procedure would only be applicable to Overland's analysis of NMPC-Electric's historic test year.
[9] See page 11 of the Direct Testimony of Andrew Sloey.

- Determine the percentages of subsidiary-controllable (full or partial control) and non-controllable (enterprise-level) services at each service company.

  Utility incentives to maintain control over service company charges

- Determine the parties responsible for service company charges within each utility.

- Determine the degree of understanding of the service company allocation process by managers in whom responsibility is vested for monitoring services provided.

- Document the processes for charging the utilities and procedures for paying for the services.

- Assess the protocol for reviewing and challenging the level of service company charges and evaluate any historic examples of utility challenges or questions.

- Assess the utility procedures for service company payment approval and payment.

Step 2 - Examination of Service Charges

In this step, Overland will perform the detail testing necessary to quantify whether and the extent to which, erroneous service company charges affected the NMPC - electric rates being set in Case 10-E-0050 and how it affected earnings of the following utilities in their most recent rate year: NMPC - gas; KEDNY; KEDLI. These procedures will address also determine if any invalid service company charges affected the regulatory assets / liabilities accounts of the subject utilities. Described below are the tasks that we plan to perform in this step.

I. Perform a review of the specific functions and services provided by service companies to utilities since 2005 for each service company.

  Review the nature of services provided in each function to the subsidiaries.

- Determine whether the subsidiaries charged are appropriate based on benefits; whether all benefiting subsidiaries (in particular, non-regulated subsidiaries) have been included in the charges.

- Determine whether the methods of charging are appropriate given the nature of the service, its usage, and the potential for subsidiaries to control the level of service provided (e.g. any services the utilities should be able to exercise usage control over should not be allocated using a global allocator).

- Review accounting data detailing charges by function to each subsidiary, by year for each service company. Analyze trends in this data in functions and amounts charged and determine why they occurred.

Document exceptions to review. Including:

- Services that should not be charged to the utilities.
- Inappropriate methods for billing the utilities.
- Utilities not obtaining control over "controllable" levels of charges.
- Errors or mistakes in the charging process.

II. Perform a detailed review of the processes for charging subsidiaries for services.

Review pricing methods by function / service, for directly charged (usage based) services.

- Judgment-based sample services based on materiality, utility impact, significance of change from year to year in amounts charged.
- Test pricing calculations.
- Assess changes in pricing methods / calculations, year-to-year.

Review allocation methods.

- Identify key allocators.
- Review allocation factor calculations.
- Review the source data used for calculation of allocation factors (financial and operational inputs) and trace to source documents. Determine whether raw inputs have been adjusted to change allocation outcomes.
- Determine the amounts allocated to each subsidiary using each allocation method.
- Determine if services to which allocators are applied could be charged directly or more directly allocated.
- Determine if allocation factors are correctly calculated and if based on most currently available source data.
- Evaluate whether the allocation factor operational and financial inputs used by the companies are appropriate for measuring the relative benefits the utilities derive from the services allocated.

Review convenience payments

- Determine the reasons for payment of utility expenses by service company and the advantages and disadvantages to the utility over paying these expenses themselves.

- Determine how utilities reimburse service companies for convenience payments.

- Determine the extent to which increases in NG USA amounts charged to utilities represents a transfer of payment responsibility from the utilities to the service company (through convenience payments).

- Review the schedule of convenience payments (nature of charges, amount, vendors).

- Determine the methods by which convenience payments are made.

- Determine if the trend of increasing convenience payments at the utilities corresponds with a decrease in expenses paid directly by the utilities.

Based on the testing above, develop a thesis for the increasing service company charges to the utilities and quantify the adjustments of service company charges to the utilities.

- Document the basis for increases in service company charges to the utilities. Potential reasons may include changes in pricing and allocation methods, service company functions duplicated by the addition of KeySpan in 2007 which have yet to be "functionally aligned", lack of cost control over services provided, inefficiencies introduced by the larger, more complex company that has developed since 2002, errors and mistakes, etc.

- In conjunction with Department Staff, determine whether any erroneous service company charges found as a result of our testing procedures should be considered material enough to warrant adjustments and / or an expansion of the testing as detailed in Part 2.

Part Two

Step 3 - Expanded Examination of NG Service Company Charges

Part 2 is an expansion of the testing performed in the previous two steps. The scope and extent of testing in this part will be a function of the results of Part 1, and, as such, are not currently known. The tasks below identify the procedures that Overland expects to perform for this step. Much of the knowledge and understanding that we will gain by performing Part 1 will facilitate our testing Part 2. As such, we have incorporated tasks in our procedures below that ensure we will effectively leverage off of this prior experience.

I. Evaluate how erroneous charges identified in Part 1 have affected prior periods.

- Evaluate the affect of invalid service charges on the utility's regulatory assets, regulatory liabilities, and plant in service account balances for the testing periods performed in Part 1.

- Review the degree and nature of any material errors affecting O&M expenses uncovered in Part 1.

II. Establish appropriate scope of assets / liabilities and earnings testing.

- Review service company contracts and cost allocation manuals for all applicable prior periods.

- Determine the degree to which service company policies have changed and the reasoning for this change.

- Determine how changes in service company policies and procedures may eliminate and / or enhance certain testing procedures.

III. Establish appropriate scope of assets/liabilities testing.

- Evaluate the testing results of Part 1 and determine whether the cause of any erroneous service company costs made to CWIP (or any other balance sheet account potentially affecting rates) were systemic in nature, or unique to a particular project or period. [10]

- Determine whether service company charges to balance sheet accounts have fluctuated in the periods under review, and how that may affect whether the erroneous service company costs are likely to be material.

IV. Establish appropriate scope of earnings testing.

- Determine whether the reason for any invalid service company costs charged to utility expense identified in Part 1 were unique to that period.

- Review the details of each utility's earnings sharing mechanisms and prior period earnings reports. Determine the likelihood that erroneous service company charges would affect earnings at a level material enough to be shared with ratepayers.

[10] For example, if Overland identifies that invalid charges uncovered in Part 1 were primarily due to an improperly designed control that has only recently been enforced, we will alter our testing procedures accordingly.

V. Perform detailed testing to identify material errors in service company charges.

- Based on knowledge gained from the previous procedures in Step 3, develop a set of detailed tests.[11]

- Review proposed testing procedures with the Staff. Modify as necessary.

- Perform testing necessary to quantify invalid service company charges affecting the regulatory assets / liabilities, plant in service and earnings of all applicable utilities and for all testing periods.

[11] Note that these procedures are expected to closely mimic the procedures that we will perform in Step 2, but there will likely be significant enhancements/improvements based on our knowledge acquired from our testing performed in Part 1.

5. Project Team and Responsibilities

This section of our proposal identifies personnel assigned to the project, gives an overview of their relevant experience and describes the project organizational structure and each person's commitment to the project.

Project Personnel

Our proposed team consists of a Project Manager, two Technical Managers, a senior consultant and a consultant. Overland proposes the following personnel for this audit engagement.

Overland Consulting Personnel	Project Responsibility
Howard Lubow	Project Director
Robert Welchlin, CPA	Project Manager, Technical Manager
Gregory Oetting, CPA	Technical Manager
Ryan Pfaff, CPA	Senior Consultant
Chadwick Epps, CPA	Consultant
Melissa Erickson, CPA	Consultant
Teri Townley	Data Manager

The National Grid Affiliate transactions audit requires an understanding and demonstrated experience in the following key areas:

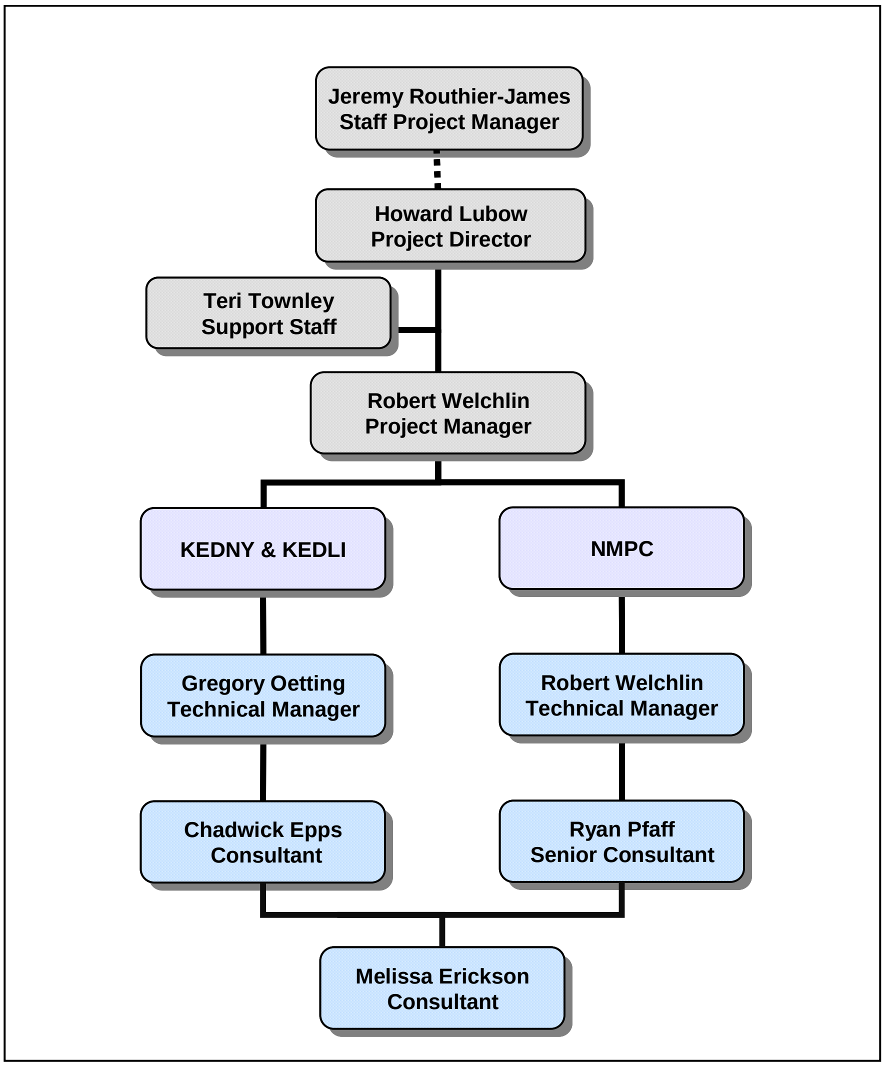
- Knowledge of utility operations, benchmarking approaches and best practices.
- Understanding of appropriate audit procedures applicable to a review of accounting for common costs, and distribution of such costs to corporate business units and operating divisions within business units.
- Understanding of appropriate cost allocation criteria for the utility industry, and standards for affiliate transactions.
- Knowledge of current issues affecting utilities operating in the State of New York.

Project Organizational Structure

As can be seen in the table below, the vast majority of NMPC service company charges derive from NG USA Service and the vast majority of KEDNY and KEDLI charges originate at the legacy KeySpan service companies.

Percentage of Total 2009 Billings by Service Company			
	NMPC	KEDNY	KEDLI
NG USA Service	92.5%	6.6%	3.8%
NG (KeySpan) Corp. Service	7.4%	83.5%	88.6%
NG (KeySpan) Utility Service	0.2%	9.5%	6.2%
NG (KeySpan) Eng and Survey Service	0.0%	0.4%	1.4%

Due to this breakout of service company charges, Overland has organized its project team primarily based on an entity focus.



By structuring our project team in this manner we will allow our consultants to focus their attention in a proportionally logical manner. For example, the Overland group assigned to KEDNY and KEDLI will be able to primarily focus on gaining an understanding of the legacy KeySpan service companies because that is where the vast majority of their service company charges originated.

The following summaries of the proposed project personnel identify areas of specific responsibility for the audit and the experience of each person relative to such delegated subject areas. Resumes included in **Section 7. Experience and Qualifications** provide additional information about individual expertise, experience, academic backgrounds, and professional credentials.

Howard Lubow, Overland's President, will serve as Project Director. Mr. Lubow will have overall responsibility for Overland's work, ensuring that key deliverables are provided on schedule. Mr. Lubow is a public utility regulatory consultant with over 30 years of utility industry experience. He has extensive experience with regulatory policy, utility finance, utility planning, and corporate governance. Mr. Lubow has been responsible for approximately 100 financial and focused utility regulatory audits. Mr. Lubow has testified as an expert witness in over 200 regulatory proceedings. He has served as Project Director or Project Manager for more than 250 consulting projects, including at least twelve projects that exceeded 5,000 hours of consulting effort. As Project Manager, Mr. Lubow will be the primary contact with the Staff Project Manager. Mr. Lubow's experience relative to these tasks includes:

- Served as Project manager in a management audit of Connecticut Natural Gas, and its parent Iberdrola USA. The audit scope included all significant functions of the company including a review of corporate governance and executive management, customer service, accounting and finance, conservation activities, and operations. A number of special topics were also addressed including: customer demand metering, billing determinates and billing procedures.

- Currently serving as Project Director in the management audit of Public Service Enterprises Group on behalf of the New Jersey BPU. This major engagement has extended over a 13 month period, and covers all elements of holding company and utility operations, including the allocation of corporate costs.

- Served as Project Manager in a 12-month comprehensive management audit of Atlantic City Electric and its parent, PHI Holdings, headquartered in Washington, D.C. While Mr. Lubow was specifically responsible for the review of the parent company board of directors, strategic and financial planning; the overall scope of the project included a review of the customer service functions of the utility.

- Recently served as Project Director in a 9,000 hour management, accounting and financial review of a proposed merger between Exelon and Public Service Enterprises, on behalf of the New Jersey Board of Public Utilities. He was the Commission Staff's policy witness, and he specifically addressed expected costs and benefits attributable to the various corporate entities and subsidiary business units impacted by the proposed merger.

Robert Welchlin, CPA will serve as Project Manager he will be in charge of developing the team's overall audit approach. Mr. Welchlin will also be in charge of the audits conducted on NMPC (both electric and gas). Mr. Welchlin will also be in charge of the testing regarding for NMPC. Mr. Welchlin is a Certified Public Accountant with more than 25 years of regulated industry experience. Mr. Welchlin has extensive regulatory and management auditing experience. He has submitted testimony and presentations in regulatory proceedings before the Federal Energy Regulatory Commission (FERC) and state utility commissions in Alaska, California, Kansas, Missouri, Oklahoma, Texas and Wyoming. Mr. Welchlin has served as a project manager for both energy and telecommunications engagements, including projects involving several thousand hours of effort. Representative experience includes:

- On behalf of law firm Reynolds, Mirth, Richards & Farmer, LLP, Mr. Welchlin is currently performing a review of the EPCOR cost allocation process as a result of a recent utility rate proceeding.

- On behalf of the Maryland Public Service Commission Staff, in 2010 Mr. Welchlin reviewed and sponsored testimony concerning Constellation Energy's service company allocations to Baltimore Gas & Electric.

- Mr. Welchlin was the project technical manager in charge of the review of Cal-Am's general office costs for the historical period 2006 through 2008 and the projected rate period 2009-2011. In the proceeding to consider Cal-Am's rate application Mr. Welchlin sponsored testimony on general office expenses and revenue requirements. A majority of the revenue requirement adjustments Mr. Welchlin recommended were adopted by the Commission.

- Project Manager on two reviews of Sempra's Corporate Center costs, cost allocations and GRC forecasting procedures.

- Project Manager and Technical Manager in charge of reviewing affiliate transaction and shared service (corporate and service company) cost allocations on various regulatory audits, including, in California: PG&E, Pacific Bell, Southern California Gas, Frontier of California and Surewest Telephone.

- Technical Manager in charge of assessing the impact of the merger of Exelon and Public Service Enterprise Group on the corporate (holding company) costs allocable to the New Jersey utility.

- Technical Manager in charge of a regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions. Submitted revenue requirements testimony covering Cal-Am's 2009 projected test years covering the O&M expenses of functions allocated from the national, regional and state levels to the district operations for which Cal-Am was seeking an increase in rates.

:

Gregory Oetting, CPA will serve as a Technical Manager in the review of KEDNY and KEDLI. Mr. Oetting is a Certified Public Accountant with over twenty years experience in accounting and regulatory consulting. Mr. Oetting has participated in numerous regulatory consulting and public accounting engagements and has served as Controller of an interstate natural gas pipeline. Mr. Oetting's specific experience includes the following:

- Participated in the regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions.
- Technical manager in the review of the General Rate Case Applications of San Diego Gas & Electric Company and Southern California Gas Company. Analyzed the shared utility services of both companies.
- Project Manager of an affiliate transactions and cost allocations audit of South Jersey Gas. Mr. Oetting was responsible for coordinating the audit effort with both the New Jersey BPU and South Jersey Gas. Mr. Oetting focused much of his attention on affiliate relationships and company compliance with New Jersey's competitive service rules.
- Technical Manager on an audit of Pacific Bell Telephone's affiliate transactions and cost allocations for the Telecommunications Division of the CPUC. Mr. Oetting was primarily responsible for the review of certain cost allocations of shared services.
- Controller of an interstate natural gas pipeline that had multiple affiliates including those in unregulated industries. Responsible for the distribution of corporate costs among regulated and unregulated entities.

Ryan Pfaff, CPA will serve as Senior Consultant assisting Mr. Welchlin his review. He joined Overland in 2009 after three years as an auditor for PricewaterhouseCoopers. In addition to assisting Messrs. Welchlin and Oetting, Mr. Pfaff will be a point of contact with the Company and the DPS concerning discovery matters and project logistics. During the Constellation / EDF proceeding Mr. Pfaff performed research in the areas of utility ring-fencing and bankruptcy protection. Mr. Pfaff also managed the flow of data from Constellation and EDF to Overland and maintained the Overland data log. During the FirstEnergy / Allegheny proceeding, Mr. Pfaff submitted expert testimony regarding various regulatory accounting and finance issues.

Chadwick Epps, CPA will serve as Consultant assisting Mr. Oetting in his review and will oversee the discovery process. With Overland Consulting, Mr. Epps has been involved in the affiliate transactions and management audit of PSEG for the New Jersey Board of Public Utilities. As a part of that project, he has had responsibilities in the areas of finance, support services, and corporate governance. He joined Overland in 2009 with one year of industry experience with a natural gas and NGL midstream operation and more than three years of public accounting experience with KPMG.

Melissa Erickson, CPA will serve as Consultant assisting Messrs. Oetting and Welchlin with their analysis. She is a Certified Public Accountant and has experience as a staff accountant and auditor at Price Waterhouse and Arthur Andersen as well as private industry.

Teri Townley will manage the database of company responses. She has more than 20 years of experience interfacing with Overland's clients and auditees. Ms. Townley will manage the data log, catalog responses and track the timing and completeness of responses, enabling the auditors to maintain an analytical focus on the project.

Team History

The project team is comprised solely of Overland employees who work together on a continuous basis. The chart below lists Overland's last five engagements and how each person was assigned.

Engagement and Type of Audit					
Consultant	EPCOR	CalAm	FirstEnergy	Baltimore Gas & Electric	Public Service Electric and Gas Company
	Review of Corporate Cost Allocations	Audit of Cost Allocation Methods and Affiliate Transactions	Merger Evaluation	Review of Headquarters Cost Allocations	Affiliate Transaction & Management Audit
Howard Lubow		Project Manager	Project Director; Technical Manager		Project Manager
Robert Welchlin	Technical Manager	Technical Manager	Lead Consultant	Technical Manager	Technical Manager
Gregory Oetting			Lead Consultant		Technical Manager
Ryan Pfaff	Sr. Consultant		Sr. Consultant	Consultant	
Chadwick Epps		Consultant	Consultant		Consultant
Melissa Erickson		Consultant	Consultant		
Teri Townley	Data Manager	Data Manager	Data Manager	Data Manager	Data Manager

6. Schedule and Budgets

Overland Consulting's not-to-exceed bid for services to complete the National Grid focused audit as described in this proposal is $682,200 for Part One. Based on our Part One estimate, we have assumed a factor of 1.5 times Part One for our Part Two estimate, which results in a cost of $1,023,300. Should Part One and Part Two both be performed, our total not-to-exceed cost would be $1,705,500. This includes professional and support staff fees along with all travel expenses and other direct costs.

In the absence of a detailed scope of effort for Part Two at this time, Staff has indicated that a preliminary cost estimate for this work should be based on a factor of 1.5 to 2.0 times the cost of the Part One. Overland is confident that, should Part Two be performed, the cost of this work will not exceed a factor of 1.5 times our Part One level of effort.

Detailed calculations of this bid can be found in the following Exhibits:

- Cost Proposal (Exhibit 6-1)
- Detail of Project Labor Costs (Exhibit 6-2)
- Detail of Project Travel and Other Direct Costs (Exhibit 6-3)
- Person-Day Labor Matrix by Task Area (Exhibit 6-4)

Overland's bid does not include any time associated with public hearings concerning our work product. If our participation at hearings is requested, these services will be provided at the standard hourly rates contained in this proposal, plus actual out-of-pocket expenses.

Our base bid discussed above also does not reflect the potentially expanded scope of Part One to cover the NMPC - Gas test year. However, we have estimated the incremental effort to complete the additional testing and we have included this as Exhibits 6-1(b) through 6-4(b). The estimated cost of this expanded testing would be $62,160.

Any costs for performance of work determined to be outside the initial scope of the RFP by the Department will only be incurred with the specific, written authorization of the Department.

Time Estimates

The time estimates included in this proposal assume reasonable cooperation of all participants, including the utilities.   A timeline of expected task phases is included in Exhibit 6-5.

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OVERLAND CONSULTING Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures Case 10-M-0451 COST PROPOSAL SUMMARY	
Description	**Project Total**
<u>Part One</u>	
Total Professional Labor	$625,000
Out-of-Pocket Expenses	57,200
Not-to-Exceed Project Cost for Part One	**$682,200**
<u>Part Two</u>	
Cost for Part One	$682,200
Bid Multiple Recommended by Staff	1.5
Not-to-Exceed Project Cost for Part Two	**$1,023,300**
Not-to-Exceed Project Cost for Part One and Part Two	**$1,705,500**

OVERLAND CONSULTING

Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures

Case 10-M-0451

PROFESSIONAL LABOR BY CONSULTANT

Consultant	Role	Daily Rate	Days	Labor Cost
H. Lubow	Project Director	$2,200	23	$50,600
R. Welchlin	Project/Technical Manager	1,680	100	168,000
G. Oetting	Technical Manager	1,680	70	117,600
R. Pfaff	Senior Consultant	1,200	92	110,400
C. Epps	Consultant	1,200	88	105,600
M. Erickson	Consultant	1,000	50	50,000
T. Townley	Data Manager	760	30	22,800
Total			**453**	**$625,000**

OVERLAND CONSULTING

Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures

Case 10-M-0451

OUT-OF-POCKET EXPENSES

Description	Qty	Price	Project Total
Travel costs			
Airfare (30 consultant trips @ $600)	30	$600	$18,000
Airport Parking & Mileage (30 consultant trips @ $140)	30	140	4,200
Hotel (120 consultant nights @ $160)	120	160	19,200
Per Diem (120 consultant days @ $50)	120	50	6,000
Car Rental (Rentals for 12 combined trips @ $400)	12	400	4,800
Other Miscellaneous Expenses			5,000
Total Out-of-Pocket Expenses			**$57,200**

All other direct costs are included in professional daily rates. A "trip" is one consultant for one trip. A "combined trip" is a cost to be spread over two or more consultants on the same trip

OVERLAND CONSULTING
Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures
Case 10-M-0451

LABOR MATRIX
PERSON-DAY ESTIMATES BY TASK AREA AND CONSULTANT

Task Areas	Howard Lubow Project Director	Robert Welchlin Project/Technical Manager	Greg Oetting Technical Manager	Ryan Pfaff Senior Consultant	Chadwick Epps Consultant	Melissa Erickson Consultant	Teri Townley Data Manager	Total
I. Orientation and Project Mobilization:								
Meet with Department Staff	2.0	2.0	1.0	2.0				7.0
Review Existing Documents	2.0	2.0	1.0	2.0				7.0
Finalize Workplan with Department Staff	2.0	6.0	4.0	5.0				17.0
Subtotal	6.0	10.0	6.0	9.0	0.0	0.0	0.0	31.0
II. Review Service Company Organization								
Analyze organization structure from management and accounting perspective	1.0	7.0	5.0	1.0	1.0	1.0	0.5	16.5
Evaluate accounting systems	0.5	4.0	2.0	1.0	1.0	1.0		9.5
Review budget and allocation procedures	1.0	18.0	12.0	3.0	3.0	1.0	2.0	40.0
Assess materiality and flow of service company charges	0.5	7.0	5.0	2.0	3.0	1.0	1.0	19.5
Subtotal	3.0	36.0	24.0	7.0	8.0	4.0	3.5	85.5
III. Review of the Internal Control Environment								
Determine the appropriateness of existing budgeting procedures	0.5	6.0	4.0	2.0	2.0	1.0	1.0	16.5
Review subsidiary participation in choosing its level of service	0.5	7.0	6.0	2.0	2.0	1.0	1.0	19.5
Assess utility incentives to control service company costs	1.0	2.0	4.0	2.0	2.0	1.0	1.0	13.0
Subtotal	2.0	15.0	14.0	6.0	6.0	3.0	3.0	49.0
IV. Assess the specific functions and services provided by service companies								
Evaluate the nature of services provided in each function to affiliates	0.5	4.0	3.0	3.0	3.0	2.0	1.0	16.5
Determine whether the methods of charging are appropriate	1.0	4.0	2.0	3.0	3.0	2.0	1.0	16.0
Assess whether affiliate charges are appropriate based on benefit received	0.5	3.0	2.0	3.0	3.0	2.0	1.0	14.5
Subtotal	2.0	11.0	7.0	9.0	9.0	6.0	3.0	47.0
V. Perform detailed review of processess used for charging affiliates for services								
Evaluate the pricing methods by function for directly charged services	0.5	1.0	1.0	7.0	7.0	3.0	3.0	22.5
Review allocation factor calculations	0.5	1.0	1.0	10.0	8.0	5.0	3.0	28.5
Determine appropriateness of existing allocation procedures	0.5	1.0	1.0	9.0	10.0	7.0	3.5	32.0
Review convenience payments and determine reasons for recent fluctuations	0.5	1.0	1.0	6.0	8.0	7.0	2.5	26.0
Develop thesis regarding service company charges	1.0	6.0	2.0	2.0	2.0	4.0	3.0	20.0
Quantify invalid service company costs and determine recommended adjusments	1.0	3.0	2.0	11.0	11.0	8.0	3.5	39.5
Subtotal	4.0	13.0	8.0	45.0	46.0	34.0	18.5	168.5
VI. Report Tasks								
Develop report	4.0	11.0	8.0	11.0	14.0	3.0	2.0	53.0
Review report with Department Staff and address comments	2.0	4.0	3.0	5.0	5.0	0.0	0.0	19.0
Subtotal	6.0	15.0	11.0	16.0	19.0	3.0	2.0	72.0
PROJECT TOTAL	**23.0**	**100.0**	**70.0**	**92.0**	**88.0**	**50.0**	**30.0**	**453.0**

OVERLAND CONSULTING

Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures
Case 10-M-0451

PROJECT TIME-LINE

PROJECT PHASE	TIME-LINE (2011-2012)									
Description	**Mar**	**Apr**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**2012**
Commence Audit/ Orientation (March 2011)	●									
Work Plan Review and Finalization (March-April 2011)	●	●								
Interviews and Site Visits			●	●	●					
Status Reports (monthly or as requested by Department Staff)	●	●	●	●	●	●	●	●	●	
Mid-Point Status Meeting (June 2011)				●						
Analysis			—	—	—	—	—	—	—	
Submit Draft Report (Sept 2011)							●			
Meetings to discuss draft report							●	●		
Final Report Briefings to PSC Commissioner/ Senior Department Staff								●		
Utility Written Comments								●		
Release Final Report									●	
Part Two, if necessary (dates TBD)										●

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OVERLAND CONSULTING **Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures** **Case 10-M-0451 (expanded NMPC - gas testing)** **COST PROPOSAL SUMMARY**	
Description	**Project Total**
Part One	
Total Professional Labor	$52,400
Out-of-Pocket Expenses	9,760
Not-to-Exceed Project Cost for Part One and Part Two	**$62,160**

OVERLAND CONSULTING Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures Case 10-M-0451 (expanded NMPC - gas testing) PROFESSIONAL LABOR BY CONSULTANT				
Consultant	**Role**	**Daily Rate**	**Days**	**Labor Cost**
H. Lubow	Project Director	$2,200	2	$4,400
R. Welchlin	Project/Technical Manager	1,680	10	16,800
R. Pfaff	Senior Consultant	1,200	26	31,200
Total			**38**	**$52,400**

OVERLAND CONSULTING

Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures

Case 10-M-0451 (expanded NMPC - gas testing)

OUT-OF-POCKET EXPENSES

Description	Qty	Price	Project Total
Travel costs			
Airfare (4 consultant trips @ $600)	4	$600	$2,400
Airport Parking & Mileage (4 consultant trips @ $140)	4	140	560
Hotel (20 consultant nights @ $160)	20	160	3,200
Per Diem (20 consultant days @ $50)	20	50	1,000
Car Rental (Rentals for 4 combined trips @ $400)	4	400	1,600
Other Miscellaneous Expenses			1,000
Total Out-of-Pocket Expenses			**$9,760**

All other direct costs are included in professional daily rates. A "trip" is one consultant for one trip. A "combined trip" is a cost to be spread over two or more consultants on the same trip

OVERLAND CONSULTING
Audit of National Grid's Affiliate Cost Allocations, Policies and Procedures
Case 10-M-0451 (expanded NMPC - gas testing)

LABOR MATRIX
PERSON-DAY ESTIMATES BY TASK AREA AND CONSULTANT

Task Areas	Howard Lubow Project Director	Robert Welchlin Project/Technical Manager	Ryan Pfaff Senior Consultant	Total
V. Perform detailed review of processess used for charging affiliates for services				
Evaluate the pricing methods by function for directly charged services		1.0	1.5	2.5
Review allocation factor calculations		1.0	6.0	7.0
Determine appropriateness of existing allocation procedures		1.0	1.5	2.5
Review convenience payments and determine reasons for recent fluctuations		1.0	2.0	3.0
Develop thesis regarding service company charges		1.0	1.0	2.0
Quantify invalid service company costs and determine recommended adjusments		1.0	9.0	10.0
Subtotal	0.0	6.0	21.0	27.0
VI. Report Tasks				
Develop report	1.0	3.0	4.0	8.0
Review report with Department Staff and address comments	1.0	1.0	1.0	3.0
Subtotal	2.0	4.0	5.0	11.0
PROJECT TOTAL	**2.0**	**10.0**	**26.0**	**38.0**

7. Experience and Qualifications of the Individuals and Firm

This section of our proposal provides a discussion of the experience and qualifications of Overland Consulting, a description of prior work relevant to the scope of the National Grid focused audit, our firm references, and our resumes. We strongly encourage Department Staff to contact our client references to discuss their satisfaction with our professionals and our firm.

Overland Consulting. We are a utility industry consulting firm comprised of accounting, financial, and management professionals. We provide finance, accounting, regulatory, and management consulting services to the electric, natural gas, and communications industries in the areas of utility finance, regulatory policy, rates and revenue requirements, and management issues. Our clients are primarily state public service commissions. Other clients include utilities, law firms, municipalities, and other governmental agencies.

***Extensive Regulatory Experience*.** Overland and the project team proposed for this audit have a well-grounded understanding of the regulatory process. The broad experience of the project team in conducting similar audits for state public service commissions has provided us with an appreciation for the perspective of regulators. Over the past twenty, members of our project team have participated in projects for public service commissions and state agencies in 18 states and the District of Columbia.

***Independent and Balanced Perspective*.** Overland's predominant client base has always been state public service commissions. Our state commission clients provide us the latitude to approach our audit analyses without bias or expectations of specific findings. Over our history as a firm, we have also had a number of major projects on behalf of industry clients. The combination of our commission and industry work gives us an independent and balanced view of industry issues in general, as well as the specific focus necessary for the National Grid audit.

***Relevant Firm Experience*.** Over the last twenty years, Overland has performed numerous focused audits of corporate costs and affiliate transactions for public service commissions throughout the United States. We have included four examples of recent analyses performed by Overland relevant to the proposed audit. These are attached as Exhibits 7-2 through 7-5. Below is a short contextual summary of the attached exhibits.

Exhibits 7-2 and 7-3 are public versions of testimony submitted by Mr. Welchlin on behalf of Maryland PSC Staff in 2009 and 2010 concerning the cost allocation procedures of Baltimore Gas and Electric (BGE). The testimony attached as Exhibit 7-2 analyzed the possible effects of cost allocation procedures at BGE due to a proposed asset sale by its parent.[1] The testimony attached as Exhibit 7-3 was performed in support of BGE's recent rate case proceeding.

Exhibit 7-4 represents a regulatory audit of California American Water Company's revenue requirement in 2009 forecasted test year revenue requirement that was prepared on behalf of the California Public Utilities Commission Division of Ratepayer Advocates. In 2010, Overland was retained by this division again in a similar capacity.

[1] This testimony discusses a multitude of issues. Mr. Welchlin's cost allocation analysis is primarily found on pages 2 through 19.

Exhibit 7-5 is a public version of an affiliate transactions and management audit performed on Atlantic City Electric for the New Jersey Board of Public Utilities. Overland has included the sections of this report most applicable to the proposed audit.

Firm References

Mr. Robert S. Tucker
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Public Service Taxation Division
1300 East Main Street
Richmond, VA 23219-3630
(804) 371-9172

Mr. Peter J. Crossett
Hiscock & Barclay, LLP
One Park Place
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(315) 425-2814

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Executive Director
Maryland Public Service Commission
6 St. Paul Street, 16th Floor
Baltimore, MD 21202-6806
(410) 767-8010

Mr. Steven S. Goldenberg
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Director, Financial Analysis Division
Kentucky Public Service Commission
211 Sower Blvd.
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(502) 564-3940 ext. 229

Project Descriptions

EPCOR Utilities – EDTI Cost Allocation Study

Overland was recently retained to perform a more detailed review of the EPCOR corporate cost allocation process as a result of a recent EDTI distribution utility rate proceeding. The Alberta Utilities Commission authorized a proceeding to exclusively address the corporate cost allocation issues. The findings of our review will be presented to the Commission in March 2011. Our work is being performed for the Commission through a law firm representing UCA on its behalf.

Client:	Reynolds, Mirth, Richards & Farmer, LLP
Client Contact:	Mr. C. Randall McCreary 3200, 10180 – 101 Street Edmonton, AB T5J 3W8 780-497-3348
Project Manager:	Robert Welchlin
Project Term:	November 2010-present

California American Water Regulatory Audit

Currently, Overland is conducting a regulatory audit and evaluation of California American Water Company's (CalAm) general office activities and costs, unregulated activities, cost allocation methods and affiliate transactions on behalf of the California Public Utility Commission's (CPUC's) Division of Ratepayer Advocates (DRA). The audit is to include a review of the 2012 forecasted test year cost estimates of CalAm's 2012 forecasted test year revenue requirement. CalAm is a subsidiary of American Water Works (AWW), the largest investor-owned water company in the United States. American Water Works Company, Inc. is listed on the New York Stock Exchange with the ticker symbol AWK. We are in the process of obtaining discovery and preparing an analysis of issues, with the goal of providing a technical report, testifying in hearings on the merits of CalAm's rate application and supporting the DRA Staff by developing cross examination and assisting in development of their initial and reply briefs. Major issues included projected test year forecasting techniques, particularly those surrounding customer service expense, staffing levels and incentive compensation; AWW's national and regional service company charges to California, including allocation methods; and AWW's lack of below-the-line accounting for the use of regulated resources by non-regulated activities;

Although the project will be performed for the DRA, Overland is approaching it as a regulatory audit. We will not serve as advocates for new policy. Rather, our work will focus on CalAm's compliance with existing CPUC policy and regulations and the consistency of CalAm's filing and forecasting methods with generally accepted ratemaking principles.

Client:	California Public Utilities Commission Division of Ratepayer Advocates 505 Van Ness Avenue San Francisco, CA 94102
Client Contact:	Danilo Sanchez Program Manager 415-703-2771 Joyce Steingass Senior Utilities Engineer 415-355-5532
Project Manager:	Howard Lubow
Technical Manager:	Robert Welchlin
Project Term:	August 2010 – Present

FirstEnergy / Allegheny
Merger Review

Overland was retained by the Maryland Public Service Commission to review the merger application in light of the statutory standard of review for mergers and acquisitions. Overland presented its analysis at hearings, representing staff's case on all policy and technical matters. In this context, Overland considered the, accounting, tax, financial, operations and rate implications of the proposed merger. The major considerations in the review were the level of synergy benefits anticipated by the merger; appropriate ring fencing provisions to be imposed; service standards that should be applied; and allocation of transaction benefits among stakeholders. A part of this review addressed the implications of the merger on corporate costs and corporate allocations. Hearings were held in November 2010, and the outcome of these proceedings in now pending.

Client:	Maryland Public Service Commission
Client Contact:	Greg Carmean Executive Director (410) 767-8010
Project Director:	Howard Lubow
Technical Managers:	Robert Welchlin Gregory Oetting
Project Term:	July 2010 – Present

Baltimore Gas and Electric Company
Review of Headquarters Cost Allocations

In 2009, CEG entered into an agreement with Electricite' de France (EDF) in which CEG's nuclear assets and operations were transferred to Constellation Energy Nuclear Group (CENG), a joint venture between CEG and EDF. Prior to the joint venture, CEG's nuclear assets, equity, employees and margins drew corporate support costs to nuclear operations and away from BGE in proportion to their size relative to the corporation as a whole. However, as part of the joint venture agreement, EDF negotiated a limitation on CEG corporate support costs that can be charged to CENG and attributed to nuclear operations. Overland reviewed these issues to determine the impact of the joint venture transaction on the allocation of headquarters costs to BGE, the utility.

In May 2010, the Maryland Public Service Commission Staff contacted Overland and requested that Overland extend an analysis of corporate support cost allocations. The objectives are to determine the impact of the CENG joint venture and related cost allocation agreements between CGE and EDF on corporate cost allocations to BGE, to determine whether CEG's corporate cost allocation and reporting procedures are reasonable, to identify deficiencies that may exist in current procedures, including the cost allocation manual (CAM), and to determine whether there are significant related issues concerning the corporate costs allocated to BGE in the most recent proposed revenue requirement filing.

Client:	Maryland Public Service Commission 6 St. Paul Street 6th Floor Baltimore, MD 21202-6806
Client Contact:	Gregory V. Carmean (973) 648-4643
Project Director:	Howard Lubow
Technical Manager:	Robert Welchlin
Completion Date:	June 2010 - October 2010

Public Service Electric and Gas Company Affiliate Transactions and Management Audit

Overland is currently conducting an affiliate transactions and management audit of Public Service Electric and Gas Company (PSE&G) on behalf of the New Jersey BPU. Phase 1 of the PSE&G audit includes affiliate relationships and transactions, allocations of cost from the service company (PSEG Services Corp.), power supplied by affiliated generating entities and adherence to the New Jersey Electric Discount and Energy Competition Act (EDECA). Phase 2 of the PSE&G audit includes a management review of executive management and corporate governance, customer service, finance and cash management, human resources, planning, accounting and property records, administrative support services and external relations.

Client:	New Jersey Board of Public Utilities Two Gateway Center Newark, NJ 07102
Client Contacts:	Dennis Moran Director – Audits (973) 648-7664 James Rekulak (973) 648-4516
Project Director:	Howard Lubow
Technical Managers:	Robert Welchlin Gregory Oetting
Project Term:	November 2009 – Present

Constellation Energy Group / Electricite de France
Nuclear Power Joint Venture

Overland was retained by the Maryland Public Service Commission staff to perform a review and submit testimony concerning Electricite de France's (EDF's) proposal to purchase 49.99 percent of the nuclear generating assets of Constellation Energy Group (CEG) and for the two companies to operate the assets as a joint venture. Overland performed extensive analysis and submitted testimony covering the following topics:

- Whether the joint venture would enable EDF to exercise "substantial control" over CEG and its utility subsidiary, Baltimore Gas & Electric (BGE),
- The joint venture's potential impact on CEG's and BGE's financial health and measures need to "ring-fence" BGE from the financial consequences of the joint venture and other non-regulated businesses,
- Corporate governance issues created by the joint venture,
- The costs and benefits of the joint venture to BGE customers,
- The impact of the joint venture and its financial consequences on the safety, reliability and adequacy of BGE's electric and gas operating business,
- The impact of the organizational changes on the allocation of shared support services costs between BGE and CEG's other businesses (nuclear generation, fossil generation and commodities),
- The income tax consequences of the joint venture, including tax benefits provided by the transaction and the impact of the joint venture on CEG and BGE pension plans.

Overland submitted several testimonies in the MPSC proceeding concerning the approval of the proposed joint venture.

Client:	Maryland Public Service Commission
Client Contact:	Greg Carmean Executive Director (410) 767-8010
Project Director:	Howard Lubow
Technical Managers:	Robert Welchlin Gregory Oetting
Project Term:	March –October 2009

Connecticut Natural Gas Management Audit

Overland was retained by the Connecticut Department of Public Utility Control to perform a management audit of Connecticut Natural Gas. Major audit areas included executive management, utility operations and field services, customer service, demand metering issues, credit and collections, finance, external relations, human resources, support services (legal, information services, facilities and transportation) and several special topics, including an analysis of cost allocations from two service companies (Utility Shared Services and Energy East Management Co.).

Our final report included 37 recommendations to the company, six of which related to customer service, field services and meter operations.

Client:	Connecticut Department of Public Utility Control 10 Franklin Square New Britain, CT 06051
Client Contact:	Robert Palermo Administrative Coordinator (860) 827-2760
Project Director:	Howard Lubow
Lead Consultants:	Robert Welchlin Gregory Oetting
Completion Date:	July 2010

Atlantic City Electric Affiliate Transactions and Management Audit

Overland performed an affiliate transactions and management audit of Atlantic City Electric (ACE) on behalf of the New Jersey BPU. Phase 1 of the ACE audit included affiliate relationships and transactions, allocations of cost from the service company (PHI Service Company), power supplied by affiliated generating entities and adherence to the New Jersey Electric Discount and Energy Competition Act (EDECA). Phase 2 of the ACE audit included executive management and corporate governance, utility operations and field services, customer service, finance and cash management, human resources, planning, accounting and property records, administrative support services and external relations.

The final report included 78 recommendations to the company.

Client:	New Jersey Board of Public Utilities Two Gateway Center Newark, NJ 07102
Client Contacts:	Dennis Moran Director – Audits (973) 648-7664

	James Rekulak
	(973) 648-4516
Project Director:	Howard Lubow
Managing Consultant:	Robert Welchlin
Completion Date:	February 2010

Verizon California Regulatory Audit

Overland completed a regulatory audit of Verizon California in 2008. The audit was ordered by the California Public Utilities Commission under its New Regulatory Framework (NRF). NRF audits were ordered to monitor the operations and financial results of California local exchange companies after they transitioned from strict cost-based regulation to rate flexibility in 1989. The audit scope included the financial and operating results of Verizon California for the years 2002 through 2004. It covered Verizon's compliance with CPUC accounting requirements, procedures to allocate costs between regulated and non-regulated activities, policies and rules for pricing transactions between Verizon California and its affiliated companies and the information filed in NRF monitoring reports. The audit determined that the financial results of Verizon California's regulated operations were generally consistent with the CPUC's accounting and NRF reporting requirements. However, the audit also found a significant disparity between the *intra*state earnings and rates of return on investment reported to the CPUC (earnings on telecommunications activity within the state) and the *inter*state earnings and rates of return reported to the FCC in the same periods (earnings from telecommunications between California and other states). We determined that a key reason for this was that certain FCC accounting rules, which dictate the jurisdictional classification of revenue and the jurisdictional allocation of telecommunications assets and operating expenses, had not been updated to reflect recent network usage trends.

Client:	California Public Utilities Commission
	Division of Ratepayer Advocates
	505 Van Ness Avenue
	San Francisco, CA 94102
Client Contact:	James Simmons
	415-703-3512
Project Director:	Howard Lubow
Technical Manager:	Robert Welchlin
Completion Date:	April 2008

California American Water Regulatory Audit

In 2008 Overland conducted a regulatory audit of California American Water Company's (CalAm's) 2009 forecasted test year revenue requirement on behalf of the California Public Utility Commission's (CPUC's) Division of Ratepayer Advocates (DRA). CalAm is a subsidiary of American Water Works (AWW), the largest investor-owned water company in the United States. During the historical test period AWW was a subsidiary of Thames Water, a British water concern and RWE, a German-owned multi-national utility holding company. We conducted discovery and an analysis of issues, provided a technical report, testified in hearings on the merits of CalAm's rate application and supported the DRA Staff by developing cross examination and assisting in development of their initial and reply briefs. Major issues included projected test year forecasting techniques, particularly those surrounding customer service expense, staffing levels and incentive compensation; AWW's national and regional service company charges to California, including allocation methods; AWW's lack of below-the-line accounting for the use of regulated resources by non-regulated activities; and conditions imposed by the CPUC relating to RWE's acquisition and subsequent divestiture of its interest in AWW.

Although the project was performed for the DRA, Overland approached it as a regulatory audit. We did not serve as advocates for new policy. Rather, our work was focused on CalAm's compliance with existing CPUC policy and regulations and the consistency of CalAm's filing and forecasting methods with generally accepted ratemaking principles. Most of our recommendations, despite opposition by CalAm, were adopted by the CPUC in its final order.

Client:	California Public Utilities Commission Division of Ratepayer Advocates 505 Van Ness Avenue San Francisco, CA 94102
Client Contact:	Danilo Sanchez Branch Manager 415-703-2771 Marcelo Poirier Staff Counsel 415-703-2913
Project Director:	Howard Lubow
Technical Manager:	Robert Welchlin
Completion Date:	December, 2008

Analysis of Kentucky's Incentives for Energy Independence Act

In 2007, the Kentucky General Assembly passed legislation, known as the Incentives for Energy Independence Act, that created various tax and financial incentives primarily aimed at entities that develop alternative transportation fuels, renewable energy, or energy efficiency projects. The Kentucky Public Service Commission requested an examination of existing statutes relating to its authority over public utilities concerning these matters. As part of this examination, Overland Consulting reviewed Kentucky's current statutes, regulations and policies governing integrated resource planning. The project resulted in twenty-eight recommendations to mitigate impediments to the development of appropriate demand-side management programs, energy efficiency, renewables, and new generation technology options available within the state.

Client:	Kentucky Public Service Commission 211 Sower Blvd. P.O. Box 615 Frankfort, KY 40602
Client Contact:	Aaron Greenwell Assistant Director – Division of Financial Analysis (502) 564-3940
Project Director:	Howard Lubow
Completion Date:	March 2008

Public Service Electric and Gas Company and Exelon Corporation
Merger Review

In December 2004, Public Service Electric and Gas Company and Exelon Corporation announced the execution of a merger agreement creating the nation's largest utility and power generator. The New Jersey Board of Public Utilities retained Overland Consulting to perform financial consulting services, including a review of the financial risks associated with the combined company; a review of corporate governance and senior management organization issues; a review of service agreements and affiliate transactions; a review of accounting, employee benefits, and tax matters; a synergy savings analysis; and a cost-benefit analysis.

As a result of the work performed, Overland submitted testimony before the New Jersey Board of Public Utilities. Exelon ultimately withdrew its merger offer, in the absence of reaching a satisfactory settlement with the parties to the New Jersey proceeding.

Client:	New Jersey Board of Public Utilities
Client Contacts:	Victor Fortkiewicz Executive Director Two Gateway Center Newark, NJ 07102 (973) 648-4852 Susan Vercheak, Attorney Deputy Attorney General Division of Law & Public Safety 124 Halsey Street P.O. Box 45029 Newark, NJ 07101 (973) 648-3510
Project Director:	Howard Lubow
Completion Date:	September 2006

Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas
Audits of Affiliate Transactions and Cost Allocations

Overland Consulting performed three separate audits (of Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas) for the New Jersey Board of Public Utilities (BPU). Each audit examined whether the Companies maintained a strict separation of risks, functions, and assets between their regulated affiliates (utilities) and unregulated affiliates (competitive service segments) to comply with BPU Standards. The audits reviewed the cost allocation methodologies used by each company and tested the actual amounts allocated between affiliates to determine if a cross-subsidization between the utility and the competitive service segments existed during the audit period.

The audits reviewed the impact on ratepayers of using utility resources to provide competitive services, the impact of competitive services on utility workers, and the impact of utility practices on the competitive services market. Overland also examined the applicability and implementation status of recommendations made during a previous audit of the Companies. The audits included a series of findings and related recommendations for each company.

Client:	New Jersey Board of Public Utilities Division of Audits Two Gateway Center Newark, NJ 07102
Client Contact:	Pat Salvemini (973) 648-2162
Project Director:	Howard Lubow
Project Manager:	Robert Welchlin
Technical Manager:	Gregory Oetting
Completion Date:	March 2003

AT&T Communications - *Affiliated Transactions*

AT&T underwent significant changes after the divestiture of its operating companies. In recent years, significant changes were made in its organizational structure. There were also significant external changes affecting the Company as well, including the implementation of access charges and federally mandated rules for the allocation of costs between regulated and non-regulated business activities. Our firm was retained by the New York Public Service Commission to perform management reviews of AT&T's affiliate relationships, internal control over access charge payments and relationship between its access cost and long distance service pricing.

Our review of affiliate transactions included analysis of AT&T subsidiary relationships from legal, functional, and cost accounting perspectives. We examined the nature of all major categories of transactions affecting the regulated communications subsidiaries. These included:

- lease of automotive and data processing equipment by AT&T Credit Corporation,
- sale of network assets by AT&T Technologies, and
- sale of communication products by AT&T Information Systems.

We also analyzed cost allocations from Bell Laboratories to AT&T Communications for research and development, and from the Corporate Headquarters for various administrative and management services. Additionally, we examined procedures governing the process of allocating the costs incurred by AT&T's End-user Organization to the Communications and Information Systems subsidiaries.

With respect to access charges, we assessed the controls over the payment of bills received for switched and special access service. We also reviewed organizations within AT&T with responsibility for designing and pricing AT&T's services to determine the key factors analyzed by AT&T in making pricing decisions.

Client:	New York Department of Public Service Three Empire State Plaza Albany, New York 12223 (518) 474-4268
Client Contact:	Howard Tarler Patrice O'Connor
Project Director:	Howard Lubow
Project Manager:	Robert Welchlin
Completion date:	1989

Syenergy Corp.

Overland was retained by this Midwest gas transmission holding company to develop a Cost Allocation Manual, establishing procedures for the allocation of corporate costs among its regulated (federal and state) and unregulated subsidiaries. The holding company, its utilities and unregulated affiliates adopted the Overland policies and procedures for internal accounting and audit purposes, as well as reflected in federal and state regulatory filings.

Client:	Syenergy Corp.; Kansas Pipeline Company 8325 Lenexa Drive, suite 400 Lenexa, KS 66214
Client Contact:	Mark Bolding, COO
Project Manager	Robert Welchlin
Completion Date	1999

New York Telephone
Focused Management Audit

Overland Consulting was retained to conduct an inventory study of New York Telephone's exchange and private line loop network. The New York Public Service Commission conducted several proceedings addressing the telephone company's rates. Questions remained at the end of the last proceeding regarding the accuracy of the company's inventory of customer loops, which is used in the rate setting process to divide costs among service categories. A significant contributor to the questions of inventory accuracy was the existence of several databases which contained loop information, each of which measured different sets of loop facilities in different ways. Overland Consulting was retained by the New York Department of Public Service to resolve these questions for the Public Service Commission.

Customer loops are telephone transmission facilities between customers and switching offices. Loop facilities are a major portion of telephone network in terms of cost. The New York Telephone databases containing loop information support a variety of functions, including billings, engineering, and maintenance of facilities. To address the Commission's concerns, our consultants designed the study to accomplish four important objectives.

1. Overland Consulting analyzed each database to determine those that were complete and accurate in terms of loop information.
2. Overland Consulting developed a theoretically sound method of counting loops and conducted the inventory.
3. Overland Consulting reconciled private line loops among the various databases which contain loop facility information, and explained the reasons for the difference.
4. Overland Consulting tested the accuracy of the billing database chosen for the loop count by comparing it to the physical telephone network.

The project posed some significant technical challenges. Among these were:

1. The design of software to standardize the format of circuit information for comparison between databases,
2. A method of systematically converting billing units to loop units, and
3. A method to verify the existence of database circuit information in the telephone network.

Using the information in these databases, Overland Consulting was able to conduct a theoretically sound and accurate loop inventory. By comparing the degree to which databases could be compared and the reasons preventing some circuits from being efficiently compared.

Client:	New York Public Service Commission
Client Contact:	Jim Lyons
	(518) 765-2300
	Howard Tarler
	(518) 474-4368
Project Director:	Robert Welchlin
Completion Date:	1991

Confidentiality

Overland understands that the nature of much of the information used in the audit is sensitive and confidential, and safeguarding this information is and always has been a priority for us. We accomplish this through several methods. We keep all confidential documents in a secure location during non-business hours, we do not reproduce confidential documents in any manner, and only authorized personnel have the ability to access the information. If requested, Overland will sign a confidentiality agreement with National Grid and the Department to provide assurance that we will safeguard proprietary information according to their security methods.

Resumes

Resumes detailing each team member's relevant experience and education are provided as Exhibit 7-1.

EXHIBIT 7-1

RESUMES

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HOWARD E. LUBOW
President

General

Mr. Lubow is President of Overland Consulting. He has more than thirty years of experience as a public utility consultant. His consulting engagements have encompassed a broad spectrum of management, finance and regulatory issues for electric, gas, water, pipeline, and telephone utilities. Recent project experience includes focused management audits, analysis of utility diversification and acquisition plans, prudence studies, accounting systems design, cost of service determination and allocation, utility property valuation, rate of return determinations and rate design issues. Mr. Lubow has testified in more than 100 regulatory and civil litigation proceedings and has testified in approximately 20 jurisdictions throughout the country.

Education

- Bachelor of Business Administration - Accounting, 1968, University of Missouri - Kansas City. Minor in economics.

- Graduate studies in quantitative and systems analysis, 1968-1970, University of Missouri - Kansas City.

Representative Experience

Electric and Gas

- Project manager in a management audit of Connecticut Natural Gas, and its parent Iberdrola USA. The audit scope included all significant functions of the company including a review of corporate governance and executive management, accounting and finance, conservation activities, and operations. A number of special topics were also addressed including: customer demand metering, billing determinates and billing procedures.

- Project Director in the review of the proposed merger of FirstEnergy and Allegheny on behalf of the Maryland PSC. Appeared as the lead policy witness, addressing financial, governance and rate issues implicit in the merger review. Proposed conditions necessary to comply with statutory criteria. Provided a set of ring-fencing conditions appropriate to maintain financial and governance policies necessary to protect Potomac Edison, the Maryland regulated utility under review.

- Project Director in the review of the proposed transaction between Constellation Energy and EDF involving, among other things, the sale of a 50% interest in Constellation's nuclear facilities. Lead witness on behalf of the Maryland Staff addressing various transaction issues including: impact on Baltimore Gas & Electric customers; corporate governance and financial implications; ring-fencing measures; and cost-benefit analysis.

- Project manager of the management audit of Atlantic City Electric, and its parent PHI Holdings. The audit covered a detailed review of the corporate governance, strategic planning, executive management, and finance functions. Other key areas of review included affiliate transactions, generation and transmission planning, and service quality and system reliability.

- Project Manager in the review of long-term financial projections prepared by Midland Cogeneration Venture Limited Partnership to be used in regulatory proceedings concerning proposed modifications to a power purchase agreement. The engagement included the sensitivity testing of major variables in the partnership's financial model.

- Project Manager in the review of accounting and finance issues raised by Connecticut utilities in connection with proceedings on long-term capacity measures. Addressed the implications of new generation facilities and DSM projects on regulated electric utilities.

- Project Director for a multi-disciplinary consulting team that reviewed the proposed Exelon / PSEG merger on behalf of the New Jersey Board of Public Utilities. Also the primary expert witness in areas of: finance and regulatory policy, responsible for analysis of the merger's financial impacts, in particular the impact on PSE&G, the New Jersey utility. Responsible for recommendations to insure that if the merger is approved, that the transaction price, terms and conditions are fair and reasonable in light of applicable standards for review, and that the New Jersey utility remains financially secure.

- Performed a financial and market feasibility study of a fiber optic network designed to provide SCADA requirements for a large multi-state electric utility interested in selling capacity to telecommunications carriers and high volume customers.

- Sponsored the overall development of utility revenue requirements, jurisdictional and class cost of service studies and rate design issues in numerous electric, gas, water and telecommunication cases throughout the country.

- Conducted an analysis of the adequacy of depreciation rates for a large independent telephone company located in Texas in order to assess the relationship of capital recovery in light of technological obsolescence.

- Directed and developed a two day training seminar for the Kentucky Public Service Commission addressing energy and telecommunications issues raised in rate filings, and utility planning and forecast models required in considering the use of projected test year data.

- Supervised and directed a group of PSC Staff members in the review of a rate filing relying upon the use of a projected test year.

- Directed a comprehensive financial and regulatory base period audit of a large gas transmission and distribution company in connection with implementation of an incentive regulation plan. Reviewed savings resulting from force reductions of 1,200 employees and implementation of aggressive cost reduction programs.

- Performed a study of an LDC's gas supply and transportation procurement practices in a post Order 636 operating environment, where the LDC's transportation and supply services continued to be provided by affiliated companies. The parent reorganized its pipeline transmission and gas supply services into a separate company, transferring jurisdiction from state regulators to the FERC. Developed a model to quantify an optimal supply and transportation mix for state ratemaking purposes.

- Performed a review of intrastate pipeline issues including the use of a straight fixed-variable cost methodology; regulatory treatment of stranded costs; pipeline competition issues; and the merits of a corporate restructuring and related effects on cost of service and changes in corporate operations.

- Developed a revenue requirement analysis of an intrastate gas transmission pipeline company addressing issues including: proper recognition of net operating loss carryforwards for ratemaking purposes; treatment of deferred start-up costs; application of criteria for consideration of acquisition premium in rates; and the recognition and relationship of financial criteria in the ratesetting process.

- Directed a comprehensive review of the $850 million PG&E gas transmission pipeline expansion project. This study included a review of regulatory considerations in recognizing construction and operating costs in light of competition in the California pipeline markets, and based upon the Commission intended allocation of risks among regulated customers, project shippers and the pipeline owner.

- Directed a review of gas procurement policies and procedures, and addressed the impact of FERC Order 636 for three Wyoming LDC's. This study addressed the relationship of gas pipeline and LDC affiliate organizations associated with the gas supply and transportation functions, and the impact of the affiliated organizational structures on gas prices measured against other utilities in the region.

- Reviewed impacts of FERC Order 636 on gas utility distribution companies including staffing and other operating requirements, changes in gas procurement and storage policies, and effects on marketing plans. Also reviewed various pipeline compliance filings, analyzing impacts on firm and non-firm customers.

- Reviewed electric and gas utility fuel procurement policies and procedures, organization and internal controls in various engagements. Developed recommendations resulting in significant benefits to utilities under review.

- Performed fuel audit investigations in several jurisdictions addressing such issues as economic dispatch procedures, fuel acquisition policies, affiliated mine or pipeline operations, captive mine development and compliance with Commission rules and regulations. These studies included the review of prices and returns produced from affiliated operations vs. third-party options and market prices available.

- Reviewed gas supply issues including procurement policies, supply mix, affiliate transactions, and contract provisions in the context of both cost of service and management review proceedings. Provided policy analysis regarding considerations and benefits of increased gas supply and pipeline competition.

- Participated in three FERC interstate pipeline rate proceedings addressing cost of service issues, including appropriate classification and allocation methodologies. Also addressed construction costs, overhead, and pipeline operations issues in a major oil pipeline docket.

- Performed a detailed analysis and presented testimony regarding the relative economic benefits of the operation of a LNG plant vs. meeting seasonal peak demands through pipeline contract commitments.

- Developed gas transportation pricing criteria and implementation guidelines in the development of tariff service offerings for several gas LDC's.

- Developed numerous gas cost service studies, and related rate design recommendations for local distribution companies, as well as pipeline suppliers. Testimony regarding such studies was presented before various state commissions, as well as the FERC.

- Responsible for gas distribution company revenue requirements in over twenty-five cases, addressing accounting, cost allocation, operations, and rate design issues. These cases generally included an analysis of gas production, gathering, and transmission systems owned by the LDC parent.

- Developed a damages model for a gas utility in civil litigation arising from acquisition of a defective distribution system caused by improper installation practices. Measured incremental construction and operating costs associated with pipe replacement program.

- Developed a risk analysis model used to associate the relationship between cost recovery and changes in class consumption patterns for a gas distribution company.

- Developed a quantitative model to estimate jurisdictional and class-peak consumption for distribution gas companies.

- Performed an overview of regulatory considerations in the oversight of holding company formations and operations. This project was conducted on behalf of a PUC to analyze issues associated with holding company formations, utility diversification, and affiliated interest oversight and controls. The four largest electric utilities in the state were included in the study. The final report covered policy issues, as well as more detailed discussions of monitoring procedures and recommended filing requirements.

- Developed diversification guidelines for utilities in several jurisdictions. Addressed regulatory concerns and limits that might be implemented to control contingent adverse consequences to utility ratepayers.

- Performed an overview of regulatory considerations in the oversight of holding company formations and operations. This study addressed appropriate regulatory guidelines and oversight policies for utility and nonutility operations.

- Directed reviews of two major utility subsidiary gas intrastate pipeline systems, addressing cost of service, operating issues, and appropriate accounting for overheads and affiliated transactions from regulated electric utility parent companies.

- Developed a financing plan and reorganization of corporate structure for an electric utility having gas properties and a separate gas subsidiary. This project included preparation of SEC U-1 filings, filings with regulatory agencies and testimony to address the impact of the proposed financing and reorganization on cost of capital and rates.

- Responsible for the independent analysis of the feasibility and economics of consolidation of two major electric utilities. The project focused primarily on the quantification of merger benefits associated with consolidated operations. This in-depth twelve-month study also included a detailed review of the scope of services and basis of pricing such services among affiliates. The study addressed a number of affiliate interest issues including: the basis of pricing and level of capacity and/or energy supplied by affiliate vs. third-parties; the services provided by an affiliate "service" company vs. internal resources or purchases from third-parties; and the consideration of management resources devoted to non-utility functions and the basis of compensation for such resource transfers.

- Reviewed American Electric Power System Agreement to assess the reasonableness of fuel and purchased power costs incurred and allocated to its utility operating companies. The analysis also considered system dispatch and related fuel accounting issues associated with energy requirements of regulated customers versus wholesale transactions.

- Responsible for the development and implementation of phase-in plans utilized to defer initial costs of new generation facilities. Developed assessment criteria and related models to assign capacity from new plant additions between jurisdictional and nonregulated service.

- Developed and conducted a training program on the measurement of relative and absolute fuel productivity measures in ranking utility's effectiveness in fuel procurement and generation system operations.

- Developed a framework for implementation of competitive pricing for an electric utility facing higher costs due to nuclear plant additions. The analysis also encompassed an incentive rate program designed to induce greater use of excess capacity, as well as to improve the utility load factor.

- Analyzed and implemented economic dispatch models used to evaluate the effects of changes in generation capacity and fuel use.

- Conducted several comprehensive nuclear management and prudence reviews addressing construction, management, planning and economics issues.

- Directed a two-year study of the impacts on and options available to an electric utility due to the abandonment of a nuclear plant near completion. Presented a workout plan to regulators. Study involved a five-year forecast of financial results including construction expenditures and operating costs.

- Developed commercial operation date criteria and guidelines for nuclear power plants, which were supported by a national industry survey.

- Developed a financial analysis of a major municipal utility facing an extended outage of its nuclear power plant, with alternative pricing strategies, recognizing competitor pricing in adjacent service areas. Developed multi-year cost of service and revenue requirements models, and presented results to the Utility Board.

- Responsible for the development of budget and forecast models for a major municipal water utility in the Midwest.

- Performed studies for municipalities to determine the feasibility of acquiring street lighting facilities, or in the alternative, pricing options other than PSC regulated tariffs.

- Conducted an industry survey of the effectiveness and relative benefits achieved from the use of uniform filing requirements in utility rate applications. The findings were published and distributed to the utility industry and regulatory commissions.

- Developed class cost-of-service studies including identification of direct assignments and review of distribution facilities, methodologies and criteria for the allocation of generation and bulk power facilities, and risk differentials associated with various classes of service.

- Project director of a review of Kentucky current statutes, regulations and policies governing integrated resource planning. The project addresses recommendations necessary to mitigate impediments to the development of appropriate demand-side management programs, energy efficiency, renewables, and new generation technology options available within the state.

- Project manager of a regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions.

Valuation

- Conducted a feasibility study regarding the sale of a utility power plant used to provide steam heat and process steam to commercial customers through a downtown area distribution system. The feasibility study addressed energy alternatives and pricing options; cogeneration; and a financial and operating forecast assuming alternative case scenarios based upon various potential ownership structures.

- Performed a valuation analysis on behalf of an investor group for the construction and operation of a high capacity fiber network between Seattle and Vancouver, designed to serve large commercial companies and telecommunications providers. Provided due diligence analysis of market demand and pricing assumptions, competition, and anticipated construction and operation costs.

- Performed a valuation analysis of an electric utility on the southwest on behalf of a private investor group interested in making a tender offer for the shareholder interests of this public company. Also participated in presentations to investment bankers and commercial banks who were to fund the acquisition.

- Performed a valuation study regarding two natural gas distribution affiliates in the Midwest, whose electric utility parent was seeking offers for a sale of the assts and related securities. Developed analysis of the impact of regulation on property values.

- Performed a valuation analysis of a gas transmission company used to evaluate offers for the company. Developed due diligence and information materials provided to interested parties. Participated in presentations to interested parties with investment bankers.

- Developed a valuation analysis used in litigation proceedings to support the reasonableness of the acquisition price for a rural electric company acquired by an investor owned electric utility company.

- Developed and applied a model for the determination of the value of helium extracted from natural gas relied upon in litigation cases in federal courts in Oklahoma and Kansas. Analysis required the determination of extraction costs at plants involving four major pipeline systems in the Midwest. Developed studies of construction and operating costs associated with helium extraction plants, as well as the analysis of incremental costs and revenues related in by-product liquid extractions.

- Performed an analysis of the value of long-term gas transportation contracts relied upon in civil litigation and by regulators. The studies included the development of construction cost and operations estimates, as well as discount rates to be employed.

- Performed a reproduction cost study for a cable television company located in the west. As part of the project, developed a continuing property records system. Company used results in the negotiation of the sale of its assets.

- Represented a member of a consortium formed to build a satellite network for cellular services with commercial applications throughout the United States. Developed a valuation analysis and business plan used in a private placement for equity financing. Acted as a co-investment advisor with a large Wall Street firm in providing these services and making presentations to potential investors.

- Developed a valuation analysis of nuclear facilities, which included a detailed study of assets, and their costs, required for environmental protection as defined by state statutes and federal regulations. The study was relied upon in determining the proper classification and valuation of nuclear assets for property tax purposes.

- On behalf of a state department of revenue, developed a review of property tax rules and definitions as applied to telephone, cellular and cable companies. The study included a national survey of valuation practices relied upon by each state department of revenue.

- Developed appraisals of telecommunications properties for property tax purposes using standard valuation methods. Presented studies in administrative and civil proceedings. Developed cost of capital analysis based upon applications of the DCF and CAPM models.

- Developed appraisals relied upon in property tax cases involving telecommunications properties where subject sales were involved within two years of the date of property assessment.

- Prepared appraisals for a natural gas transmission company in appeals of property tax assessments in administrative proceedings in Kansas and Oklahoma.

- Prepared appraisals of two investor owned utilities on behalf of the Iowa Department of Revenue. The appraisals included a subject sale analysis, and a review of economic obsolescence.

- Developed appraisals of two Class I railroad companies in contested property tax valuation in civil proceedings in New York. Valuation studies included the review of the cost method based on RCNLD.

- Assisted an electric G&T coop in valuation and due diligence analysis of electric and gas properties offered for sale by a large independent telephone company.

- Developed a manual for “Alternative Valuation Procedures” on behalf of the Virginia State Corporation Commission – Public Service Taxation Division in a state that otherwise relies on the cost method.

- Developed a business plan and other financial advisory services to the National Homebuilders Association joint venture subsidiary – “Smarthouse”; in connection with securities offerings.

- Developed a complete appraisal of a cogeneration facility on behalf of the Virginia State Corporation Commission, Public Service Taxation Division. The study included “Subject Sale” and “Comparable Company” analyses, as well as a review of capacity and energy forecast prices in the PJM market area.

- Prepared a complete appraisal of CSX railroad operating property on behalf of the Florida Department of Revenue.

- Prepared a complete appraisal of Qwest Corporation on behalf of the Iowa Department of Revenue. The appraisals included “Subject Sale” and “Comparable Company” market analyses.

Telecommunications

- Developed and directed a three-day nationally attended conference entitled "Competitive Strategies in the Local Exchange Marketplace".

- Directed audits of RBOCs regarding compliance with regulatory accounting requirements; procedures to allocate costs between regulated and non-regulated activities; policies and rules for pricing transactions among affiliates; and monitoring reports filed with regulators.

- Conducted a review of depreciation rates for local exchange telecommunications property of the central division of a national carrier.

- Directed a comprehensive review of the operation of a RBOC telecommunications incentive plan, based upon a revenue sharing mechanism, over a three-year period. The study reviewed quality of service measures, capital expansion programs, work force reductions, and other major elements of operating expense for the review period. Provided policy options regarding modifications to the incentive plan for prospective consideration.

- Developed business plan and other related materials for telecommunications reseller in its initial public offering. Provided ongoing financial and regulatory services, including development of all SEC filings.

- Directed an analysis of switching and other LEC facilities required and costs of providing inter-exchange services to an alternative service provider in the Phoenix, Arizona area.

Publications and Presentations

- "The Use of Uniform Filing Requirements by State Regulatory Commissions - An Industry Survey," May 1980.

- "Regulatory and Accounting Implications of Phase-in Plans," NARUC Biennial Regulatory Information Conference, September 1984.

- "Rate Moderation Plan Considerations" Public Utilities Accounting and Ratemaking Conference, sponsored by the Texas Society of CPAs, April 1985.

- "Review of The Proposed Amendment to FASB Statement No. 71," Presentation to the Financial Accounting Standards Board, June 1986.
- "Regulatory Implications Associated with the Prudence Audit Process," NARUC Biennial Regulatory Information Conference, September 1986.
- "On the South Texas Project and Other Cases," The Advisory, March 4, 1987.
- "Regulatory Considerations Inherent in Assessing Utility Culpability" (Richard Ganulin coauthor), Public Utilities Fortnightly, 1987.
- "Framework for a Competitive Strategy," Southeastern Regional Public Utilities Conference, Atlanta, GA, September 1988.
- "Competitive Strategies in the Local Exchange Marketplace," a three-day telecommunications conference sponsored by Overland Consulting and the University of Missouri at Kansas City, September 1991.
- "Considerations Associated with the Review of Rate Applications Based Upon Projected Test Periods," a two-day training seminar conducted on behalf of the Kentucky Public Service Commission, December 1992.
- "Impact of Deregulation and Competition On Property Tax Valuation Within the Utility Industry," Western States Association of Tax Administrators, Austin, Texas, September 1995.
- "Appraisers Find Help in Recent Accounting Rules" (Gregory Oetting, coauthor), Fair & equitable, August 2003.
- "Blue Chip Method Overview", 21st Conference of Unit Value States; Memphis, Tennessee, October 2004.
- "The Yield Capitalization Method – Application Issues", WSATA Unitary Appraisal School, Advanced Class – Logan, Utah, January 2007.
- "Overview of FIN 46(R), SFAS No. 133, and SFAS No. 71," (Gregory Oetting, co-presenter), Connecticut Department of Public Utility Control, May 2007.
- "Accounting and Finance Issues Associated with Contracts for Differences-Generation/DSM Projects" (Gregory Oetting, co-presenter), Connecticut Department of Public Utility Control, September 2007.
- "Accounting Pronouncements Impacting Financial Reporting Associated with Utility Purchase Power Agreements", WSATA Unitary Appraisal School, Advanced Class, Logan, Utah, January 2008.
- "Rating Agencies – Current Methods Employed and Recognition of Imputed Debt", WSATA Unitary Appraisal School, Advanced Class, Logan, Utah, January 2008.

Consulting Work History and Industry Experience

1991 - Present: **Overland Consulting**
President. Responsible for administration and review of management auditing, regulatory consulting, and litigation support services. Provide expert witness services in projects involving decision analysis, damages assessment, ratemaking, valuation, and accounting.

1997 – 1999 **Kansas Pipeline Company**
Executive Vice-President; Chief Operating and Financial Officer. Responsible for the day-to-day operations of this natural gas pipeline, as well as direct responsibilities associated with the financial, accounting, and regulatory functions of the Company. Implemented a reengineering and downsizing program that resulted in a major reduction in operating expenses. Negotiated new gas supply and transportation contracts. Renegotiated credit lines on more favorable terms. Responsible for the negotiation and acquisition of a natural gas marketing company. Developed and implemented a management incentive program for senior executives. Developed due diligence and presentation materials relied upon by potential buyers of Kansas Pipeline assets.

1990 – 1991 **Amerifax, Inc. (Americonnect)**
Chief Executive Officer. Directed the IPO for this telecommunications switchless rebiller. The company implemented a national marketing program, focusing primarily in the Midwest. After five years, the company was acquired for approximately three times its IPO valuation.

1983 - 1991: **LMSL, Inc.**
President. Responsible for administration and review of regulatory services projects and research studies. Expert witness in regulatory proceedings. Director of special projects including management audits, financing feasibility studies, property acquisition and merger feasibility studies and development of innovative solutions to current regulatory issues.

1976 - 1982: **Drees Dunn Lubow & Company**
Managing Partner. Responsible for projects for utility clients. Responsibility included financial and managerial analysis of public utility companies and the presentation of expert testimony before regulatory commissions.

1972 - 1976: **Troupe, Kehoe, Whiteaker & Kent**
Senior Regulatory Consultant. Responsible for special services work for utility clients, including accounting systems design, cost of service determination and allocation, budgeting and rate designs. Performed fair value determinations, developed cost

analysis studies, curtailment requirements analysis, and forecasts of utility operations.

1968 - 1972: **Kansas City Power & Light Company**
Senior Accountant. Analyzed accounting and reporting procedures, taxes and costs of operations. Assisted in the preparation of the Federal and State income tax returns and the Annual Report to stockholders. Assisted with rate filings in Kansas and Missouri. Developed tax basis property accounting system.

ROBERT F. WELCHLIN, CPA
Senior Manager

General

Regulatory consultant to the telecommunications, cable, electric and gas industries. Manage operational, financial and regulatory audits, reviews of rate filings and cost studies in the energy utility, telecommunications and cable industries. 30 years of industry experience.

Education

- Master of Business Administration, St. Edwards University
- Bachelor of Science, Accounting and Business Administration, Eastern Illinois University,

Representative Experience

Electric and Gas

- FirstEnergy's Acquisition of Allegheny Energy – Project Lead In charge of the review of the merger synergies and the likely impacts of the merger on Potomac Electric Maryland service company cost distributions. This work was on behalf of the Staff of the Maryland Public Service Commission (2010), Calculated the discounted cash flow value of net regulated synergies attributable to Potomac Maryland customers. Recommended post-merger review of the impact of allocation procedures on regulated Maryland utility operations (2010).

- Connecticut Natural Gas Management Audit – Participated as a Technical Manager in a diagnostic management audit of CNG for the Connecticut Department of Public Utility Control. Areas of responsibility included transactions with and services exchanged with Southern Connecticut Gas, Energy East and other affiliates, human resources (staffing, compensation, labor relations and performance appraisal processes), customer service and call center operations, dispatch, field operations and appliance services, meter operations, distribution sales and marketing, supply chain management, fleet operations, facilities management, security and external relations. (2010)

- Constellation Energy / Electricite de France Joint Nuclear Venture – Reviewed and provided testimony concerning the potential impact of the proposed CE / EDF joint nuclear venture, CENG, on corporate and other centralized costs allocated to CE's regulated utility subsidiary, Baltimore Gas & Electric. (2009)

- Atlantic City Electric Affiliate Relationships and Management Audit – Participated as a Technical Manager in an affiliate relationships and management audit of Atlantic City Electric, a subsidiary of Pepco Holdings, Inc. (PHI) on behalf of the New Jersey Board of Public Utilities. Areas of responsibility included allocations of corporate and shared utility costs from PHI Service Company, transactions with affiliates including Atlantic Southern Properties and Millennium Account Services, compliance with New Jersey's Electric Discount and Energy Competition Act (EDECA), and the management of various functions, including information technology, fleet, stores and supply chain, security, facilities, real estate and records management. (2009)

- Exelon / PSEG Merger – Assisted the New Jersey Board of Public Utilities in review of the proposed merger of Exelon (Commonwealth Edison, Pennsylvania Energy) with PSEG (Public Service Electric & Gas). Responsible for the review of the impact of combining the two holding companies' service companies (the companies that provide managerial, technical and administrative services to associated companies) on the New Jersey genco and utility. (2005-2006)

- Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas Regulatory Audits – Project Manager for audits of the affiliate relationships and cost allocations of Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas conducted on behalf of the New Jersey Board of Public Utilities (BPU). The audits examined whether each Company maintained a strict separation of risks, functions, and assets between their regulated utilities and unregulated affiliates to comply with BPU Standards. The audits also documented each Company's cost allocation methodologies and results for a two-year period. (2002-2003)

- Sempra Energy – Project Manager for a review of the costs of Sempra Energy's holding company. The review, conducted on behalf of the Utility Consumer Action Network (UCAN) was a part of the review of Sempra Energy's rate application with the California Public Utilities Commission (A.02-12-027 and A.02-12-028). (2003) Performed a similar review in the subsequent rate applications of subsidiaries, San Diego Gas & Electric Company and Southern California Gas Company (A.06-12-009 and A.06-12-010). (2007)

- Kansas Pipeline Company - Directed the cost of service component of the initial FERC "Section 7" cost of service and base rate filing of Kansas Pipeline, which had been exempt from FERC rate regulation prior to 1997. Submitted and defended testimony on behalf of Kansas Pipeline before the FERC covering the overall cost of service filing, the historical basis for the calculation of acquisition premium and company's test year operations and maintenance expenses (1998 – 2000).

- Pacific Gas and Electric 1999 General Rate Case - Reviewed projected test year administrative and general expense levels and allocation of costs between the utility and affiliates. Submitted and defended testimony on behalf of the California Public Utilities Commission (1998).

- Pacific Gas and Electric Audit of Inter-Company Relationships and Transactions - Managed an audit of PG&E's compliance with regulatory requirements and internal control over relationships and transactions between the utility and its unregulated affiliates on behalf of the California Public Utilities Commission. (1998).

- Southern California Gas Performance Based Ratemaking (PBR) Filing - Conducted a review of 1994 and 1995 base margin costs. Submitted testimony on behalf of the California Public Utilities Commission. Issue areas included operations and maintenance expenses, corporate allocations, employee and executive compensation, post-retirement benefits, and savings from restructuring and force reduction programs (1996).

- Missouri Gas Energy Rate Case - Submitted cost of service testimony on behalf of Mid-Kansas Partnership and Riverside Pipeline, L.P. in connection with Missouri Gas Energy's base rate filing. Issues included deferred gas safety costs, merger-related savings and weather normalization (1996).

- Western Resources / Kansas Power and Light Rate Case - Conducted a rate case audit and submitted and defended cost of service testimony on jurisdictional cost allocations, operations and maintenance expenses and pension expenses on behalf of the Kansas Corporation Commission (1992).

- Montana Dakota Utilities and Mountain Fuels - Conducted focused management audits of the gas supply operations of two western local distribution utilities for the Wyoming PSC. Assessed the management and organization of each company as it related to gas supply, the degree to which supply options were optimized, the potential impact of FERC Order 636, and the relationships between the LDCs and their pipeline and production affiliates (1992).

- Big Rivers Electric Cooperative - Reviewed fuel receiving and inventory policies and coal contract terms in connection with a focused management audit of fuel procurement for the Kentucky PSC. (1993).

- Illinois Power Company (Illinova) - Performed internal operational audits of nuclear and fossil fuel procurement, natural gas procurement and delivery, various corporate, power plant and service area operations, and nuclear plant construction contracts. (1980 to 1983).

Telecommunications

- Frontier (Citizens) Telecommunications Regulatory Audit - Directed a California statutory regulatory audit of Citizens' California PUC financial reporting and shareable earnings, including transactions between Citizens, its Connecticut-based parent company and its affiliates. (2004-2005).

- Pacific Bell Regulatory Audit – Directed a California statutory regulatory audit of Pacific Bell's California PUC financial reporting, including transactions between Pacific Bell, its parent company (SBC) and its affiliates and subsidiaries. (2001-2002).

- Roseville Telephone Regulatory Audit - Directed and conducted a regulatory audit of the company's compliance with affiliate and non-regulated activity transaction rules and reviewed the company's calculation of earnings shareable with customers under the California PUC's New Regulatory Framework rules. Submitted and defended testimony on the audit on behalf of the CPUC (1999- 2000) Performed a followup audit of 2001-2003 regulated earnings (2004).

- New York Telephone Loop Study - Directed a study of NYT's subscriber loop network. Coordinated the effort of a multi-disciplined team that included regulatory, network operations, engineering and data processing specialists. The major work products included an inventory of subscriber facilities, determination of facility utilization in different geographic regions, determination of the relative accuracy of the major databases containing network facility information, and verification of billing records with installed facilities (1991).

- AT&T Review of Affiliate Transactions - Conducted a review of the affiliate management and accounting relationships among the subsidiaries of AT&T. Documented significant transactions and allocations through the AT&T organization that affected AT&T Communications. Examined policies and procedures that affected the Communication subsidiary's decision to use internal sources of supply and the corporate entity's allocation of costs to subsidiaries (1990).

- Bay Area Teleport - Conducted a review of the impact of local exchange carrier price flexibility on competitive access in California (1988).

- GTE - Analyzed Indiana local exchange rates and developed a computer model to distribute the carrier's revenue requirement over a matrix of local services and rate groups (1989).

Water

- California American Water Company Regulatory Audit and Rate Case – Twice technical Manager for the regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions. Submitted revenue requirements testimony covering CalAm's projected test years covering the O&M expenses of functions allocated from the national, regional and state levels to the district operations for which CalAm was seeking an increase in rates. (Two rate case cycles (2008-2010 GRC, work performed in 2008 and 2011-2013 GRC, work performed in 2010-2011).

Cable

- Late Payment Costs - Analyzed costs imposed on cable systems by late-paying customers and prepared studies to quantify the additional costs of handling past due accounts. (1995 through 2001).

- Cost of Service (Revenue Requirements) – The rates of most US cable systems were "re-regulated" for a time during the 1990s. Cable systems could choose two forms of regulation, one price-based (limiting rates to existing prices plus inflation) and one cost of service-based, based on traditional historical test year ratemaking principles. Analyzed cable system costs and prepared cost-of-service rate studies for cable companies, including two of the nation's largest cable systems (TCI Chicago and DCLP). Developed cost-of-service methodologies to properly account for affiliate relationships and corporate and divisional cost allocations to the cable systems. Analyzed incremental cost of service under FCC Form 1235 rules for a group of systems calculating the revenue requirement impact of upgrading system capacity upgrades (1994-1998).

- Franchise Issues - Developed financial models to determine the financial and potential rate impact of franchise requirements for system upgrades and rebuilds. In 1997, coordinated the financial aspects of a franchise proposal submitted by the Company by a California local franchise authority (1995 and 1997).

- Programming Costs - Developed a database application to calculate programming cost increases on a cable-system basis to comply with FCC requirements (1994).

Work History

1996 - Present: **Overland Consulting**
Senior Manager. Plan, supervise and perform telecommunications and energy industry consulting projects, including audits, on behalf of public utility commissions and other government agencies.

1993 - 1996: **KPMG Peat Marwick LLP**
Senior Manager. Information, Communications and Entertainment Line of Business. Developed and managed cable TV, and telecommunications and industry consulting engagements.

1987 - 1993: **LMSL, Inc., Overland Consulting**
Manager. Conducted audits of energy and telecommunications companies; sponsored testimony in regulatory proceedings. (LMSL is a predecessor firm of Overland Consulting).

1984 - 1986: **Public Utility Commission of Texas**
Senior Staff Accountant. Reviewed electric, telephone and water utility rate and regulatory filings and sponsored cost of service testimony in rate hearings.

1980 - 1983: **Illinois Power Company**
Senior Internal Auditor. Planned, directed and performed operational and financial audits of the company's headquarters departments, power stations and service offices. Prepared the annual department operating plan and drafted the report to the Audit Committee of the Board of Directors for approval by the Director of Internal Auditing. Coordinated work with external auditors.

Certifications

Illinois CPA Certificate No. 31763, University of Illinois, February 18, 1982.
Kansas CPA Certificate No. 9821
Kansas Practice Permit No. 3349
Member, American Institute of CPAs

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GREGORY S. OETTING, CPA
Senior Manager

General

Regulatory consultant to the electric, gas, and telecommunications industries, Mr. Oetting has experience in financial and regulatory reviews, management audits, and valuations. His regulatory and management audit experience includes reviews of cost allocation methodologies, compliance with competitive service standards, and internal controls. Mr. Oetting has also been involved in the valuation of several utilities and railroads in which industry cost of capital was analyzed. Mr. Oetting has nearly twelve years of regulated industries' consulting experience, three years of experience as an auditor in a national CPA firm, and three years of experience as a controller of an interstate natural gas pipeline.

Education and Professional Certification

- Bachelor of Science degree in Accounting and Business Administration, University of Kansas, May 1987
- CPA Certificates in Kansas and Missouri
- Kansas CPA permit #3602

Experience

- Lead consultant in the evaluation of the acquisition of Allegheny Energy Inc. by FirstEnergy Corp. This work was performed for the Staff of the Maryland Public Service Commission. Provided testimony on various subject matters, including the merger accounting, money pool, and credit ratings (2010).

- Technical manager in the management audit of Public Service Electric & Gas Company for the New Jersey Board of Public Utilities. Responsible for analyzing executive management and corporate governance matters, customer service, accounting, cash management, and finance (2009-present).

- Technical manager in the diagnostic management audit of Connecticut Natural Gas Corporation for the Connecticut Department of Public Utility Control. Areas of responsibility included finance, accounting and internal controls, executive compensation, system design, planning, and construction (2009-2010).

- Lead consultant in the review of the impact on Baltimore Gas and Electric Company of the proposed merger of its parent, Constellation Energy Group, with EDF. This work was performed on behalf of the Staff of the Maryland Public Service Commission. Provided testimony on subject matters relevant to the public interest criteria, including costs associated with the transaction, credit ratings, cost of capital, and liquidity (2009).

- Technical manager in the management audit of Atlantic City Electric Company for the New Jersey Board of Public Utilities. Analyzed various matters including accounting and property records, cash management, financing, customer service, and support services (2008-2009).

- Participated in the regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions (2008).

- Participated in the review of long-term financial projections prepared by Midland Cogeneration Venture Limited Partnership to be used in regulatory proceedings concerning proposed modifications to a power purchase agreement. The engagement included the sensitivity testing of major variables in the partnership's financial model (2008).

- Participated in the review of Kentucky current statutes, regulations and policies governing integrated resource planning. The project addresses recommendations necessary to mitigate impediments to the development of appropriate demand-side management programs, energy efficiency, renewables, and new generation technology options available within the state (2008).

- Technical manager in the review of the General Rate Case Applications of San Diego Gas & Electric Company and Southern California Gas Company on behalf of the Utility Consumers' Action Network. Analyzed the shared utility services of both companies (2007).

- Technical manager in the regulatory audit of Verizon California. Analyzed the financial reporting of the Company in accordance with California Public Utilities Commission rules and requirements (2006-2007).

- Technical manager in the review of accounting issues raised by Connecticut utilities in connection with proceedings on long-term capacity measures (2007).

- Technical manager in the review of the Public Service Enterprise Group - Exelon Corporation merger petition on behalf of the New Jersey Board of Public Utilities. Analyzed the financial impacts of the merger, in particular the proposed money pool arrangement between affiliates (2005-2006).

- Technical manager in the regulatory audit of South Jersey Gas Company. Analyzed the allocation of costs between South Jersey Gas Company and affiliates and compliance with competitive service standards of the New Jersey Board of Public Utilities (2002-2003).

- Technical manager in the regulatory audit of Pacific Bell. Analyzed the allocation of costs from affiliates to Pacific Bell in accordance with California Public Utilities Commission rules and requirements (2001-2002).

- Participated in the focused management audit of Harrison County Rural Electric Cooperative Corporation (1997).

- Participated in Overland's audit of the Southern California Gas Company's performance based management (PBR) incentive rate plan application (1995-1996).

- Participated in the determination of gas pipeline utility cost of service in Overland's rate case audit of the Kansas Pipeline Operating Company (1995).

- Controller of a Midwest-based interstate pipeline. Responsible for all financial reporting ranging from monthly to annual financial statements and detailed regulatory reports filed with pipeline regulatory bodies. Position involved extensive analysis and evaluation of all financial transactions as well as supervision of accounting department staff. Assisted in the preparation of a rate case filing before the Federal Energy Regulatory Commission. Assisted in valuations related to the potential purchase or sale of utility assets (1997-2000).

- Technical manager for an independent valuation of the operating property of Qwest Corporation. This valuation was used in settlement negotiations related to a property tax appeal in the State of Iowa (2006).

- Technical manager in the development of alternative valuation procedures under consideration for use in utility assessments in Virginia (2005).

- Technical manager for an independent appraisal of the Hopewell Cogeneration Facility. This valuation was used in a property tax appeal in the Commonwealth of Virginia (2004-2005).

- Technical manager for an independent appraisal of CSX Corporation's railroad operating property. This valuation was utilized in settlement negotiations related to a property tax appeal in the State of Florida (2004).

- Technical manager for an independent utility valuation of Interstate Power Company's operating property. This valuation was utilized in settlement negotiations concerning a property tax appeal before the Iowa State Board of Tax Review. The valuation included a subject sale analysis as well as other generally recognized valuation approaches (2002-2003).

- Assisted in the development of appraisals of two Class I railroad companies in contested property tax proceedings in New York (2002).

- Performed a utility valuation appraisal relied upon in determining the market value of Citizens Utilities Company's Arizona Telephone Operations for property tax purposes. The appraisal incorporated applications of the stock and debt method, direct and yield capitalization methods, and analysis of market transactions (1995).

- Participated in the planning, administration, and financial reporting of the first-time-through audit related to United Cities Gas Company's acquisition of Union Gas Company (1990).

- Participated in the audit of St. Joseph Light & Power Company for three years. Responsibilities included the planning, supervision, and reporting of numerous engagements (10Q and 10K) (1987-1990).

- Participated in the audit of Raytown Water Company for three years. Responsibilities included the planning, supervision, and financial reporting of the annual audit (1987-1990).

Work History

2000 – Present: **Overland Consulting –** Senior Manager. Direct energy and telecommunications industry consulting projects on behalf of public utilities commissions and other government agencies.

1997 – 2000: **Midcoast Energy Resources, Inc., Kansas Pipeline Operating Company –** Controller. Supervised the accounting and cash management functions of an interstate natural gas pipeline company.

1995 - 1997: **Overland Consulting –** Senior Consultant. Participated in energy and telecommunications industry consulting projects on behalf of companies, public utilities commissions, and other government agencies.

1990 - 1995: **Various.** Served as special projects accountant and supervisor of accounting for various companies in private industry.

1987 - 1990: **Arthur Andersen & Company –** Senior Accountant. Planned, supervised, administered, and reported on audits and other engagements in a variety of industries including utilities. Experienced in the evaluation of internal controls.

Professional Affiliations

- The American Institute of Certified Public Accountants

Publications and Presentations

- "Accounting and Finance Issues Associated with Contracts for Differences-Generation/DSM Projects" (Howard Lubow, co-presenter), Connecticut Department of Public Utility Control, September 2007.
- "Overview of FIN 46(R), SFAS No. 133, and SFAS No. 71," (Howard Lubow, co-presenter), Connecticut Department of Public Utility Control, May 2007.
- "Appraisers Find Help in Recent Accounting Pronouncements," (Howard Lubow co-author), Fair & Equitable, August 2003.

RYAN J. PFAFF, CPA
Senior Consultant

General

Mr. Pfaff holds a Bachelor of Science degree from Truman State University. He came to Overland with over three years of public accounting experience with a “Big 4” accounting firm.

Education and Professional Certification

- B. S. in Accounting, Economics Minor, Truman State University, May 2005, with Honors
- Passed Uniform CPA Examination November 2005,
  Missouri CPA certificate #2007010551

Representative Experience

Electric and Gas

- Participated as a senior consultant in the evaluation of Allegheny Energy Inc. by FirstEnergy Corp. Provided testimony on behalf of the Staff of the Maryland Public Service Commission on regulatory accounting issues (2010)
- Participated as a consultant in the management audits of Atlantic City Electric for the New Jersey Board of Public Utilities, and Connecticut Natural Gas for the Connecticut Department of Public Utilities. Analyzed various accounting/regulatory issues, and assisted in the organization of discovery and the preparation of the final audit report (2009-2010).
- Participated as a consultant in the preparation of testimony regarding the review of the Constellation Energy Group / Electricite de France Nuclear Power Joint Venture. Assisted in analyzing the costs and benefits of the joint venture. Performed research concerning ring-fencing and bankruptcy protection issues (2009).

Work History

2009-Present: ***Overland Consulting*** – Senior Consultant. Assists in the managing of regulatory audits and valuation studies of electric, gas, railroad and telecommunications companies.

2005-2009: ***PricewaterhouseCoopers* -** Associate. Led multi-person audit teams in various industries.

Publications and Presentations

- "Constellation / EDF Nuclear Joint Venture: Regulatory Issues and Subsequent Resolutions," (Howard Lubow and Dr. J. Robert Malko, co-authors), published in the *Electricity Journal*, March 2010. Also presented at the Western States Association of Tax Administrators Annual Meeting, February 2010.

CHADWICK B. EPPS, CPA
Consultant

General

Mr. Epps holds a Master's of Accountancy degree from Truman State University. He has over three years of public accounting experience with a "Big 4" accounting firm and another year of industry experience with a natural gas and NGL midstream operation.

Education and Professional Certification

- B. S. in Accounting, Spanish Minor, Truman State University, May 2003, graduated Summa Cum Laude;
  Master's of Accountancy, Truman State University, August 2004
- Passed Uniform CPA Examination October 2004,
  Missouri CPA certificate #2005010551

Representative Experience

Electric and Gas

- <u>FirstEnergy/Allegheny Energy Merger</u> – Assisted as a Consultant with determining the Maryland allocation of merger savings and cost-to-achieve analyses relating to the FirstEnergy/Allegheny merger for the Maryland Public Service Commission (2010)

- <u>Public Service Enterprise Management Audit</u> – Participated as a Consultant in a management audit and audit of affiliate transactions of PSEG for the New Jersey Board of Public Utilities. Areas of responsibility included finance, executive management and corporate governance, external relations, strategic planning, risk management, energy efficiency, operations and appliance services. (2009-2010)

Work History

2009-Present: ***Overland Consulting*** – <u>Consultant.</u> Assists in conducting regulatory audits and valuation studies of electric, gas, railroad and telecommunications companies.

2008-2009 **Inergy LP** – <u>Accounting Manager.</u> Managed the accounting function for three natural gas and NGL storage facilities

2004-2008: ***KPMG*** **–** <u>Senior Associate</u>. Ran various multi-person audit teams in various industries for public and private companies.

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MELISSA M. ERICKSON, CPA
Consultant

General

Ms. Erickson holds a Bachelor of Science degree from the University of Kansas. She has several years of accounting experience and worked as an auditor with a "Big 4" accounting firm.

Education and Professional Certification

- B. S. in Accounting, University of Kansas, May 1990, graduated with distinction
- Passed Uniform CPA Examination May 1991, Missouri CPA certificate # 16266

Representative Experience

Electric and Gas

- FirstEnergy/Allegheny Energy Merger – Assisted as a Consultant in performing cost-benefit and regulatory accounting analysis (2010).

Work History

2008-Present:	***Overland Consulting*** – Consultant. Assists in conducting regulatory audits and valuation studies of electric, gas, railroad and telecommunications companies.
1998-2007:	***First Tier Financial, Inc.***, Mortgage Company, Overland Park, KS Owner and Accountant. Performed accounting and compliance functions including licensing, payroll tax deposits and reports, and preparing books for annual State Bank Commissioner and HUD required audits.
1992-1993:	***Arthur Andersen & Co. -*** Staff Accountant for contract with the Resolution Trust Corporation, researched source documents and proposed correcting journal entries.
1990-1992:	***Price Waterhouse -*** Staff Accountant. Served on various audits in mutual funds, financial institutions, and manufacturing.

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TERI TOWNLEY
Manager – Information Systems

General

Ms. Townley serves as Manager of Information Systems to Overland Consulting, providing internal computer applications support in both energy and telecommunications consulting projects. Her areas of specialty include developing PC-based programs and information systems applications to analyze data in connection with various consulting projects. She developed Overland's data log application and has managed data responses for several regulatory audits.

Experience

- Create and maintain spreadsheets and discovery databases for various regulatory projects.
- Developed database to track and sort construction cost information for a regulatory audit of Pacific Gas & Electric Company's Pipeline Expansion project.
- Provide network administration and software/hardware computer support.
- Developed and maintained FERC mandated, web-based systems for several gas pipelines, utilizing ASP database connectivity. Websites supported FERC regulated customer nomination processes and reporting requirements for gas pipelines.
- Developed and supported internal and external SQL reports for several gas pipeline's gas control, scheduling, and revenue management departments.
- Supported and maintained Altra Gas/Altra Web pipeline system for large gas company.
- Developed and maintained OCI's proprietary data request/response.
- Developed database to allow monthly plant by plant coal price comparisons for a ten year period based on data reported on FERC Form 423.
- Developed computer programs to select random samples of New York Telephone customers using valid telephone number combinations.
- Developed and maintained programs and databases to handle various in-office accounting procedures.
- Created spreadsheets to categorize findings associated with reconciliation of database information in New York Telephone's operational and billing information systems.
- Developed a PC-based litigation support system to catalog a local gas distribution company's mains and services as part of a damages study.

- Developed graphs, charts and tables for displaying the results of electric, gas and telecommunications audits.

- Set-up and maintain all in-house accounting packages.

Work History

2002 - Present: **Overland Consulting**
Manager of Information Systems. Provide network and computer software/hardware support to employees. Develop and maintain programs utilizing a variety of software applications for various energy and telecommunication projects. Develop and maintain company website. Responsible for coordination of report production and all in-house accounting/office procedures.

1999 - 2002: **Enbridge Midcoast Energy, Inc. (Enbridge, Inc.)**
Information Systems Developer. Developed and maintained various SQL database systems for this Houston-based company and their customers. Developed and maintained company website that conforms to FERC regulations.

1997 - 1999: **Kansas Pipeline Company**
Information Systems Developer. Developed and maintained website in support of KPC's customer nomination processes that conformed to FERC regulations. Provided network and computer software/hardware support to employees and field offices.

1984 - 1997: **Overland Consulting (previously LMSL)**
Computer Specialist/Office Manager. Developed and maintained programs utilizing a variety of software applications for various energy and telecommunication projects. Responsible for coordination of report production and all in-house accounting/office procedures.

1977-1984: **Drees Dunn Lubow & Company**
Office Manager. Responsible for the management and training of all system applications/word processing staff and coordinated and managed all report production.

Qualifications:

- Associate of Science, Computer Information Systems, 1995
- Computer Programming Certificate, 1992
- Computer Applications Technology Certificate, 1991

Before the Public Service Commission of Maryland

Case No. 9173
Phase II

IN THE MATTER OF THE CURRENT AND FUTURE FINANCIAL CONDITION OF BALTIMORE GAS AND ELECTRIC COMPANY

Prepared Reply Testimony of

Robert F. Welchin

On Behalf of the Staff of the

Maryland Public Service Commission

August 28, 2009

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Introduction

Q. Please state your name and business address.

A. My name is Robert F. Welchlin. My business address is 11551 Ash St., Suite 215, Overland Park, KS 66211.

Q. By whom are you employed and in what capacity?

A. I am employed by Overland Consulting as a Senior Manager.

Q. Please summarize your experience and qualifications relevant to these proceedings .

A. I have provided financial and regulatory consulting services related to the energy and telecommunications industries for approximately 23 years. Among my responsibilities, I have testified and/or provided consulting services pertaining to holding company and service company matters in the context of regulatory audits and rate cases. During the last 20 years I have analyzed the affiliate transaction and corporate and shared services cost allocation processes of a number of regulated companies, including electric, gas, telecommunications and water utilities. My resume is included as Exhibit RFW-1.

Q. Please describe the subject of your testimony.

A. My testimony will address the following:

1. The potential impact of the CENG joint venture on cost of support services allocated by Constellation's parent company to BGE.

2. The funded status of CEG's pension plans and the allocation of pension assets and liabilities to the CENG joint venture.

3. Calculation of income taxes associated with the joint venture transaction.

Corporate Support Services

Summary of Key Facts and Issues

Q. Please summarize the key facts and issues concerning CEG's corporate support services and cost allocations as they relate to this proceeding.

A. The key facts and issues are as follows:

1. CEG currently incurs approximately **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** annually for "headquarters" and other corporate support services. **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** of this amount is allocable to BGE and other CEG business segments and approximately **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** is chargeable using "consumption based pricing."[1] In 2008, CEG allocated and charged **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** to BGE.[2]

2. Most of BGE's corporate services costs are allocated using a four-factor formula.[3] The four-factor formula allocator is based on an equal weighting of BGE's assets, equity, gross margin and employees relative to the assets, equity, margin and employees in CEG as a whole.[4] BGE pays CEG for allocated corporate support services through the affiliate transaction process.

3. It does not appear that CEG's corporate services costs have been allocated to the books of subsidiaries other than BGE, although a contradiction between CEG's cross examination testimony in Phase I and a response to a Staff data request in Phase II puts this into question.[5] Absent an opportunity to analyze

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[1] Response to CEG Discovery, Staff 5-2, attachment 1, *2009 Headquarters Cost Allocation Plan*.
[2] BGE Cost Allocation Manual, April 30, 2009, Maillog 116430, Schedule of 2008 Cost Allocations from Affiliates to BGE. This excludes approximately **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** for payments made by CEG on behalf of BGE. Including these reimbursements, the total amount charged by CEG to BGE in 2008 was **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]**.
[3] The schedule in CEG 5-2, Attachment I shows **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** is allocable in 2009 using the four-factor formula.
[4] BGE Cost Allocation Manual, April 30, 2009, Maillog 116430, Appendix F.
[5] During the Phase I hearing, CEG's witness Michael Wallace stated that "we have not heretofore established the allocation [of corporate services] among the various business units that are part of the merchant. Those costs have been attributed only to the merchant as a whole." (See cross examination of Michael Wallace, Hearing Transcript, Case No. 9173, Volume III, p. 217). Contradicting this, in response to CEG discovery 20-2, item A, CEG states "[t]he

CEG's allocation process in more detail, we do not know what to make of the contradiction, but the details provided in the Phase I cross-examination testimony lead us to believe that CEG has not, at least in the past, allocated the costs of corporate services to subsidiaries other than BGE.

4. BGE's corporate services bill is primarily driven by the four-factor formula and is heavily dependent on the way non-regulated subsidiaries are treated in the formula's calculation. Regardless of whether or not CEG's non-regulated subsidiaries currently receive corporate services cost allocations, their financial "weight" has a significant impact on four-factor formula allocator, and therefore on BGE's corporate allocation. Given the fact that more than **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** annually is distributed using the four-factor formula, changing the way a large non-regulated subsidiary such as CENG is treated in calculating the allocator is likely to have a significant impact on BGE's corporate services bill.

5. After the joint venture transaction closes, corporate services costs will, perhaps for the first time, be charged to CENG. A 2009 Headquarters Cost Allocation Plan and documents prepared by CEG for discussions with EDF indicate that CENG's share of corporate services costs (other than consumption-based priced services), is between **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in 2009.[6] However, EDF and CEG have negotiated an annual limit of **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** on charges to CENG, approximately **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** less than current allocation procedures would indicate.[7] The **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** is not based upon the

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cost of corporate support services are allocated to the books of BGE and other non-regulated Constellation affiliates . . . "

[6] Response to CEG Discovery, Staff 5-2, attachment 1, *2009 Headquarters Cost Allocation Plan*, shows **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in corporate support services (other than consumption-based priced services) allocable to CENG. Response to EDF Discovery, Staff 1-15, indicates that EDF and CEG reached a **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** and this amount **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** The response to EDF Discovery, Staff 1-15 further indicates that **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** According to the response to CEG Discovery, Staff 12-1, the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** does not include "embedded" or "consumption-based priced" services.

[7] Response to CEG Discovery, Staff 12-1.

identification or assignment of any specific CEG corporate services or costs; it is simply a “negotiated amount.”[8]

6. There are a number of different ways that the change in CENG’s ownership status and CEG’s balance sheet could affect corporate services costs allocated to BGE. For example, it is unclear how the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** that EDF’s negotiation removed from CENG’s cost allocations will be treated or whether BGE will bear any of the cost. Moreover, BGE’s share of the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** four-factor formula cost pool will depend on whether CENG is included in the allocator’s calculation, and if so, whether CENG’s assets and equity are included based on the investment values on the books of the joint venture partners (CEG and EDF), or the values recorded on the books of CENG. CEG states that it does not know how the joint venture transaction will affect the four-factor formula allocation percentages, but it is sure that “costs not allocated to the nuclear joint venture as a result of an agreement between CEG and EDF” will “not impact the Constellation Energy costs allocated to BGE.”[9] Given that the four-factor formula is the primary vehicle for distributing costs to BGE, and that it is heavily dependent on the inclusion of financial inputs from merchant subsidiaries, including CENG, it is difficult to see how changes in the merchant segment balance sheet brought about by the joint venture could not have a significant impact on BGE.

7. There is currently no service agreement between BGE and CEG describing the service relationship between the utility and the parent, the corporate services provided, the costs allocated to BGE or the terms of payment.[10] BGE’s Cost Allocation Manual (CAM) does not adequately document the corporate support services provided by CEG or the allocation of related costs. The only quantitative information in the CAM concerning corporate support services is a column of numbers summarizing the functional amounts allocated to BGE by corporate department. Descriptions of the corporate services charged to BGE,

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[8] Response to CEG Discovery, Staff 12-1.
[9] Response to CEG Discovery, Staff 17-7 and response to CEG Discovery, Staff 12-1.
[10] Response to CEG Discovery, Staff 6-14.

the amounts attributable to other business segments (merchant, other non-regulated), the percentage breakdown of allocations between BGE and other CEG segments, and the calculation of factors for the primary allocator (the four-factor formula) are all missing from the CAM. The lack of adequate process documentation and the lack of a service agreement increase the potential for cross-subsidization of CEG's non-regulated subsidiaries by BGE.

Corporate Support Services Recommendations

Q. Please describe your recommendations concerning headquarters support services cost allocations.

A. My recommendations are as follows:

1. The Commission should require CEG to fully allocate the costs of corporate support services to the books of all subsidiaries benefiting from corporate services. Non-regulated subsidiaries should compensate CEG in the same way BGE compensates the parent for corporate services. To help ensure consistent cost allocation treatment, all subsidiaries, including BGE, should enter into a service agreement with CEG defining the services to be provided and the allocation methods to be used. As discussed above, BGE does not currently have an agreement with CEG defining corporate support services, BGE's rights with respect to purchasing the services, service pricing or payment. However, CEG anticipates that there will be a service agreement covering the corporate services to be provided to the CENG joint venture.[11] EDF's negotiation efforts have resulted in a limit on the corporate support services to be provided and charged to the CENG joint venture.[12] The negotiated limit is about a third lower than the annual amount that would have been attributable to CENG if the allocations were based on CEG's 2009 Allocation Plan or amounts shown in documents CEG prepared for discussion with EDF. To ensure that BGE, CENG and other non-regulated subsidiaries are treated equally with respect to the types of corporate services they are required to absorb and the methods used to charge for the services, and to ensure that the costs of corporate support services rejected by EDF do not get shifted to BGE, all subsidiaries should be subject to the same rules regarding the allocation of corporate costs; in

[11] Responses to CEG Discovery, Staff 6-15.
[12] Response to EDF Discovery, Staff 1-15.

particular, the costs of "unattributable" services benefiting the corporation as a whole. This requires an allocation of corporate costs to all subsidiaries deemed to benefit from them and uniform service agreements with a common set of rules applicable to all subsidiaries receiving corporate services.

2. <u>The Commission should require that BGE's cost allocation manual (CAM) disclose certain basic information about the corporate support services cost allocation process. This should include 1) meaningful descriptions of the corporate services provided and the subsidiaries that receive them, 2) a description of how corporate support services costs are distributed among subsidiary cost objectives, and 3) information and data showing how allocation factors are calculated and the financial and operating inputs used to calculate the factors.</u> BGE's corporate services bill depends on the procedures used to divide costs between BGE and other CEG business segments. BGE's CAM does not currently contain enough information to perform even a cursory analysis of corporate services and the cost allocation process. The only information in the CAM describing corporate services is a listing of the departments included in allocations to BGE (corporate affairs, accounting, tax, finance and treasury, etc.) The CAM should contain descriptions equivalent to the "sub-function" service descriptions CEG provided in the documents used as a basis for discussions with EDF. The only corporate cost data in the CAM is a column of data showing the costs charged to BGE by corporate department. In order to provide a basis for analysis, the CAM should include a schedule showing the distribution of corporate support costs at the function and sub-function level to each business segment and subsidiary cost objective, not just BGE. The CAM also does not provide sufficient information about the cost allocation process. For example, although CEG uses a "four-factor formula" allocator to distribute a majority of its corporate support costs to BGE, the only information in the CAM about the allocator is a one-sentence definition stating that it is a "mathematical formula that provides equal weight to each affiliate's gross margin, total assets, common equity and employee count" and stating that these inputs are "adjusted for significant changes" such as "acquisitions, sales of affiliates and major accounting changes." CEG's choices concerning the recognition (or non-recognition) of the CENG joint venture in calculating the four-factor formula will have a significant impact on the amount of corporate services cost allocable to BGE. The Commission should ensure that the CAM includes worksheets showing the inputs (employees, assets, equity, etc.) and the calculations of the four-factor formula

and the other allocators used to distribute CEG's headquarters support services costs. This is the minimum information necessary to make the CAM useful as a tool for evaluating the corporate allocation process.

3. The Commission should review CEG's corporate cost allocation process from the top-down to ensure that allocation procedures applicable to BGE, CENG and other subsidiaries are reasonable, reflect fully-distributed cost principles, and do not cause BGE to cross-subsidize CENG or other non-regulated CEG subsidiaries. As noted above, data responses indicate that EDF negotiated a **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** annual limit on corporate support services charged to the CENG joint venture. Prior to agreeing to the cap, CEG prepared documents for discussions with EDF that showed a **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** allocation of corporate services to the joint venture was warranted. The Commission should perform a review of CEG's cost allocation process to determine:

- Whether all subsidiaries (including CENG under the joint venture structure) are treated equally with respect to the corporate services and cost allocations.

- Whether corporate services costs are charged using the most direct method possible. This requires an analysis of corporate functions and services (particularly the majority of services in which costs are distributed using the four-factor formula allocator) at the sub-functional level to determine which subsidiaries cause or benefit from each service.

- Whether corporate services that are deemed "unattributable" to specific subsidiaries, but which are allocated because they benefit the corporation as a whole, are fully distributed in the same manner to all subsidiaries if they are distributed to BGE.

The Impact of the Joint Venture on the Cost of Support Services Allocated by Constellation's Parent Company.

Q. Please summarize the corporate headquarters cost allocation process.

A. CEG allocates the costs incurred in a number of corporate departments, including accounting and finance, human resources, legal, public affairs, strategic planning, and marketing and communications, among others, to BGE. The organizations that conduct these functions reside in the corporate parent (headquarters) organization, rather than in a separate service company. In addition to purely "corporate" services, certain other services, such as information technology, are shared and charged based on the level of services consumed. The 2009 corporate support services budget is at least **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**, excluding "reimbursable" items paid by CEG on behalf of subsidiaries.[13] This includes at least **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in services charged using consumption-based pricing (CBP) and **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in allocated services.[14]

Q. How are corporate support services distributed to subsidiaries?

A. Excluding services charged out using consumption-based pricing, the 2009 budget includes **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in allocable corporate services costs, of which **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** is allocable using the four-factor formula.[15] The four-factor formula is a composite allocator based on four equally-weighted measures of subsidiary size: assets, equity, gross margin and employees. Of the **[BEGIN CONFIDENTIAL]**

[13] Response to CEG Discovery, Staff 5-2, Attachment 1. The $349 million budget excludes reimbursements, which are payments CEG makes to professional services vendors and for insurance on behalf of BGE and perhaps other subsidiaries. BGE's reimbursements to CEG totaled **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL].**

[14] Response to CEG Discovery, Staff 5-2 Attachment 1, 2009 Headquarters Cost Allocation Plan shows **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** is distributed, including **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in information technology charged using "consumption-based pricing" and **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** for allocated services (four-factor formula and "alternative method"). However, response to EDF Discovery, Staff 1-15, which includes documents prepared by CEG for the purpose of negotiating CENG's post-transaction with EDF, indicates that additional corporate support services (legal, security, risk, marketing and communications) are also provided using consumption-based pricing. These additional consumption-based pricing amounts are not included in the 2009 Headquarters Cost Allocation schedule supplied in response to CEG Discovery, Staff 5-2. Thus, its 2009 total budgeted corporate support services is probably more than **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**, but we cannot determine the specific amount.

[15] Response to CEG Discovery, Staff 5-2, Attachment 1.

[END CONFIDENTIAL] is allocable to BGE, almost all of which is distributed through the four-factor allocator. The 2009 Allocation Plan also shows allocations to the merchant segment **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** and to "other non-regulated" **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL].** However, based on CEG's testimony in Phase I, it appears that allocations to specific CEG subsidiaries within the merchant segment have not been made.[16] Thus, apart from allocations to BGE, the allocations shown in the 2009 Corporate Allocation Plan appear to be pro forma (theoretical), rather than actual. The 2009 Plan shows the following pro-forma cost allocations to business units within the merchant segment:

- Customer Supply - **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**
- Commodities - **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**
- Non-Nuclear Generation - **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**
- Nuclear Generation - **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**.

Q. BGE's CAM describes its cost allocation process as a "fully distributed cost allocation methodology."[17] Is the headquarters allocation process, in fact, a fully distributed cost allocation process?

A. Based on testimony provided by the company in the Phase I hearing, it does not appear so. As described in BGE's CAM, "a fully distributed cost allocation is premised on the concept of distributing all costs to business activities." But the issue of whether CEG actually allocates any corporate services cost to subsidiaries other than BGE is murky. In discussing the cost allocation process during the Phase I hearing, CEG witness Michael Wallace indicated that costs were not allocated to specific non-regulated subsidiaries:

> In Constellation Energy we have not heretofore established the allocation among the various business units that are part of the merchant. Those costs have all been attributed only to the merchant as a whole. With the CENG joint venture, we now need to differentiate the joint venture from those other parts of the merchant.[18]

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[16] See cross examination of Michael Wallace, Hearing Transcript, Case No. 9173, Volume III, p. 217.
[17] *BGE Cost Allocation Manual*, April 30, 2009, Maillog 116430, p. 3, "Cost Allocation Philosophy"
[18] Wallace cross examination, Hearing Transcript, Case No. 9173, Volume III, p. 217.

Mr. Wallace was asked to look at a document headed "actual headquarters costs allocated to nuclear" for the years 2006, 2007 and 2008. When asked whether the document portrayed "a set of allocations that never happened", Mr. Wallace responded that it "portrays a set of data that never existed contemporaneously with the time that would be indicated."[19] Asked about CENG allocations shown on a schedule dated 2006; specifically, whether they were "actual allocations" and what it meant, Mr. Wallace responded as follows:

> It means it's taking the actual aggregate costs of 2006 and determining on an allocated basis, looking retrospectively, what would seem to be the appropriate amount from headquarters that would be attributable to CENG *if we had been operating under a full allocation methodology for the past several years* (emphasis added).[20]

Despite several questions and answers in Wallace's cross examination that would lead to an understanding that CEG does not allocate corporate services to its non-regulated subsidiaries, in response to a data request issued to confirm the meaning of the cross examination, CEG stated "[t]he cost of corporate support services are allocated to the books of BGE and other non-regulated Constellation (CE) affiliates as demonstrated in Data Request 5, Items 1 and 2."[21] [22] The data response further asserts that non-regulated CEG subsidiaries compensate CEG for corporate services provided, even though the Wallace cross-examination suggests that the cost allocations were never made. One thing the data response does *not* do is clarify the apparent contradiction. It is not possible to state with certainty what is actually done; however, based on the details provided in the Wallace cross-examination, it appears that CEG has not, in the past, allocated corporate services costs to its non-regulated subsidiaries in the way that it has to BGE.

Q. As long as BGE is not charged for more than a reasonable share of corporate services, why is it important for corporate services to be charged to non-regulated subsidiaries?

A. Not charging or obtaining payment from non-regulated subsidiaries for corporate services effectively results in making capital contributions to these subsidiaries that are

[19] Id, p. 222.
[20] Wallace cross examination, Hearing Transcript, Case No. 9173, Volume III, p. 227.
[21] Response to CEG Discovery, Staff 20-2, item A.
[22] The schedules provided in response to CEG Discovery, Staff 5-1 and 5-2, do not demonstrate that costs are allocated to BGE's affiliates.

not made to BGE. When compared with BGE, non-regulated subsidiary income and non-regulated cash flow from operations is inflated by the corporate services expenses not charged to those subsidiaries.[23] This has the potential to distort financial comparisons between BGE and non-regulated operations. If nothing else, the goal of maintaining transparency requires that all CEG subsidiaries, regulated and non-regulated, be subjected to the same corporate services allocation and compensation procedures.

Q. How will the joint venture affect corporate cost allocations to BGE?

A. Currently, almost 70 percent of CEG's corporate services costs are grouped into a single cost pool and allocated (at least to BGE) using a four-factor formula.[24] Although CEG's non-regulated subsidiaries do not appear to receive allocations on their books, their financial and operating "weight" (their assets, equity, operating margins before administrative expenses and taxes, and number of employees) directly determines the share of the corporate support services "pie" allocated to BGE. With the formation of the joint venture, CENG will, perhaps for the first time, be charged for corporate support services, but its share of services will be capped at **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]**, about a third lower than the current four-factor formula would suggest should be allocated. CEG indicated that the **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** is a negotiated amount that cannot be associated with specific corporate support services.[25] It is unclear how much, if any, of the approximately **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** cost that the joint venture will avoid because of EDF's negotiation will ultimately be allocated instead to BGE. It is also unclear whether, or how, the financial inputs associated with the nuclear joint venture will be incorporated into the calculation of the four-factor formula for the purpose of determining future BGE allocations.

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[23] Income is inflated on subsidiary financial statements, which affects a comparison between BGE and other subsidiaries. At the corporate level income is not affected.

[24] **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** or 69.4%, as shown in the 2009 Headquarters Cost Allocation Plan (response to CEG Discovery, Staff 5-2, Attachment 1).

[25] Response to CEG Discovery, Staff 12-1 states"[a]s the **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** was a negotiated amount, it was not developed based upon the assignment of any functional costs."

Q. Did you request information from CEG on how they intended to reflect CENG in their four-factor allocation process after the transaction closes?

A. Yes. In response to Staff data request set 12, question 1, concerning the components of CEG's and EDF's negotiated **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** cap on corporate charges to the joint venture, CEG stated:

> Any Constellation Energy costs not allocated to the Nuclear JV as a result of an agreement between CEG and EDF will be allocated among the other Merchant entities, which will include the entity that will hold Constellation's ownership in the Nuclear JV and would not impact the Constellation Energy costs allocated to BGE."[26]

As noted above, CEG has stated that corporate services cost allocations have not been made to the entities *within* the merchant segment, so it is unclear how any costs will be allocated to "the other Merchant entities" unless the procedure has been or will be changed. Moreover, CEG's statement in response to 12-1 does not make much sense, given that:

- Allocations to the merchant segment are determined to a large extent by the "weight" that CENG adds to the four-factor formula, something that is likely to change as a result of the joint venture transaction; and,

- BGE's allocations are directly and heavily dependent on the four-factor allocations made (or not made) to the merchant segment.

In fact, unless CENG's financial inputs to the four-factor formula are literally frozen at pre-joint venture levels, and unless the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** corporate services cost cap negotiated by EDF is ignored for purposes of future allocation calculations, the joint venture transaction will most certainly affect the amount of corporate services cost allocated to BGE.

Given CEG's statement, we asked CEG to describe how it intended to calculate the four-factor formula for the merchant segment. In response, CEG stated:

[26] Response to CEG Discovery, Staff 12-1.

> Constellation has not determined the impact of the EDF Transaction on the calculation of the four-factor allocation percentages. However, costs allocated to BGE pursuant to the four-factor allocation methodology are subject to review by the Commission in a base rate proceeding before they may be recovered from customers.[27]

We recommend the Commission review CEG's corporate allocation procedure before CEG implements any post-transaction cost allocation procedure.[28] This should include a review of CEG's intended method of incorporating the joint venture's balance sheet weight into the four-factor formula as well as the allocation treatment of corporate services costs generally and the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** capped amount to be charged to the joint venture.

Q. Please elaborate on some of the different ways CEG might incorporate the joint venture into the four-factor formula and how this could affect BGE's headquarters cost allocations.

A. There are a number of ways the joint venture could be treated in the cost allocation process, with potentially widely varying impacts on the amount of cost allocable to BGE. Below are just a few possibilities:

1. Based on the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** charge to the joint venture negotiated by EDF, and CEG's conclusion that it will no longer own a controlling financial interest in CENG,[29] CEG might decide to remove the joint venture entirely from the four-factor formula. This would remove CENG's financial and operating "weight" from the allocator, causing BGE's share of corporate services costs to increase. If CEG removes the joint venture from the cost allocation process, it is logical, but not necessarily guaranteed, that CEG would also remove the **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** from the corporate support services cost total before determining the allocation to BGE.

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[27] Response to CEG Discovery, Staff 17-7.

[28] Although it may be within the Commission's authority to determine BGE's share of corporate allocations, waiting until the next base rate proceeding to deal with corporate allocations, after CEG implements its chosen procedures, is akin to closing the barn door after the horse has left.

[29] Response to CEG Discovery, Staff 3-32 supplemental, Attachment 10, p.10.

2. CEG could continue to include the joint venture's financial and employee inputs in the four-factor formula calculation. There are several ways that the financial inputs; in particular, the balance sheet inputs (assets and equity) could be incorporated into the formula:

- Based on the assets and equity recorded on the books of the joint venture itself,
- Based on the combined asset and equity values recorded on CEG's and EDF's books,
- Based only on the portion of the asset and related equity in the joint venture recorded on CEG's books.

The four-factor formula is simply a way of dividing up a **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** cost "pie." Each of the possibilities listed above results in a different slice of the pie allocable to the merchant segment, to CENG and to BGE.

The Commission should require CEG to fully allocate the cost of corporate services to benefiting subsidiaries and to enter into a uniform service agreement with subsidiaries describing the nature and basis for charging corporate support services.

Q. Please explain the need for a full allocation of corporate services costs and a uniform service agreement between CEG and the subsidiaries benefiting from corporate services.

A. A service agreement is a means of documenting the service relationship, including the transactions and pricing, between CEG and the subsidiaries to which corporate services costs are to be distributed. A uniform agreement applicable to all operating subsidiaries will help ensure that BGE and other subsidiaries are treated consistently with respect to corporate services provided and costs allocated. Limiting the opportunities to treat subsidiaries differently helps minimize the opportunity for cross-subsidies to occur. A uniform service agreement requires charging costs to the books of benefiting subsidiaries in return for services provided. Uniformity does not mean every subsidiary must receive the same services. Different subsidiaries may require different amounts and types of support services. However, if purely "corporate" services (services required to maintain and manage the holding company, but not to run specific subsidiaries) are allocated to BGE on the basis that they benefit the corporation as a whole, they should be allocated to all subsidiaries on the same basis.

Q. What should the service agreement contain?

A. At a minimum, the service agreement between CEG and each subsidiary should describe the services to be provided, differentiate between discretionary and non-discretionary services (i.e. those that the subsidiary may reject or control usage of and those it may not), and fully describe how the services will be charged. If different cost allocation methods are to be used for different services, the methods applicable to each service should be described, and definitions of the inputs to the allocators should also be included in the agreement. The service agreement should also describe payment terms and conditions and these should be consistent among subsidiaries.

The Commission should require BGE's cost allocation manual (CAM) to disclose certain basic information about the corporate support services cost allocation process.

Q. Please explain the basis for your recommendation that BGE increase the amount of corporate support services cost allocation information in its CAM.

A. The direct testimony filed by BGE's witness Defontes implies that a "wealth of information" in BGE's CAM should mitigate concerns about "affiliate or cross-subsidization issues."[30] In fact, the CAM contains almost no information about the services charged to BGE by the headquarters organization. To illustrate, a copy of BGE's CAM, filed April 30, 2009, is included in Confidential Exhibit RFW-2 to this testimony. Deficiencies in the information supplied in the CAM include:

- <u>Information describing services provided by the corporate headquarters organization to BGE is insubstantial and inadequate</u>. Affiliate services are described primarily in Appendixes E and F of the CAM. Appendix E covers services provided *by* BGE to affiliates and it contains reasonable descriptions of the utility services provided to affiliates in a number of areas. These descriptions cover five and one half pages for utility services that totaled approximately **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in 2008. Services provided *to* BGE by CEG's corporate headquarters organization are described in

[30] Phase II, Direct Testimony of Kenneth W. Defontes, page 13, lines 20-23 and page 14, lines 5-8.

Appendix F. BGE's charges for these services totaled approximately **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in 2008, excluding reimbursements.[31] These services are addressed in three short paragraphs that cover one-half page. The CAM's description of the services provided to BGE by the corporate organization consists of nothing more than a list of departments (or functions), as shown in the following sentence:

> The services provided by CE to the utility include: Corporate Affairs, Finance and Accounting, Tax, Payroll, information Technology, Audit, Corporate Communications, Corporate Strategy and Development, Human Resources, Legal, Risk Management, Investor Relations, Real Estate, and Business Performance Improvement.

- Information quantifying the amounts charged by the corporate headquarters organization is insufficient. The cost documentation for corporate headquarters services in the CAM consists of one column of numbers listing amounts charged to BGE for the year by department (Audit, Corporate Office, Finance and Accounting, Information Technology, Legal, etc.). Amounts attributable to other CEG businesses are not disclosed, so the reasonableness of the amount charged to BGE cannot be assessed relative to the other businesses. A breakdown of costs within the department (by subfunction and service) is also not provided; in fact no detail about the corporate services provided by corporate departments is provided.

- Documentation describing and supporting the allocation methods used to distribute corporate headquarters services cost to BGE is insufficient. Other than generic descriptions, there is no documentation of the allocation factors used to distribute corporate services expense to BGE and other CEG segments and subsidiaries. For example, a majority of the corporate services expense allocated to BGE is distributed using the four-factor formula allocator. CAM documentation of the four-factor formula consists of the following sentence:

> Constellation Energy corporate overhead not direct charged or distributed through indirect attribution is allocated to all affiliates (including BGE) using a mathematical formula based on each

[31] Including reimbursements by BGE for items paid by the parent on behalf of BGE, the total paid by BGE to the parent was **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in 2008.

> affiliate's share of total corporate assets, equity, employees and gross margin. For more information on Constellation Energy services provided to BGE, see Appendix F.[32]

Appendix F repeats the description of the four-factor formula listed above, while providing the additional detail that the mathematical formula provides equal weight to each factor (i.e., it assigns a 25% weight each to assets, equity, employees and margin). Appendix F also contains the same one-sentence description of corporate services noted in the bullet above (essentially nothing more than a list of corporate departments), and both the narrative in the CAM and Appendix F contain a generalized description of the cost allocation hierarchy: direct charging, followed by allocation based on a causal relationship, followed by indirect costs based on homogenous cost pools and so on. However, missing from the CAM is anything that could be used to analyze the corporate services allocation process.

Q. At a minimum, what should be added to BGE's CAM to improve the Commission's ability to evaluate corporate headquarters services charged to BGE?

A. The CAM should contain the following substantive corporate services information and allocation data:

- Information describing the services provided by corporate headquarters (at the sub-functional level) and an identification of the subsidiaries receiving the services. It is noteworthy that when EDF and CEG began negotiating the corporate services to be allocated to the joint venture, CEG provided EDF with corporate service descriptions at the sub-function level. This detail is shown in Confidential Exhibit RFW-3.

- A schedule showing, by department and subfunction (on the vertical), a distribution of corporate services costs to each CEG subsidiary, including BGE (on the horizontal).

- A schedule showing, by cost-allocation hierarchy (direct charge, direct attribution, indirect attribution and unattributable) and by allocation factor (if more than one

[32] 2008 Cost Allocation Manual.

factor applies within a hierarchy level), a distribution of corporate services costs to each subsidiary, including BGE.

- For each corporate services allocation factor, a schedule showing the financial and operational inputs from each subsidiary used to calculate the factor, provided in such a way that either each subsidiary's allocation factor is shown or can be calculated from the data.

Q. Please provide some examples of how the recommended schedules could be used to evaluate the allocation process and the reasonableness of BGE's corporate services charges?

A. Following are two examples of analysis that could be performed if some basic information not currently included in the CAM was added.

- <u>Reasonableness of the four-factor formula and related allocations</u> - As noted above, the four-factor formula is applied to a cost pool containing a majority of CEG's corporate services expenses. If the CAM included the financial and operating input values used to calculate the components of the allocator it would provide a basis for at least a cursory evaluation of the formula. For example, the allocator input values could be compared to the segment financial and operating information provided in the annual SEC financial statements (Form 10K) to determine whether the formula reflects actual, or adjusted, asset, equity and perhaps employee values. This would provide a basis for more detailed analysis, if necessary. Furthermore, the factors could be applied to the amount shown as allocated using the four-factor formula to determine whether the amounts allocated to each subsidiary are as expected, given the input values provided.

- <u>Overall reasonableness of cost distributions to subsidiaries</u> - If the CAM included a schedule of allocations to subsidiaries other than BGE, the subsidiaries on the cost allocation schedule could be compared with the entities listed on the corporate organization chart provided in CAM Appendix C. Operating entities shown on the organization chart that do not show up as cost objectives on the allocation schedule could be investigated.

The Commission should review CEG's corporate cost allocation process to ensure that allocation procedures applicable to BGE, CENG and other subsidiaries are reasonable, reflect fully-distributed cost principles, and do not cause BGE to subsidize CENG or other non-regulated affiliates.

Q. Please explain the need for a review of CEG's corporate allocation process.

A. The negotiation that took place between CEG and EDF resulted in a **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** annual limit on the corporate service costs to be charged to CENG. As explained above, this presents a risk that CENG and BGE will not be treated consistently in the corporate services allocation process. CEG has stated that it has not determined the impact of the joint venture transaction on the factor that results in a majority of the corporate services costs allocated to BGE.[33] The choices CEG has with respect to how it treats the joint venture in the allocation process produce significantly different allocation results for BGE, both lower and higher than the amounts charged to BGE prior to the transaction. Based on the apparent contradiction between CEG's response to Staff data request set 20, question 2 and testimony provided by CEG's witness Wallace during cross-examination in the Phase I hearing, at this point it is not even confirmed whether CEG charges corporate services costs to the books of non-regulated subsidiaries. The Commission should determine how CEG's allocation process actually works, what services are provided and how they are charged, and the extent to which the joint venture will affect BGE's corporate services allocations. The Commission should approve an allocation methodology that will not produce a significantly higher amount of corporate services cost to be funded by BGE's ratepayers.

[33] Response to CEG Discovery, Staff 17-7.

Defined Benefit Obligations

Summary of Key Facts and Issues

Q. Please summarize the key facts and issues concerning CEG's pension, post-retirement and post-employment plans.

A. The key facts and issues are as follows:

1. CEG has pension, post-retirement and post-employment plans covering its employees and retirees. With the exception of employees of the Nine-Mile Point nuclear plant, employees in all subsidiaries are covered by CEG plans.

2. The qualified pension plans of CEG and the Nine-Mile Point nuclear plant are backed by pension assets. Executive supplemental pension plans, post-employment and post-retirement plans are not funded. The total net liability for all plans (assets for funded plans minus obligations for all plans) was approximately $1.4 billion at the end of 2008.[34] As of July 31, 2009 the net liability for these plans was approximately **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL].**[35]

3. At the end of 2008, CEG's net pension liability (which includes the liabilities associated with two unfunded, non-qualified pension plans for upper management) was approximately $937 million.[36] The net liability increased by $551 million during 2008, primarily due to a decrease in the market value of pension assets, but also because CEG's pension contributions were insufficient to keep up with growth in the projected pension benefit obligation. By July 31, 2009, the net pension liability was **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL].**[37]

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[34] SEC Form 10-K, Annual Report for the Period Ending December 31, 2008, Financial Statement Note 7.
[35] Response to CEG Discovery, Staff 16-1, Attachment 1. This shows that as of July 31, 2009, the net pension liability was **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]** and the post-retirement plan liability was **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]**. We did not receive an updated value of the post-employment liability. Assuming it remained at approximately $60 million, the combined value of the obligations on July 31, 2009 was **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]**.
[36] SEC Form 10-K, Note 7.
[37] Response to CEG Discovery, Staff 16-1, Attachment 1.

4. As noted above, CEG provides post-retirement and post-employment benefits that include health, dental and life insurance and, for disabled employees, income replacement benefits. Unlike the qualified pension plans, the post-retirement and post-employment plans are not backed by assets. At the end of 2008, the combined liability (accumulated benefit obligation) of these plans was approximately $475 million, down from $488 million at the end of 2007.[38]

5. Documents provided in discovery responses show that CEG will separate its benefit plans for the CENG joint venture.[39] The intent is to provide joint venture employees with the same benefits they currently have, but in separate plans. Separating the plans will require selecting a method of separating liabilities and, in the case of the qualified pension plan, pension assets.

Q. Do you have any recommendations concerning the defined benefit obligations?

A. Yes. A CEG document discussing benefit plan separation notes that the intent in separating the pension plans to identify the costs associated with the joint venture employee group **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL].”**[40] In response to a Staff discovery request, CEG further indicated that it will perform an actuarial analysis of the benefit obligations attributable to each plan participant for the nuclear joint venture and that an actuarial analysis will determine the allocation of pension assets between CEG and the joint venture in accordance with ERISA Section 4044. Given that the division of pension assets and benefit obligations between CEG and the joint venture has the potential to affect the benefit funding attributable to BGE, I recommend the Commission review the actuarial analysis to determine that assets and liabilities associated with benefit obligations are not separated in a way that creates a disadvantage for CEG or BGE relative to the joint venture.

Q. Please describe CEG’s defined benefit obligations

A. CEG’s defined benefit obligations include pension, post-retirement and post-employment benefits. The net liability for these plans at the end of 2007 and 2008 is summarized below.

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[38] SEC Form 10-K, Annual Report for the Period Ending December 31, 2008, Financial Statement Note 7.
[39] Response to CEG Discovery, Staff 12-4, Attachment 3, pp.5-6.
[40] Id.

Table 1 **Constellation Energy Group** **Defined Benefit Plans - Net Liability** **($ amounts in thousands)**		
	12/31/2007	**12/31/2008**
Pension benefits	385,700	936,700
Post-retirement benefits	421,500	415,400
Post-employment benefits	66,300	59,900
Total net benefit liability	**873,500**	**1,412,000**
Source: Fin. Stmt. Note 7, 2008 SEC Form 10-K (Annual Report)		

Pension consists of obligations under qualified CEG and Nine-Mile Point pension plans and obligations under non-qualified senior management and executive supplemental plans. Post-retirement obligations consist of medical, dental and life insurance plans for retired employees. Post-employment plans consist of health, life and income replacement benefits for disabled employees. Among these plans, the only ones backed by long term funds are the qualified CEG and Nine-Mile Point pension plans. CEG pays benefits for non-qualified executive pension, post-retirement and post-employment plans on a current basis.

Q. Please summarize the pension plans.

A. Actuarial reports provided by CEG show that it currently sponsors the following pension plans:

- Pension Plan of Constellation Energy Group, Inc. - The CEG pension plan is a qualified defined benefit plan covering employees of BGE, CEG and CEG's non-regulated subsidiaries. On January 1, 2000 employees were permitted to select between two options: 1) an "enhanced traditional plan" (ETP) in which annual benefit payments for the life of each employee are based on service credits applied to historical salary levels; and 2) a "pension equity plan" (PEP) in which service credits are applied to final average annual pay to calculate a gross pension amount which may be taken as an annuity or lump sum. Employees hired after 1999 are eligible only for the PEP. The table below summarizes plan participants as of January 1, 2008.

[BEGIN CONFIDENTIAL]

Table 2

Constellation Energy Group Pension Plan

Participants By Category, January 1, 2008

Category	BGE	BGE Home	CEG	Commod-ities Segment	Power Segment and Other (1)	Total
Active Employees						
Participants on Long Term Disability						
Term-vested Employees						
Retired Employees						
Beneficiaries						
Total Participants						

Source: CEG Pension Plan 2008 Actuarial Report, Table 3.3, Response to Staff Data Request 4-7, Attachment 9.
(1) Excludes employees of the Nine Mile Point Power Plant.

[END CONFIDENTIAL]

Participants CEG's nuclear affiliates (excluding Nine Mile Point employees covered by a separate pension plan discussed below) include:

CENG **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**
Calvert Cliffs **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**
Ginna **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**
Total Nuclear **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**

By the end of 2008 the total number of plan participants had dropped slightly, to **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**.[41]

- Nine Mile Point (NMP) Pension Plan - The NMP pension plan covers current and former employees of the NMP power plant. As of January 1, 2008 this included **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**.

- Senior Executive Supplemental Pension Plan and Supplemental Pension Plan - This plan covers designated senior executives and certain officers and key employees of CEG and its subsidiaries designated as participants as of January 1, 2000. **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** The plan incurred a net periodic benefit cost of **[BEGIN**

[41] Response to CEG Discovery, Staff 16-2, Attachment 1.

CONFIDENTIAL] **[END CONFIDENTIAL]** in 2008, up from **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in 2007. These plans are unfunded (have no assets).

- <u>Senior Management Pension and Supplemental Pension Plans and Benefits Restoration Plans</u> - The Senior Management Pension and Supplemental Pension Plans cover participants who had reached either age 59 (for the pension plan) or age 53 (for the supplemental pension plan) by January 1, 2000. There are no new participants after December 31, 1999 and the Senior Management Pension Plan has no active participants. The Benefits Restoration Plan covers employees whose pension benefits are reduced by Internal Revenue Code limitations. On a combined basis, as of January 1, 2008, the plans had **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**. There were also **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in the Benefit Restoration Plan. There were **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in the Senior Management plans on January 1, 2008. On a combined basis, these plans incurred a net period benefit cost of **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in 2008. Like the Senior Executive plans, the Senior Management and Benefit Restoration plans are unfunded and have no assets.

Q. Please summarize the funded status of CEG's pension plans.

A. Data in Constellation's 2008 Form 10-K annual report shows that the net pension liability (assets minus liabilities) grew substantially between the end of 2007 and 2008. By the end of 2008 the net pension liability, based on the projected benefit obligation (PBO), approached $1 billion[42]:

[42] The liabilities are shown before the effect of taxes. Because IRS rules do not permit pension expense tax deductions based on GAAP pension accounting, there is a deferred tax asset (prepaid tax) associated with the pension liability that is not reflected in the net pension liability itself. In the event of plan liquidation and settlement, CEG's obligation, net of deferred tax, would be approximately 65 percent of the net liability calculated using the ABO.

[BEGIN CONFIDENTIAL]

Table 3 **Constellation Energy Group** **Pension Net Liability as of December 31, 2007 and 2008** **($ amounts in thousands)**		
Pension Net Liability = PBO or ABO Minus Pension Assets	**Based on Accum. Benefit Obligation**	**Based on Projected Benefit Obligation**
Pension Net Liability - 12/31/2008		
Pension Net Liability - 12/31/2007		
ncrease in Net Liability During 2008		
Source: Fin. Stmt. Note 7, 2008 SEC Form 10-K (Annual Report)		

[END CONFIDENTIAL]

The funded status of the individual pension plans, as of January 1, 2009, is as follows:

[BEGIN CONFIDENTIAL]

Table 4 **Constellation Energy Group** **Pension Plan Funded Status as of January 1, 2009** **($ amounts in thousands)**						
Plan	**Fair Market Value - Assets**	**Accumulated Benefit Obligation**	**Funded Status: Assets / ABO**	**Projected Benefit Obligation**	**Funded Status: Assets / PBO**	**Surplus / Shortfall Based on PBO**
CEG Pension Plan						
Nine Mile Point Pension Plan						
CEG Senior Executive Supplemental Pension Plan & Supplemental Pension Plan						
CEG Senior Mgt. Pension Plan, Senior Mgt Supplemental Pension Plan and Benefits Restoration Plan						
Total						
Source: Response to CEG Discovery, Staff 16-2, Attachment 1.						

[END CONFIDENTIAL]

Q. Please briefly describe and explain the difference between the accumulated and projected benefit obligations.

A. The accumulated benefit obligation (ABO) is the present value of pension benefits that the actuary has attributed to employee service rendered before a certain date. It includes vested pension benefits as well as benefits that an employee may have earned based on service, but in which the employee may not yet be vested. For the table above, it includes employee service rendered through December 31, 2008. The ABO effectively reflects the liquidation value of pension obligation on the measurement date. The projected benefit obligation (PBO) is based on the same employee service credits, but takes into account future employee compensation levels. The PBO represents the pension liability under the assumption that the plan continues to accumulate obligations going forward.

Q. Please summarize CEG's recent pension plan contributions and benefit payments, and their relationship to the net pension liability.

A. In 2007 and 2008 combined, CEG reported that it made $215.5 million in contributions to its pension plan.[43] This is approximately equal to the benefits paid to participants during the same two year period.[44] Although contributions during 2007 and 2008 were sufficient to replace benefit payments, the net pension liability grew substantially. Growth in the net liability was due primarily to a large negative return on pension plan assets and growth in the projected benefit obligation (the pension liability). However, it should also be noted that between January 1 and July 31, 2009, the net pension liability was reduced, from $945 million to **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**. We did not determine the extent to which the reduction came about as a result of market recovery or increased plan contributions, but it is likely that both played a role.

Q. Summarize CEG's post-retirement and post-employment benefit plans.

A. CEG's post-retirement benefit plans consist of medical, dental and life insurance plans. Depending on retirement date and medical plan choices, retirees contribute to varying degrees to the cost of post-retirement medical and dental coverage. Post-employment benefits include medical and life insurance and income replacement payments for disabled employees.

Q. What is the funded status of the post-retirement and post-employment plans?

A. CEG pays for these benefits from current funds and does not have assets backing the post-retirement or post-employment benefit liabilities. At the end of 2008, the ABOs were approximately $415 million for post-retirement and $60 million for post-employment benefits.[45] Most of the liabilities in these plans are associated with medical benefits.

[43] SEC Form 10-K, Annual Report for the Period Ending December 31, 2008, Financial Statement Note 7.
[44] Id.
[45] Id.

Impact of the CENG Joint Venture Transaction on CEG and BGE Defined Benefit Plan Obligations

Q. Will the joint venture transaction affect CEG's pension, post-retirement and other obligations, and if so, how?

A. Yes. A confidential document dated April 21, 2008, entitled **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** indicates that certain benefit plans cover both CEG and CENG employees.[46] The document points out that after the transaction closes, IRS rules will no longer permit single employer treatment for the plans because CENG will no longer be owned at least 80 percent by CEG. To avoid triggering multiple-employer plan status, the document indicates that CEG intends to **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** Apart from the IRS regulations, given that the CENG joint venture will have different ownership, it makes business sense to separate the plans to avoid problems associated with combined plan assets and liabilities in the future. The document notes that the new CENG joint venture plans (CENG and Nine-Mile Point) will continue to be administered by CEG's Human Resources function.

Q. What new plans will be created?

A. The document indicates that new pension and retiree medical plans will be created for CENG. Other plans not associated with retirement benefits, including employee medical, dental, disability, life insurance and savings will also be created. It appears that with a few exceptions, such as **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**[47] According to the document the Nine-Mile Point retirement and employee plans, which are already separate from CEG's plans, will **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**

Q. How will retirement benefit assets and liabilities be divided between CEG and the joint venture?

A. In response to our data request, CEG described the division of benefit obligations as follows:

[46] Response to CEG Discovery, Staff 12-4, Attachment 3.
[47] Id.

> An actuarial analysis of the benefit obligations of the employees and other participants of the nuclear joint venture will be prepared to determine joint venture pension and post-retirement benefit obligations / liabilities. The calculation will be prepared for each participant based on age, years of service, salary, mortality and other demographic factors.[48]

The division of assets is to occur as follows:

> An actuary will determine the allocation of pension assets between CEG and the nuclear joint venture. The professional standard methodology we intend to follow is in ERISA Section 4044. Section 4044 requires calculation of every covered participant's benefit and allocates assets to that benefit in a hierarchy beginning with those already in retirement and ending with those recently hired.[49]

CEG's data response provides an impression that pension assets are to be assigned to participant benefits in a manner that gives priority to retirees. If the pension plan participant statistics shown in CEG's 2008 actuarial report are accurate, it would seem to indicate a favorable distribution of pension assets to CEG, since although the nuclear unit affiliates (other than Nine Mile Point) claim **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** of the CEG pension plan's employee participants, they have only **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** of the plan's retiree participants.[50] A brief review of ERISA section 4044[51] shows that the rules associated with asset allocation are complex and cannot easily be interpreted to include a participant hierarchy favoring retirees as suggested by CEG in its data response. To ensure that the overall distribution of assets and obligations to CEG and the joint venture is reasonable, the Commission should review CEG's actuarial analysis.

Income Tax

Q. Please explain why the income tax payable as a result of the transaction is important.

A. Income tax paid on the gain on CEG's sale of assets to EDF is a direct offset to the liquidity to be made available to CEG from the transaction. It is therefore important for

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[48] Response to CEG Discovery, Staff 17-5, item A.
[49] Response to CEG Discovery, Staff 17-5, item B.
[50] Response to CEG Discovery, Staff 4-7, Attachment 9, Actuarial Valuation Report, Pension Plan of Constellation Energy Group, December, 2008, Table 3.3, Participant Counts by Affiliate. These statistics exclude participants associated with Nine Mile Point, which has its own plan.
[51] U.S. Code Title 29, Chapter 18, Sub-chapter III, Subtitle C, Section 1344, Allocation of Assets.

CEG and EDF to carefully study the income tax consequences of the transaction and optimize the tax structure.

Q. Summarize what you have learned about the income tax impact of the transaction.

A. In its December17, 2008 Investor Presentation, CEG and EDF indicated the following:

> We project to receive $3 billion in after-tax proceeds at close. This figure is conservative and assumes no tax optimization. We believe substantial opportunity exists for tax savings and we will work during the pendency of approval to implement the optimum structure. The benefits achieved will accrue to both EDF and CEG and be split 50/50.[52]

Given sales proceeds of $4.5 billion, the $3 billion estimate for after-tax proceeds reflects a current income tax estimate of $1.5 billion.

In Phase II data request 3-16 we asked CEG to provide all documents describing or estimating the income tax consequences of the transaction. The response to request 3-16 was supplemented in the response to CEG Phase II request 4-8. The supplemental response shows that CEG expects to pay **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** in state and federal income tax based on 35% federal and 5% effective state tax rates.[53] This suggests that the tax savings that result from optimization efforts between the December, 2008 Investor Presentation and the preparation of the worksheets provided in response to CEG request 4-8 is approximately **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** . CEG confirmed that this reflects its most current optimized tax calculation.[54] A calculation of the currently anticipated income tax is shown below:

[52]Constellation Energy and EDF Investor Presentation, December 17, 2008, p. 18.
[53] The effective 5% state tax rate is based on apportionment of state taxable income between Maryland and New York and takes into account the deductibility of state tax on the federal return.
[54] Response to CEG Discovery, Staff set 7-2.

[BEGIN CONFIDENTIAL]

Table 5 Constellation Energy Group Income Tax Calculation Summary ($ amounts in thousands)			
	Sale Portion (Sec 754)	**Contribution Portion (Sec 707)**	**Total**
Sales Proceeds			
Subtract: Reimbursement of pre-formation capital expenditures and qualified debt repayments			
Subtract: Tax basis (cost of sale)			
Gain on sale			
Combined federal and state rate:			
Current Tax on Gain			

Source: Response to CEG Discovery, Staff 4-8, Attachment 1.
Section 754 of the I.R.C. contains rules for the election of an optional adjustment to the basis of partnership property.
Section 707 of the I.R.C. contains rules covering transactions between a partner and the partnership.

[END CONFIDENTIAL]

Q. Does it represent the final tax calculation?

A. No. In response to a followup data request, CEG indicated that the calculations and analysis provided in response to CEG set 4, question 8 does not reflect the finalized tax implications of the transaction.[55] CEG's response goes on to list a number of items on which tax payable is dependent, including:

- The final agreed upon purchase price, which itself is dependent on CENG cash and debt on hand at closing, and on purchase price adjustments.
- The identification and tax basis of the CENG assets and assumed liabilities at the time of closing, including the computation of tax depreciation through the closing date.
- The amount of pre-formation expenditures and qualified liabilities of CENG at closing.
- The allocation of the gain from the sale between Maryland and New York, and other combined reporting states, to be determined based on the level of sales, property and payroll in each state for 2009.

[55] Response to CEG Discovery, Staff 7-1.

CEG further stated that it does not expect the final income tax calculation to be completed until the second or third quarter of 2010. The above items reflect actual data currently anticipated at the time of closing. It is unclear if CEG an EDF are continuing to pursue options to the tax structure that may further reduce the taxes that would otherwise be triggered by the transaction.

Q. Does this conclude your testimony?

A. Yes, it does.

ROBERT F. WELCHLIN, CPA
Senior Manager

General

Regulatory consultant to the telecommunications, cable, electric and gas industries. Experience includes managing and conducting operational, management, financial and regulatory audits and analysis of rate filings.

Education

- Master of Business Administration, St. Edwards University, 1986.
- Bachelor of Science, Accounting and Business Administration, Eastern Illinois University, 1979.

Representative Experience

Electric and Gas

- Exelon / PSEG Merger Review – Assisted the New Jersey Board of Public Utilities in review of the proposed merger of Exelon (Commonwealth Edison, Pennsylvania Energy) with PSEG (Public Service Electric & Gas). Responsible for the review of the impact of combining the two holding companies' service companies (the companies that provide managerial, technical and administrative services to associated companies) on the New Jersey genco and utility. (2005-2006).

- Atlantic City Electric / Pepco Holdings Inc. Management Audit – Project Technical Manager in charge of an analysis of affiliate transactions and operations, the PHI holding company cost accumulation and distribution process, organization structure and support services, conducted as part of a management audit of Atlantic City Electric, performed for the New Jersey Board of Public Utilities, Audits Division. (2008-2009).

- Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas Regulatory Audits – Project Manager for audits of the affiliate relationships and cost allocations of Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas conducted on behalf of the New Jersey Board of Public Utilities (BPU). The audits examined whether each Company maintained a strict separation of risks, functions, and assets between their regulated utilities and unregulated affiliates to comply with BPU Standards. The audits also documented each Company's cost allocation methodologies and results for a two-year period. (2002-2003)

- Sempra Energy – Project Manager for a review of the costs and cost allocations of Sempra Energy's holding company. The review, conducted on behalf of the Utility Consumer Action Network (UCAN) was a part of the review of Sempra Energy's rate application with the California Public Utilities Commission (A.02-12-027 and A.02-12-028) (2003). Performed a similar review in the subsequent rate applications of subsidiaries, San Diego Gas & Electric Company and Southern California Gas Company (A.06-12-009 and A.06-12-010). (2007)

- Kansas Pipeline Company - Directed the cost of service component of the initial FERC cost of service and base rate filing of Kansas Pipeline, which had been exempt from

FERC rate regulation prior to 1997. Submitted and defended testimony on behalf of Kansas Pipeline before the FERC covering the overall cost of service filing, the historical basis for the calculation of acquisition premium and company's test year operations and maintenance expenses (1998 – 2000).

- Pacific Gas and Electric 1999 General Rate Case - Reviewed projected test year administrative and general expense levels and allocation of costs between the utility and affiliates. Submitted and defended testimony on behalf of the California Public Utilities Commission (1998).

- Pacific Gas and Electric Audit of Inter-Company Relationships and Transactions - Managed an audit of PG&E's compliance with regulatory requirements and internal control over relationships and transactions between the utility and its unregulated affiliates on behalf of the California Public Utilities Commission. (1998).

- Southern California Gas Performance Based Ratemaking (PBR) Filing - Conducted a review of 1994 and 1995 base margin costs. Submitted testimony on behalf of the California Public Utilities Commission. Issue areas included operations and maintenance expenses, corporate allocations, employee and executive compensation, post-retirement benefits, and savings from restructuring and force reduction programs (1996).

- Missouri Gas Energy Rate Case - Submitted cost of service testimony on behalf of Mid-Kansas Partnership and Riverside Pipeline, L.P. in connection with Missouri Gas Energy's base rate filing. Issues included deferred gas safety costs, merger-related savings and weather normalization (1996).

- Western Resources / Kansas Power and Light Rate Case - Conducted a rate case audit and submitted and defended cost of service testimony on jurisdictional cost allocations, operations and maintenance expenses and pension expenses on behalf of the Kansas Corporation Commission (1992).

- Montana Dakota Utilities and Mountain Fuels - Conducted focused management audits of the gas supply operations of two western local distribution utilities for the Wyoming PSC. Assessed the management and organization of each company as it related to gas supply, the degree to which supply options were optimized, the potential impact of FERC Order 636, and the relationships between the LDCs and their pipeline and production affiliates (1992).

- Big Rivers Electric Cooperative - Reviewed fuel receiving and inventory policies and coal contract terms in connection with a focused management audit of fuel procurement for the Kentucky PSC. (1993).

- Illinois Power Company (Illinova) - Performed internal operational audits of nuclear and fossil fuel procurement, natural gas procurement and delivery, various corporate, power plant and service area operations, and nuclear plant construction contracts. (1980 to 1983).

Telecommunications

- Frontier (Citizens) Telecommunications Regulatory Audit - Directed a California statutory regulatory audit of Citizens' California PUC financial reporting and shareable earnings. , including transactions between Citizens, its Connecticut-based parent company and its affiliates. (2004-2005).

- Pacific Bell Regulatory Audit – Directed a California statutory regulatory audit of Pacific Bell's California PUC financial reporting, including transactions between Pacific Bell, its parent company (SBC) and its affiliates and subsidiaries. (2001-2002).

- Roseville Telephone Regulatory Audit - Directed and conducted a regulatory audit of the company's compliance with affiliate and non-regulated activity transaction rules and reviewed the company's calculation of earnings shareable with customers under the California PUC's New Regulatory Framework rules. Submitted and defended testimony on the audit on behalf of the CPUC (1999- 2000) Performed a followup audit of 2001-2003 regulated earnings (2004).

- New York Telephone Loop Study - Directed a study of NYT's subscriber loop network. Coordinated the effort of a multi-disciplined team that included regulatory, network operations, engineering and data processing specialists. The major work products included an inventory of subscriber facilities, determination of facility utilization in different geographic regions, determination of the relative accuracy of the major databases containing network facility information, and verification of billing records with installed facilities (1991).

- AT&T Review of Affiliate Transactions - Conducted a review of the affiliate management and accounting relationships among the subsidiaries of AT&T. Documented significant transactions and allocations through the AT&T organization that affected AT&T Communications. Examined policies and procedures that affected the Communication subsidiary's decision to use internal sources of supply and the corporate entity's allocation of costs to subsidiaries (1990).

- Bay Area Teleport - Conducted a review of the impact of local exchange carrier price flexibility on competitive access in California (1988).

- GTE - Analyzed Indiana local exchange rates and developed a computer model to distribute the carrier's revenue requirement over a matrix of local services and rate groups (1989).

Water

- California American Water Company Regulatory Audit – Technical Manager for the regulatory audit and revenue requirements analysis of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions (2008).

Cable

- Late Payment Costs - Analyzed costs imposed on cable systems by late-paying customers and prepared studies to quantify the additional costs of handling past due accounts. (1995 through 2001).

- Cost of Service - Analyzed cable system costs and prepared cost-of-service rate studies for several cable companies, including several of the nation's largest cable systems. Developed cost-of-service methodologies to properly account for affiliate relationships and corporate and divisional cost allocations to the cable systems. Analyzed incremental cost of service under FCC Form 1235 rules for a group of systems calculating the revenue requirement impact of upgrading system capacity upgrades (1994-1999).

- Franchise Issues - Developed financial models to determine the financial and potential rate impact of franchise requirements for system upgrades and rebuilds. In 1997, coordinated the financial aspects of a franchise proposal submitted by the Company by a California local franchise authority (1995 and 1997).

- Programming Costs - Developed a database application to calculate programming cost increases on a cable-system basis to comply with FCC requirements (1994).

Work History

1996 - Present: **Overland Consulting**
Senior Manager Plan, supervise and perform telecommunications and energy industry consulting projects, including audits, on behalf of public utility commissions and other government agencies.

1993 - 1996: **KPMG Peat Marwick LLP**
Senior Manager. Information, Communications and Entertainment Line of Business. Developed, managed cable TV and telecommunications and industry consulting engagements. Also participated in and helped manage electric and gas utility engagements.

1987 - 1993: **LMSL, Inc., / Overland Consulting**
Manager. Conducted audits of energy and telecommunications companies; sponsored testimony in regulatory proceedings. (LMSL is a predecessor firm of Overland Consulting).

1984 - 1986: **Public Utility Commission of Texas**
Senior Staff Accountant. Reviewed electric, telephone and water utility rate and regulatory filings and sponsored cost of service testimony in rate hearings.

1980 - 1983: **Illinois Power Company**
Senior Internal Auditor. Planned, directed and performed operational and financial audits of the company's headquarters departments, power stations and service offices. Prepared the annual department operating plan, drafted the report to the Audit Committee of the Board of Directors for approval by the Director of Internal Auditing and coordinated work with external auditors.

Certifications

Illinois CPA Certificate No. 31763
Kansas CPA Certificate No. 9821
Kansas Practice Permit No. 3349
Member, American Institute of CPAs

Exhibit RFW-2

CONFIDENTIAL DOCUMENT

Exhibit RFW-3

CONFIDENTIAL DOCUMENT

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Before the Public Service Commission of Maryland

Case No. 9230

Application of Baltimore Gas and Electric Company for Revisions in its Electric and Gas Base Rates

Prepared Reply Testimony of
Robert F. Welchlin

On Behalf of the Staff of the

Maryland Public Service Commission

<u>PUBLIC VERSION</u>

July 30, 2010

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Introduction

Q. Please state your name and business address.

A. My name is Robert F. Welchlin. My business address is 11551 Ash St., Suite 215, Leawood, KS 66211.

Q. By whom are you employed and in what capacity?

A. I am employed by Overland Consulting as a Senior Manager.

Q. Please summarize your experience and qualifications relevant to this proceeding.

A. I have provided financial and regulatory consulting services related to the energy and telecommunications industries for approximately 23 years. Among my responsibilities, I have testified and/or provided consulting services pertaining to holding company and service company matters in the context of regulatory audits and rate cases. During the last 20 years I have analyzed the affiliate transaction and corporate and shared services cost allocation processes of a number of regulated companies, including electric, gas, telecommunications and water utilities. My resume is included as Exhibit RFW-1.

Q. Please describe the subject of your testimony.

A. My testimony addresses shared services cost allocations from Constellation Energy Group's (CEG's) parent organization to Baltimore Gas and Electric (BG&E). I address the current procedures and internal controls governing shared services allocations and the impact that last year's joint venture transaction with Electricite de France (EDF) had on the allocations. I present recommendations to strengthen internal control over the shared services allocation process as it affects BG&E.

Q. Please summarize your recommendations.

A. My recommendations are as follows:

- <u>BG&E should enter into a shared services administrative agreement with CEG no later than January 1, 2011. The agreement should be structured to</u>

ensure that BG&E is charged only for the services it needs, in the quantities needed. The agreement should also ensure that the services are provided as cost-efficiently as possible. CEG currently has service agreements with Constellation Energy Nuclear Group (CENG) and Unistar, but not with BG&E.[1] An agreement with BG&E should be developed and structured to ensure that BG&E is provided only the categories of services it needs in the quantities it needs. I recommend the MPSC review the proposed agreement and approve it so that it can be put into effect by January, 2011. Approval should be conditional, subject to the completion of an audit of shared services, as recommended below.

- The agreement between CEG and BG&E should be based on specific service-level agreements (SLAs) describing, in detail, the services to be provided, and should contain appropriate limits on services that can be charged to BG&E. The agreement should include a "most favored customer" clause to ensure that a favorable provision granted to any BG&E affiliate also applies to BG&E. The Administrative Service Agreement for Allocated Services between CEG and CENG places a dollar limit of [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] on the amount CENG must pay CEG in 2010 for services allocable under the four-factor formula[2]. However, a new agreement containing individual service level agreements (SLAs) is scheduled to go into effect between CEG and CENG in 2011. The SLAs are intended to identify activities performed and quantify the volumes, quality and cost of services to be provided over the following year. In addition, the current agreement between CEG and CENG places restrictions on the types of services and circumstances under which CEG may charge CENG for Additional Services.[3] Similar SLAs, controls and restrictions on the services that can be charged should be in place for a shared services agreement with BG&E. Finally, to ensure that BG&E is not put at a relative disadvantage because of favorable provisions granted to affiliates, the agreement should contain a "most favored customer" clause applicable to both the agreement in general and to the individual SLAs.

[1] Response to Staff data request 8-15.
[2] Response to Staff data request 8-14.
[3] Response to Staff data request 8-14.

- Before the end of 2011, the MPSC should conduct an audit of internal controls and cost distributions to BG&E under the CEG / BG&E shared services agreement. Final approval of the agreement should be subject to the findings of the audit and the implementation of any audit recommendations that the MPSC adopts. Responses to Staff data requests indicate that the process of assigning most of CEG's shared services costs to a single cost allocation pool and distributing them with a four-factor formula is about to change. This change may have a significant effect on the way costs are charged to BG&E and on the amount of cost charged. In fact, it could substantially increase the amount of shared services cost charged to BG&E. The MPSC should undertake a careful review of shared services processes and ensure that appropriate internal controls are in place and operating as intended. The MPSC should audit the costs being charged to ensure they are properly distributed between BG&E and other affiliates using acceptable pricing and allocation methods. The audit should also determine that the costs charged by the parent are reasonable and necessary for the provision of service to utility customers under Maryland rules. This requires an examination of the nature of the costs being charged.

- BG&E's CAM should be improved to ensure that basic information about the shared services cost allocation process is properly disclosed. Information that should be added to the disclosures in BG&E's CAM includes: 1) a description of the management and legal entities that supply each category of corporate services, 2) meaningful, detailed descriptions of the services provided to the utility; and, 3) a description of each charging and allocation process used to distribute costs along with information and data supporting allocation factors.

- As it implements new processes in 2011 to account and charge for shared services, CEG should consider placing shared services and the employees who provide them into a separate service company. A majority of energy utility holding companies (including companies with multi-state utility operations) provide shared services through a company designated for that purpose. The primary benefit of a separate service company is to provide accounting and management separation between shared services and the other operations and activities of the company. Separating shared services from other activities helps improve the transparency of the process, as well as the ability to understand and audit it.

The Current Shared Services Allocation Process

Q. Please summarize CEG's current shared services allocation process.

A. Excluding reimbursements to the parent for expenses paid on behalf of subsidiaries, CEG charges between [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] annually to subsidiaries for shared services and use of shared assets.[4] A majority of this consists of services allocated under a four-factor formula. The four-factor formula portion of shared services is less variable than total shared services charges, averaging around [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] annually during the past few years.[5] Shared services include accounting, finance, human resources, legal, environmental, information technology, supply chain, public affairs, marketing, communications, corporate planning and corporate strategy. Shared services costs also include facilities charges and depreciation on shared assets. The table below summarizes 2009 actual, 2010 planned and test year end July 31, 2010 allocations from CEG to the major business units. The Merchant unit consists of Nuclear Generation and Fossil Generation segments. New Energy consists of Commodities and Customer Supply segments. Beginning in 2010, ONR (Other Non-Regulated) costs are accounted for as part of New Energy.

[4] Response to Staff data requests 8-1 and 8-2 and response to Staff data request 5-1 in Case 9173.

[5] Id. However, it is noteworthy that the four-factor formula pool is [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] in the test year.

[BEGIN CONFIDENTIAL]

Table RFW-1
Constellation Energy Group (CEG)
Shared Services Cost Allocations
2009 Actual, 2010 Budgeted and Test Year Requested Amounts
(Amounts in 000s)

AMOUNTS	BGE	ONR	New Energy	Merchant	Total
2009 Actual					
Four Factor Formula					
Consumption Based Pricing					
Other					
Total 2009 Actual					
2010 Budgeted					
Four Factor Formula					
Consumption Based Pricing					
Other					
Total 2009 Actual					
Test Year Requested					
Four Factor Formula					
Consumption Based Pricing					
Other					
Total Test Yr Requested					

Sources: Responses to Staff data request 8-1 and 8-3 (confidential)

[END CONFIDENTIAL]

As shown in the table, a majority of the cost distributions occur through the four-factor formula. This formula is based on an equal weighting of subsidiary gross margin, assets, equity and employees. "Consumption based pricing" consists mainly of information technology infrastructure costs billed as they are consumed. "Other" consists of a variety of costs, some of which appear to represent charges directly attributable to specific business units.

Q. From a regulatory perspective, what is the current internal control environment governing shared services charged to BG&E?

A. In dollar terms, shared services allocations and charges account for the majority of BG&E's affiliate transactions.[6] Unlike most large utility holding companies, CEG does not have a service company, so shared services are provided by the

[6] BG&E Cost Allocation and Transfer Pricing Manual, April 30, 2010 (2010 CAM), Confidential Schedule of 2009 Costs from BG&E to Affiliates and Confidential Schedule of 2009 Costs from Affiliates to BG&E.

parent company, and potentially by other affiliates, including BG&E.[7] Unlike CENG, BG&E does not have an agreement with CEG defining the shared services to be provided, how they are to be charged, and the process for determining how BG&E will pay for them. The primary document currently defining and governing BG&E's affiliate transaction and cost allocation process is the BG&E Cost Allocation Manual (CAM). Based on affiliate regulations in the Code of Maryland Regulations, the CAM is required to contain a corporate organization chart, a list of officers of the utility, parent company and (if applicable) service company, a "complete description of the types of all costs shared with an affiliate" and a description of the methodology and procedure used to allocate costs.[8] A review of BG&E's CAM shows that it includes the required organization chart and list of officers. It also describes the four-factor formula methodology used to distribute a majority of the parent-incurred costs. However, the CAM does not provide a description of the "consumption based pricing" method, the second largest cost distribution method in dollar terms, used to charge certain information technology costs. It does not describe the "other affiliate billings" methods that accounted for over [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] in charges to BG&E in 2009. The CAM also does not provide "a complete description of the types of all costs" charged by the parent company to BG&E.

[7] Response to Staff data request 20-1 states "substantially all of the employees whose activities generate Headquarters compensation and benefit expenses work for company 50, Constellation Energy." The response goes on to list a number of other companies for which CEG is "charged for the compensation and benefit expenses and reimburses the employees' company." Among these are BG&E and various companies in the New Energy and Merchant business segments. This data response was received a few days before this testimony was due to be filed; as such, we have not had an opportunity to follow up as to the extent to which companies other than CEG, the parent, may be incurring and charging subsidiaries for shared services costs. However, we noted that among the service categories listed in the "Other" category of Headquarters services are "Supply Chain Support" and something which appears to be "BGE Finance." Parent company organizations do not typically include stores and purchasing activities, and the term "BGE Finance" suggests a service provided by the utility, rather than by the parent.
[8] 2010 CAM, p.2.

Q. What description of the types of shared services does the CAM contain?

A. The shared services description in the CAM is highly generalized. It is included in Appendix F – Index of Affiliate Provided Services. It states "CE costs charged to BGE include the utility's allocation of total holding company overhead costs, direct charges, and charges indirectly attributed from the holding company." It further states that "[t]he services provided by CE to the utility include: Corporate Affairs, Accounting, Tax, Finance and Treasury, Information Technology, Audit, Corporate Communications, Corporate Strategy and Development, Human Resources, Legal, Risk Management, Corporate and Information Security, and Investor Relations." Beyond this, which I consider to be just a list of service categories, the CAM contains no description of the shared services provided to BG&E. For example, the CAM includes no description of what specific services constitute accounting, finance, human resources, information technology or any other service category.

Q. Can you provide an example of what you would consider to be a better description of the services provided by CEG to a subsidiary?

A. Yes. A much more detailed set of descriptions is included in the Administrative Services Agreement for Allocated Services between CEG and CENG. For the purpose of comparison with the service category list in the CAM, I have attached the service descriptions from the current CEG-CENG Allocated Services agreement as confidential Exhibit RFW-2. It is important to note that these represent a basket of services currently provided to CENG. It is likely that most of these are also provided to BG&E; however, services not listed in the descriptions in Exhibit RFW-2 may also be provided to BG&E.

<u>The Impact of the CEG / EDF Joint Venture on Shared Services Cost Allocations</u>

Q. Please summarize the impact that the CEG / EDF joint venture transaction had on the shared services allocation process.

A. The joint venture transaction had two major effects on the shared services allocations. Firstly, negotiations between EDF and CEG resulted in a limit of [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] in allocated services charges to

CENG for the year 2010.[9] Secondly, although the EDF transaction dramatically increased the equity attributable to CEG's Nuclear segment, a dividend paid by CENG to CEG, also associated with the transaction, lowered the segment's equity level to approximately one-half the pre-transaction amount. A lower relative level of Nuclear segment equity, together with other changes in the relative size of four-factor formula inputs, increased BG&E's 2010 share of the four-factor formula to a little more than 32 percent using unadjusted financial inputs. However, the MPSC, in its order granting EDF's proposed joint venture with CEG, established a limit of 31 percent on CEG's allocation of costs to BG&E as a condition for transaction approval. Thus, CEG was compelled to change the formula's allocation inputs to keep BG&E's composite allocation at or below 31 percent. To accomplish this, CEG allowed the four-factor formula's calculation to reflect the increase in Nuclear segment equity created by the transaction, but excluded from the allocation calculation the concomitant reduction in equity caused by the dividend paid to the parent. As described in the CAM:

> For the allocation ratios effective in January 2010, a $4.7 billion dividend from Constellation Nuclear to Constellation Energy was excluded from the computation. This dividend, which was directly related to the sale of certain nuclear assets to EDF Development, Inc. (EDF) in late 2009, cause the Constellation Generation Group equity ratio [in the four-factor formula] to be artificially low.[10]

The discussion goes on to indicate that the resulting allocation to BG&E would have been 32.3 percent, but would have been capped by the MPSC at 31 percent.

In Staff request 16-20 we asked the Company whether the dividend adjustment would continue to be made in future years. We also asked for a definition of the boundary for "artificially low" generation segment equity. The Company responded that it expects to make the adjustment until the impact "is no longer

[9] Response to Staff Request 8-14, Attachment 2, CEG and CENG Administrative Services Agreement for Allocated Services, Section 2.2(a)
[10] 2010 CAM, Appendix F

distortive." Further, the Company stated that the "dividend adjustment applied for the $4.7 billion dividend in 2009 was extraordinary in nature . . . [t]herefore, the Company did not need to identify a boundary defining 'artificially low'." Interestingly, in 2009 CEG did not find [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] to be "distortive" for purposes of calculating the four-factor formula.[11] It is fairly clear that the adjustment to the 2010 four-factor calculation was made to make the allocation factor result compliant with the MPSC order. This highlights the arbitrary nature of size-based allocators such as the four-factor formula and the fact that they do not establish a causative link between the organization incurring a cost and the subsidiary to which it is allocated. For this reason, regulators should look carefully at size-based allocators and determine how they are calculated from year to year.

It is also noteworthy that the adjustment to the four-factor formula's inputs significantly increased the amount allocable to the Nuclear segment. If CEG had used the segment's unadjusted equity, as it did for every other four-factor financial input, the allocation to Nuclear would have been [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] With the adjustment reversing the dividend payment, needed to bring BG&E's into compliance with the MPSC condition, the Nuclear segment's allocation percentage rose to nearly [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] This increased the Nuclear segment's share of 2010 budgeted four-factor costs from [BEGIN CONFIDENTIAL] [END CONFIDENTIAL], a 43 percent increase.[12] In sum, four-factor allocations to other subsidiaries, including BG&E, were reduced by an equal amount.

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[11] Response to Staff data request 8-7, Attachment 1.

[12] However, the limit on 2010 allocated services in CENG's Allocated Services agreement with CEG appears to have prevented CENG from absorbing the increase caused by the MSPC's limit on allocations to BG&E. In Staff data request 16-15, we determined that the difference between the [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] allocable to Nuclear under the 2010 shared services budget and the [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] limit in the CENG service agreement was allocated to Constellation Nuclear, company 528. We were unable to find company 528 on any of the consolidating financial worksheets provided to us; however, it appears from the corporate organization chart to be a nuclear holding company and the owner of CENG and Unistar.

<u>BG&E should enter into an administrative shared services agreement with CEG no later than January 1, 2011. The agreement should be structured to ensure that BG&E is charged only for the services it needs, in the quantities needed. The agreement should also ensure that the services are provided as cost-efficiently as possible.</u>

Q. Please address your recommendation that BG&E enter into a shared services agreement with CEG.

A. CEG currently has service agreements with nuclear entities Unistar and CENG. There are two agreements with CENG, one for directly charged services and one for allocated services. These agreements contain limits on the services provided and amounts that can be charged to CENG. The services provided by CEG are subject to oversight by CENG's Chief Administrative Officer.[13] The agreements contain a provision which subjects the services to periodic performance reviews by CENG and provides for actions to reverse [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] in performance. In other words, the agreements serve to protect the interests of CENG. BG&E should have a similar service agreement defining the terms, conditions, pricing and allocation methods under which shared services are charged. It should be structured to protect BG&E from absorbing the costs of services it does not need, does not benefit from or that do not meet reasonable standards for performance. I recommend such an agreement be reviewed and conditionally approved by the MPSC, subject to the completion of an audit of shared services processes and costs. Following conditional approval, the agreement should be implemented and go into effect for the year 2011.

<u>The agreement between CEG and BG&E should be based on specific service-level agreements (SLAs) describing, in detail, the services to be provided, and should contain appropriate limits on the services that can be charged to BG&E. The agreement should include a "most favored customer" clause to ensure that a favorable provision granted to any BG&E affiliate is automatically applicable to BG&E.</u>

[13] Response to Staff Request 8-14, Attachments 1 & 2, CEG and CENG Administrative Services Agreements for Direct Allocated Services, Section 2.3(c)

Q. Do you have any other recommendations concerning how the BG&E service agreement should be structured and what it should contain?

A. Yes. A balanced treatment of shared services and related cost allocations among subsidiaries is much more likely if all subsidiaries benefiting from the services are subjected to the same rules. Currently, this is not the case. BG&E has no service agreement with the CEG, leaving CEG with most (if not all) of the power to decide what services to provide to BG&E and how much to provide. CENG, on the other hand, has agreements that give it at least some measure of control over the quantity and quality of services provided by CEG and limit CENG's cost for most services to a fixed annual amount. BG&E is entitled to an agreement (or agreements) that provide a similar level of control over the quantity, quality and cost of parent-provided shared services. To ensure that BG&E is not put at a relative disadvantage because of favorable provisions granted to affiliates, BG&E's shared services agreement should contain a "most favored customer" clause applicable to the agreement in general and to individual service level agreements (SLAs), discussed below.

Q. Can you elaborate on the CENG agreements and the control over shared services they provide to CENG?

A. Yes. The current Allocated Services Agreement between CEG and CENG limits the amount that CENG pays for Allocated Services to a fixed annual amount of [BEGIN CONFIDENTIAL] . [END CONFIDENTIAL][14] However, the agreement also has a number of other features that serve to limit CEG's ability to simply designate services as attributable to CENG and allocate associated costs as it chooses. For example, as shown in Exhibit RFW-2, the specific services that constitute Allocable Services are described in detail. Among the 12 categories, the agreement defines nearly 60 service sub-categories and over 200 individual services, all of which are covered by CENG's fixed payment amount.[15] Moreover, there are strict limitations on providing and charging CENG for Additional Services not covered by the [BEGIN CONFIDENTIAL] [END

[14] Response to Staff Request 8-14, Attachment 2, CEG and CENG Administrative Services Agreement for Allocated Services, Section 2.2(a)

[15] [BEGIN CONFIDENTIAL] [END CONFIDENTIAL].

CONFIDENTIAL] annual fixed payment. In order to be separately charged to CENG, Additional Services must [BEGIN CONFIDENTIAL]

[16] [END CONFIDENTIAL] Among the controls CENG has over Additional Services it might choose to purchase are the following:

[BEGIN CONFIDENTIAL]

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[END CONFIDENTIAL].[17]

Q. Is it reasonable for a shared services agreement between BG&E and CEG to provide BG&E with a level of control over the quantity and cost of shared services similar to what CENG was able to negotiate?

A. Yes. From a management standpoint, every subsidiary receiving and paying for centrally-provided services should be afforded as much control over quantity and price as is practical. Over time, this helps ensure that the services are provided as cost-efficiently as possible. Obviously, there are certain enterprise-level services, such as executive management, corporate strategic planning and certain others, that must be incurred on behalf of the corporation as a whole and cannot be provided at the discretion of individual subsidiaries. However, these services, to the extent allocated to any subsidiary, should be allocated to all subsidiaries under the same set of rules. The alternative, in this case, would be

[16] Response to Staff Request 8-14, Attachment 2, CEG and CENG Administrative Services Agreement for Allocated Services, Section 1.1(iv)
[17] Response to Staff Request 8-14, Attachment 2, CEG and CENG Administrative Services Agreement for Allocated Services, Section 2.1 (c) and (d)

for CEG, the parent, to retain such costs. For services other than enterprise-level services, to the extent a subsidiary such as CENG is permitted through its agreements to limit the services or service quantities it receives and funds, other subsidiaries must be given similar control. If they are not, the likelihood is that rather than leading to the implementation of efficiencies by the service provider, the cost of services avoided by the subsidiary with the control will be pushed to the subsidiaries that do not have the ability to pick and choose services and service quantities. To deter this possibility, I recommend BG&E's service agreement with CEG provide BG&E with the same controls over service terms provided in agreements with CENG and other affiliates, as applicable.

Q. Please elaborate on your recommendation that a BG&E shared services agreement should be based on service-level agreements (SLAs).

A. SLAs are mechanisms to ensure that the services covered by an agreement are defined at a sufficient level of detail to provide both the service provider and recipient with an understanding of what the agreement encompasses. SLAs also facilitate control over the services and the efficiency with which they are provided. Typically, companies that employ SLAs use them to define what services are needed, plan the level and quantity of services, develop volume-based pricing, and evaluate the performance of the service provider. Based on information obtained in response to data requests, it appears that CEG is in the process of developing agreements for 2011 that will contain SLAs and will be applicable to BG&E and other subsidiaries.[18] In fact, the existing Allocated Services agreement between CEG and CENG will be replaced by an agreement based on SLAs. As stated in Appendix 2 of the CENG Allocated Services Agreement.[19]

[BEGIN CONFIDENTIAL]

[END CONFIDENTIAL]

[18] Response to Staff data request 8-15.
[19] Response to Staff data request 8-14, Attachment 2.

It is unclear to what extent this will replace the fixed-fee component of the CENG agreement and the extent to which BG&E's agreement will be identically structured remains to be determined. It is likely that EDF, in representing its interest in CENG, will require stringent controls over the amount of services CENG is required to absorb and it is currently unclear whether BG&E will be afforded the same degree of control. However, in response to Staff data request 15-7, [BEGIN CONFIDENTIAL]

[END CONFIDENTIAL].

<u>The MPSC should review and conditionally approve BG&E's shared services agreement so that it can go into effect in 2011. Before the end of 2011, the MPSC should conduct an audit of internal controls and BG&E's cost distributions under the CEG / BG&E shared services agreement. Final approval of the agreement should be subject to the findings of the audit and the implementation of any audit recommendations that the MPSC adopts.</u>

Q. Please address the recommendation to conditionally approve BG&E's shared services agreement prior to January, 2011.

A. Based on information in the shared services agreement between CENG and CEG and on other BG&E responses to Staff data requests, it is clear that the process of providing and charging for shared services is being completely revamped. Based on the information available, it appears that many of the shared services currently lumped together and allocated using the size-based four-factor formula will be analyzed, related resources and activities will be identified and priced, and the services will be more directly charged. It appears that BG&E intends to enter into some type of administrative agreement with CEG that will specify the terms and conditions under which shared services will be provided. I recommend the MPSC conditionally approve the BG&E-CEG agreement after reviewing it to determine that the terms and conditions are reasonable and do not adversely affect BG&E. More specifically, the MPSC should base its conditional approval on determining that the agreement has the following features:

- Contains service-level agreements specifying services and related payment terms in detail.
- Provides BG&E with the same degree of control over services and service quantities as provided in CEG's agreements with other affiliates, including CENG.
- Provides BG&E with the same rights to performance review and input into service design and pricing as provided in agreements with other affiliates, including CENG.
- Provides BG&E with the same invoicing and payment terms as provided in agreements with other affiliates, including CENG.
- Contains a "most favored customer" clause, essentially guaranteeing the items above.

Q. What is the significance of ensuring the BG&E shared services agreement contains the same terms as provided in the agreement with CENG?

A. Unlike BG&E and CEG's other key subsidiaries, CENG's partial ownership by EDF, an entity outside the CEG corporate umbrella, means that CENG has an interest independent of CEG. This helps ensure that a service agreement between CEG and CENG is at arms-length and that the interests of the service provider and service recipient are balanced. Prior to the joint venture transaction the Nuclear segment was one of the largest recipients of four-factor-allocated costs.[20] It is likely that the current effort to revamp the shared services process to better correlate service cost with usage is a direct consequence of EDF's ownership interest in CEG's Nuclear segment and the limits on shared services allocations EDF required for CENG. To the extent BG&E's agreement has terms similar to those in the agreement with CENG, it helps protect BG&E's interests as a key funding source for the services. However, it is important to emphasize that an agreement that balances the interests of CEG and BG&E on paper does not guarantee BG&E's interests are protected in practice. The fact remains that

[20] Even in the post-transaction environment, due in part to the MPSC's condition limiting BG&E's four-factor allocation to 31 percent, the nuclear segment has the highest calculated percentage of four-factor costs. However, because CENG's shared services agreement limits its distribution of Allocated Services costs to an annual amount of [BEGIN CONFIDENTIAL]

[END CONFIDENTIAL] Constellation Nuclear, the nuclear holding company.

CENG has an interest in the agreement that is independent of service provider CEG, while BG&E does not.

Q. Please address the recommendation that the MPSC conduct an audit of shared services internal controls and cost distributions to BG&E and that final approval of the BG&E shared services agreement be subject to the results of the audit.

A. As noted above, CEG's shared services allocation process is being reworked. In the past, a majority of the cost of shared services was distributed using a four-factor formula. This has resulted in an allocation of less than a third of the cost of shared services to BG&E To the extent the process is changed and made more direct, BG&E's share of shared services cost could increase substantially, particularly if the Nuclear segment, represented by CENG, aggressively seeks to limit the types and quantities of services it agrees to purchase. Over time, the cost impact of an increase in BG&E's share of the cost could be offset if efficiencies and cost savings are achieved as recipient subsidiaries are brought into the process of service planning and performance measurement. However, service efficiencies and related savings are likely to be achieved over a period of years, while an increase in BG&E's share of the cost could take effect as soon as the new process becomes effective, which is likely to occur in January, 2011. The MPSC's 31 percent limit on four-factor allocations to BG&E will not serve to protect BG&E if costs are removed from the four-factor cost pool and distributed using some other method. As such, I recommend the MPSC review the internal controls and audit the cost distributions under the new process to determine that it does not have an adverse impact on BG&E.

Cost distributions under the new process will be planned and budgeted over the next few months. For the current year, as discussed above, I believe the MPSC should focus on reviewing the process as documented in proposed service agreements between CEG and BG&E and between CEG and other subsidiaries. Next year, after the process has been operational for some months, and after cost distributions have been planned and budgeted for 2012, the MPSC should conduct an audit of the process and the related cost distributions to BG&E. Final approval of the agreement with BG&E should be conditioned on the implementation of any recommendations that come from this audit.

Q. Is there anything in addition to the allocation process that should be included in the scope of an MPSC audit?

A. Yes. The audit should include an examination of the nature of the shared costs charged to BG&E to determine that they are reasonable and necessary for the provision of utility services under Maryland rules. It should determine that any costs attributable to BG&E that are not normally recovered through regulated rates are either designated for removal from BG&E's revenue requirement, recorded "below the line" (in accounts that contain costs not recovered from regulated customers) or retained by the parent. In examining the nature of shared services costs charged to BG&E, the audit should also consider whether the services duplicate similar services provided by the utility. For example, among the shared services designated in the CAM Appendix F are human resources and legal services. Appendix E of the CAM contains a list of services that BG&E provides to other affiliates. Among these are human resources and legal services. The audit should determine whether the services allocated by CEG duplicate services provided within the utility and whether resources in the utility effectively duplicate the resources in the shared services organization.

Q. Do you have any more comments or recommendations concerning an audit of shared services?

A. Yes. In order for the audit to be successful, the auditor must be permitted to interact directly with the BG&E and CEG employees familiar with the shared services organization and related accounting processes. Often, the initial audit of a technical process such as shared services is like peeling the layers of an onion. In some cases it may be necessary to speak with a subject matter expert more than once in order to perform appropriate follow-up and achieve a sufficient understanding of a process. Although a regulatory audit is subject to formalities, such as a written data request process it is important not to permit the Company to impose unnecessary restrictions on the transfer of information. For example, an audit of shared services requires the review of a significant amount of accounting data. It is far more efficient and a lot less time consuming to work with such data in electronic spreadsheet format than it is to work with data in a paper format. Data analysis requires sorting, filtering, totaling and sub-totaling, calculating and internal comparison. Depending on the volume of data to be reviewed, these tasks can be much more difficult when the data are available only in paper format. The ground rules for conducting an audit of shared services should be agreed upon between the Company and auditor before the audit begins.

BG&E's CAM should be improved to ensure basic information about the shared services cost allocation process is properly disclosed.

Q. Please address your recommendation to improve the level of disclosure in BG&E's CAM.

BG&E's CAM is the only publicly available document describing BG&E's affiliate transactions. Concerning shared services allocations from CEG, at a minimum, the CAM should contain adequate descriptions of the allocation process, the methods used to distribute costs to BG&E, and the services being provided to BG&E. Disclosures that should be added to BG&E's current CAM include:

- The legal entities that supply the corporate services to BG&E should be described. Since BG&E receives services from multiple affiliates (seven different affiliates charged costs to BG&E in 2009, for example), a brief description of these entities should be included. At a minimum, the descriptions of these entities should include the business purpose of each of these entities.

- To the extent affiliates other than CEG participate in the process of supplying shared "Headquarters" services, these entities and the resources (employees or outside contractors) providing the services should be described in the CAM.

- The shared services provided to the utility need to be described. As discussed above, the description of shared services in the current CAM is a list of service categories. Shared services provided to BG&E should be described at a level of detail sufficient to provide an understanding of the nature of the service. Assuming that BG&E's service agreement with CEG is based on service level agreements (SLAs), as previously recommended, then BG&E could comply with this recommendation by incorporating the services agreement, with the SLAs, as an exhibit to the CAM.

- Each charging and allocation process applicable to shared services and affiliate transactions should be properly described. Currently, the only specific shared services allocation process described in the CAM is the calculation of the four-factor formula. As discussed above, the process of providing shared services is likely to undergo fundamental change next year as CEG adopts more direct methods to measure and price specific services. Each individual method used to price and distribute shared services costs to BG&E, along with the services to which it is applied, should be described in the CAM. Depending on how the services agreement discussed above is structured, including it as an exhibit to the CAM may satisfy this recommendation.

As it implements new processes in 2011 to account and charge for shared services, CEG should consider placing shared services and the employees who provide them into a separate service company.

Q. Please address your recommendation that CEG consider establishing a separate service company for shared services activities.

A. A majority of energy utility holding companies with diverse operations provide shared services through separate service companies. In many companies with multi-state operations, service companies have existed for decades, having been established pursuant to the Public Utility Holding Company Act (PUHCA) of 1935. Holding companies with multi-state utility operations today are subject to a revised PUHCA under which they report shared services financial results and cost distributions to subsidiaries in a publicly available annual report to the Federal Energy Regulatory Commission (FERC).[21] CEG is not required, as

[21] *FERC Financial Report, FERC Form no. 60: Annual Report of Centralized Service Companies*. In Maryland, for example, Allegheny Energy, the parent of Potomac Edison, and Pepco Holdings,

multi-state holding companies are, to separately account for and report its shared services results to the FERC. Further, CEG is not required by the MPSC or the FERC to maintain a separate service company. With the information available from this analysis, I am not prepared to state that the MPSC should require CEG to establish a separate service company. However, I think the benefits of separating shared services from other activities probably outweigh the costs involved in setting up a service company, and I recommend CEG consider it.

Q. Does this conclude your testimony?

A. Yes, it does.

Inc., the parent of Delmarva, report shared services results annually in Form 60. The affiliate cost distribution information BG&E classifies as confidential in schedules attached to its CAM is filed as public information by companies filing Form 60. In fact, the public information in Form 60 includes not just allocations to the utilities, but to all subsidiaries. FERC Form 60 also includes: the financial results of service company operations, including balance sheet and comparative income statement detail, organizational information concerning the service company, and descriptions of allocation methods.

ROBERT F. WELCHLIN, CPA
Senior Manager

General

Regulatory consultant to the telecommunications, cable, electric and gas industries. Manage operational, financial and regulatory audits, reviews of rate filings and cost studies in the energy utility, telecommunications and cable industries. 21 years of industry experience.

Education

- Master of Business Administration, St. Edwards University
- Bachelor of Science, Accounting and Business Administration, Eastern Illinois University,

Representative Experience

Electric and Gas

- Connecticut Natural Gas Management Audit – Participated as a Technical Manager in a diagnostic management audit of CNG for the Connecticut Department of Public Utility Control. Areas of responsibility included transactions with and services exchanged with Southern Connecticut Gas, Energy East and other affiliates, human resources (staffing, compensation, labor relations and performance appraisal processes), customer service and call center operations, dispatch, field operations and appliance services, meter operations, distribution sales and marketing, supply chain management, fleet operations, facilities management, security and external relations. (2010)

- Constellation Energy / Electricite de France Joint Nuclear Venture – Reviewed and provided testimony concerning the potential impact of the proposed CE / EDF joint nuclear venture, CENG, on corporate and other centralized costs allocated to CE's regulated utility subsidiary, Baltimore Gas & Electric. (2009)

- Atlantic City Electric Affiliate Relationships and Management Audit – Participated as a Technical Manager in an affiliate relationships and management audit of Atlantic City Electric, a subsidiary of Pepco Holdings, Inc. (PHI) on behalf of the New Jersey Board of Public Utilities. Areas of responsibility included allocations of corporate and shared utility costs from PHI Service Company, transactions with affiliates including Atlantic Southern Properties and Millennium Account Services, compliance with New Jersey's Electric Discount and Energy Competition Act (EDECA), and the management of various functions, including information technology, fleet, stores and supply chain, security, facilities, real estate and records management. (2009)

- Exelon / PSEG Merger – Assisted the New Jersey Board of Public Utilities in review of the proposed merger of Exelon (Commonwealth Edison, Pennsylvania Energy) with PSEG (Public Service Electric & Gas). Responsible for the review of the impact of combining the two holding companies' service companies (the companies that provide managerial, technical and administrative services to associated companies) on the New Jersey genco and utility. (2005-2006)

- Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas Regulatory Audits – Project Manager for audits of the affiliate relationships and cost allocations of Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas conducted on behalf of the New Jersey Board of Public Utilities (BPU). The audits examined whether each Company maintained a strict separation of risks, functions, and assets between their regulated utilities and unregulated affiliates to comply with BPU Standards. The audits also documented each Company's cost allocation methodologies and results for a two-year period. (2002-2003)

- Sempra Energy – Project Manager for a review of the costs of Sempra Energy's holding company. The review, conducted on behalf of the Utility Consumer Action Network (UCAN) was a part of the review of Sempra Energy's rate application with the California Public Utilities Commission (A.02-12-027 and A.02-12-028). (2003) Performed a similar review in the subsequent rate applications of subsidiaries, San Diego Gas & Electric Company and Southern California Gas Company (A.06-12-009 and A.06-12-010). (2007)

- Kansas Pipeline Company - Directed the cost of service component of the initial FERC "Section 7" cost of service and base rate filing of Kansas Pipeline, which had been exempt from FERC rate regulation prior to 1997. Submitted and defended testimony on behalf of Kansas Pipeline before the FERC covering the overall cost of service filing, the historical basis for the calculation of acquisition premium and company's test year operations and maintenance expenses (1998 – 2000).

- Pacific Gas and Electric 1999 General Rate Case - Reviewed projected test year administrative and general expense levels and allocation of costs between the utility and affiliates. Submitted and defended testimony on behalf of the California Public Utilities Commission (1998).

- Pacific Gas and Electric Audit of Inter-Company Relationships and Transactions - Managed an audit of PG&E's compliance with regulatory requirements and internal control over relationships and transactions between the utility and its unregulated affiliates on behalf of the California Public Utilities Commission. (1998).

- Southern California Gas Performance Based Ratemaking (PBR) Filing - Conducted a review of 1994 and 1995 base margin costs. Submitted testimony on behalf of the California Public Utilities Commission. Issue areas included operations and maintenance expenses, corporate allocations, employee and executive compensation, post-retirement benefits, and savings from restructuring and force reduction programs (1996).

- Missouri Gas Energy Rate Case - Submitted cost of service testimony on behalf of Mid-Kansas Partnership and Riverside Pipeline, L.P. in connection with Missouri Gas Energy's base rate filing. Issues included deferred gas safety costs, merger-related savings and weather normalization (1996).

- Western Resources / Kansas Power and Light Rate Case - Conducted a rate case audit and submitted and defended cost of service testimony on jurisdictional cost allocations, operations and maintenance expenses and pension expenses on behalf of the Kansas Corporation Commission (1992).

- Montana Dakota Utilities and Mountain Fuels - Conducted focused management audits of the gas supply operations of two western local distribution utilities for the Wyoming PSC. Assessed the management and organization of each company as it related to gas supply, the degree to which supply options were optimized, the potential impact of FERC Order

636, and the relationships between the LDCs and their pipeline and production affiliates (1992).

- Big Rivers Electric Cooperative - Reviewed fuel receiving and inventory policies and coal contract terms in connection with a focused management audit of fuel procurement for the Kentucky PSC. (1993).

- Illinois Power Company (Illinova) - Performed internal operational audits of nuclear and fossil fuel procurement, natural gas procurement and delivery, various corporate, power plant and service area operations, and nuclear plant construction contracts. (1980 to 1983).

Telecommunications

- Frontier (Citizens) Telecommunications Regulatory Audit - Directed a California statutory regulatory audit of Citizens' California PUC financial reporting and shareable earnings, including transactions between Citizens, its Connecticut-based parent company and its affiliates. (2004-2005).

- Pacific Bell Regulatory Audit – Directed a California statutory regulatory audit of Pacific Bell's California PUC financial reporting, including transactions between Pacific Bell, its parent company (SBC) and its affiliates and subsidiaries. (2001-2002).

- Roseville Telephone Regulatory Audit - Directed and conducted a regulatory audit of the company's compliance with affiliate and non-regulated activity transaction rules and reviewed the company's calculation of earnings shareable with customers under the California PUC's New Regulatory Framework rules. Submitted and defended testimony on the audit on behalf of the CPUC (1999- 2000) Performed a followup audit of 2001-2003 regulated earnings (2004).

- New York Telephone Loop Study - Directed a study of NYT's subscriber loop network. Coordinated the effort of a multi-disciplined team that included regulatory, network operations, engineering and data processing specialists. The major work products included an inventory of subscriber facilities, determination of facility utilization in different geographic regions, determination of the relative accuracy of the major databases containing network facility information, and verification of billing records with installed facilities (1991).

- AT&T Review of Affiliate Transactions - Conducted a review of the affiliate management and accounting relationships among the subsidiaries of AT&T. Documented significant transactions and allocations through the AT&T organization that affected AT&T Communications. Examined policies and procedures that affected the Communication subsidiary's decision to use internal sources of supply and the corporate entity's allocation of costs to subsidiaries (1990).

- Bay Area Teleport - Conducted a review of the impact of local exchange carrier price flexibility on competitive access in California (1988).

- GTE - Analyzed Indiana local exchange rates and developed a computer model to distribute the carrier's revenue requirement over a matrix of local services and rate groups (1989).

Water

- California American Water Company Regulatory Audit and Rate Case – Technical Manager for the regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions. Submitted revenue requirements testimony covering CalAm's 2009 projected test years covering the O&M expenses of functions allocated from the national, regional and state levels to the district operations for which CalAm was seeking an increase in rates. (2008)

Cable

- Late Payment Costs - Analyzed costs imposed on cable systems by late-paying customers and prepared studies to quantify the additional costs of handling past due accounts. (1995 through 2001).

- Cost of Service (Revenue Requirements) – The rates of most US cable systems were "re-regulated" for a time during the 1990s. Cable systems could choose two forms of regulation, one price-based (limiting rates to existing prices plus inflation) and one cost of service-based, based on traditional historical test year ratemaking principles. Analyzed cable system costs and prepared cost-of-service rate studies for cable companies, including two of the nation's largest cable systems (TCI Chicago and DCLP). Developed cost-of-service methodologies to properly account for affiliate relationships and corporate and divisional cost allocations to the cable systems. Analyzed incremental cost of service under FCC Form 1235 rules for a group of systems calculating the revenue requirement impact of upgrading system capacity upgrades (1994-1998).

- Franchise Issues - Developed financial models to determine the financial and potential rate impact of franchise requirements for system upgrades and rebuilds. In 1997, coordinated the financial aspects of a franchise proposal submitted by the Company by a California local franchise authority (1995 and 1997).

- Programming Costs - Developed a database application to calculate programming cost increases on a cable-system basis to comply with FCC requirements (1994).

Work History

1996 - Present: **Overland Consulting**
Senior Manager. Plan, supervise and perform telecommunications and energy industry consulting projects, including audits, on behalf of public utility commissions and other government agencies.

1993 - 1996: **KPMG Peat Marwick LLP**
Senior Manager. Information, Communications and Entertainment Line of Business. Developed and managed cable TV, and telecommunications and industry consulting engagements.

1987 - 1993: **LMSL, Inc., Overland Consulting**
Manager. Conducted audits of energy and telecommunications companies; sponsored testimony in regulatory proceedings. (LMSL is a predecessor firm of Overland Consulting).

1984 - 1986: **Public Utility Commission of Texas**
Senior Staff Accountant. Reviewed electric, telephone and water utility rate and regulatory filings and sponsored cost of service testimony in rate hearings.

1980 - 1983: **Illinois Power Company**
Senior Internal Auditor. Planned, directed and performed operational and financial audits of the company's headquarters departments, power stations and service offices. Prepared the annual department operating plan and drafted the report to the Audit Committee of the Board of Directors for approval by the Director of Internal Auditing. Coordinated work with external auditors.

Certifications

Illinois CPA Certificate No. 31763, University of Illinois, February 18, 1982.
Kansas CPA Certificate No. 9821
Kansas Practice Permit No. 3349
Member, American Institute of CPAs

EXHIBIT RFW-2

CEG-CENG
Allocated Services Agreement – Service Descriptions

CONFIDENTIAL

CONFIDENTIAL

EXHIBIT A

EXHIBIT C

CONFIDENTIAL MATERIALS REDACTED

CONFIDENTIAL MATERIALS REDACTED

CONFIDENTIAL MATERIALS REDACTED

CONFIDENTIAL MATERIALS REDACTED

EXHIBIT F

CONFIDENTIAL

EXHIBIT G

Exhibit 7-3

EXHIBIT J

EXHIBIT K

EXHIBIT L

REGULATORY AUDIT OF 2006 AND 2007 GENERAL OFFICE EXPENSE AND TEST YEAR 2009 REVENUE REQUIREMENT OF CALIFORNIA AMERICAN WATER COMPANY

Prepared for the

CALIFORNIA PUBLIC UTILITIES COMMISSION
DIVISION OF RATEPAYER ADVOCATES

by

OVERLAND CONSULTING
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SEPTEMBER 11, 2008

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Executive Summary

This report contains the findings of a regulatory audit by Overland Consulting (Overland) of California American Water Company's (CalAm's) 2009 forecasted test year General Office (GO) revenue requirement. CalAm is a subsidiary of American Water Works Company (American Water or AW). In addition to the test year revenue requirement, we also reviewed the allocation of common regulated and non-regulated costs from American Water's service companies to CalAm and CalAm's relationships with affiliated companies.

This report contains the following chapters:

1. Summary of CalAm's General Office Rate Filing and 2009 Test Year Revenue Requirement - Summarizes Overland's review of CalAm's GO expenses for 2006 and 2007, CalAm's test year 2009 rate filing and the test year revenue requirement.

2. Adjustments to CalAm's General Office Revenue Requirement - Summarizes Overland's recommended adjustments to CalAm's test year operations & maintenance expense.

3. National Service Company Allocations to CalAm - Summarizes, for each NSC rate filing category except customer service, the basis for CalAm's historical and test year NSC expenses and allocations, Overland's analysis, and Overland's test year recommendations. Recommendations relating to test year expense mirror those discussed in Chapter 2.

4. NSC Customer Service Center - Discusses customer service expense incurred by AW's two national call centers, growth in expenses charged to CalAm, CSC allocations to CalAm and CSC services provided under non-regulated contracts with municipalities. Includes related recommendations for test year expense, mirrored in Chapter 2.

5. Local Service Company and California Corporate Allocations to CalAm - Summarizes, for the LSC and Cal Corp, the basis for CalAm's historical and test year expenses, allocations to CalAm and Overland's analysis of LSC and Cal Corp.

6. RWE Acquisition and Spin-Off of Interest and Analysis of Synergy Savings from Citizens Acquisition - Addresses certain matters associated with Commission-imposed requirements from previous proceedings; namely:
   - Conditions imposed in D.02-12-068, authorizing the transfer of control of American Water to RWE.
   - Conditions imposed in D.07-05-031, authorizing the American Water IPO.
   - Conditions required by D.01-09-057, allowing recovery of an acquisition premium associated with the purchase of Citizens Utilities water assets in California.

   Chapter 6 also addresses ongoing requirements imposed by the Commission associated with: the CalAm acquisition of water assets previously owned by Citizens Utilities; specifically the analysis of synergy benefits imputed due to the operation of these properties by CalAm in relation to the acquisition premium allowed in rates to date.

Executive Summary

Finally, potential implications of the recent sale of the Felton assets on the amount of acquisition premium recoverable from CalAm customers is addressed.

7. Rate Case Expense - Discusses CalAm's requested rate case expense associated with the current GRC cycle. Rate case expense is not part of the GO test year revenue requirement discussed above. DRA, rather than Overland, is making a recommendation concerning rate case expense recovery.

8. District Allocations of the General Office Revenue Requirement - Discusses Overland's recommended customer-based method and CalAm's proposed "four-factor" method for allocating the GO revenue requirement to California districts.

Summary of the General Office Revenue Requirement

The following table compares previously authorized, requested (by CalAm) and recommended (by Overland) test year GO revenue requirements. The components of this table are discussed in Chapter 1. The test year revenue requirement "per CalAm" calculation is based on our analysis of the rate filing. It does not appear, per se, in the rate filing.

Table ES-1
California American Water
Comparison of Previously-Authorized Company-Requested and Overland-Recommended
General Office Test Year Revenue Requirements

Components of CalAm's General Office Revenue Requirement	Last Authorized (2006 Test Year)	Test Year 2009			
		Per CalAm		Per Overland (DRA)	
		Amount	Change from Authorized	Amount	Change from Authorized
O&M Expense Revenue Requirement	11,298,350	16,858,609	5,560,259	13,226,419	1,928,069
Rate Base Rev. Req. (1)	823,405	140,066	(683,339)	140,066	(683,339)
CalAm General Office Revenue Req.	12,121,755	16,998,675	4,876,920	13,366,485	1,244,730
Percentage Increase		-	40.23%	-	10.27%

Sources: CalAm numbers: Rate Filing Exhibit B, Ch 1, Sec 3, Table 1 ; Overland numbers: Report Table 1-2 (Rate Base); Table 2-1 (Operating Expense)
(1) Last Authorized rate base rev reqmt is calculated using data provided by CalAm in Rate Filing Exh B, Ch 1, Sec 3, Table 1 Overland does not have high confidence in this amount, but it is the only amount available It does not appear to include either the C tizens acquis tion premium or the RWE merger synergy savings (for which approved amounts are shown in D 06-11-050, Att 3)

Executive Summary

CalAm's and Overland's 2009 test year GO revenue requirements, as allocated to the district level, are shown below.[1] The components of this table are discussed in Chapter 8.

Table ES-2
California American Water
Test Year 2009 General Office Revenue Requirement Allocation to District Operations
Rate Base and O&M Expense

CalAm District	Per CalAm 4 Factor Pcts	Per CalAm Amount	Per Overland Customer Pcts	Per Overland Amount	Overland Adjustment to CalAm
Coronado	10.80%	1,835,857	12.22%	1,633,384	(202,472)
Los Angeles	13.54%	2,301,621	16.30%	2,178,737	(122,884)
Village	13.39%	2,276,123	12.35%	1,650,761	(625,362)
Monterey Water	31.81%	5,407,279	23.55%	3,147,807	(2,259,471)
Monterey Wastewater	2.28%	387,570	1.32%	176,438	(211,132)
Felton	1.54%	261,780	0.00%	-	(261,780)
Sacramento	24.75%	4,207,172	32.88%	4,394,900	187,728
Larkfield	1.89%	321,275	1.38%	184,457	(136,817)
Totals	**100.00%**	**16,998,675**	**100.00%**	**13,366,485**	**(3,632,190)**

Sources: Per CalAm: 4 Factor Pcts - CalAm Workpaper GO-100; Cal-Am Total Rev Req Amount - Table ES-1 Per Overland: Customer Allocation Factors - Table 8-1, Total 2008 & 2009 Revenue Requirements - Table ES-1; District-Allocated Amounts (Per CalAm and Per Overland) - Calculated from totals and factors

Recommended Adjustments to CalAm's General Office Revenue Requirement (Chapter 2)

1. Adjustment to Annualize Labor to Reflect Actual Budget Year Staffing - Overland recommends limiting recovery of test year GO labor expense to compensation for employees on service company payrolls as of May 31, 2008. This reduces test year expense allocated to CalAm by $338,591 in 2008 and $380,171 in test year 2009 (Chapter 2, page 2).

2. Reduce Budgeted Employee Incentive Compensation - Overland recommends that GO incentive compensation be limited to amounts paid for 2007, adjusted for salary inflation, and limited to employees in salary bands for which CalAm provided requested incentive plan documents. This reduces GO expense allocated to CalAm by $589,158 in 2008 and $598,546 in test year 2009 (Chapter 2, page 4).

[1] As far as Overland can determine, CalAm's rate filing supports a 2009 GO revenue requirement calculation of $16,998,675 before district allocation, a Monterey-Toro-Chualar-Ambler Park-Ralph Lane allocated water revenue requirement of $5,407,279 and a Monterey wastewater revenue requirement of $387,570. This is calculated from Proposed Total GO O&M of $16,858,609 and Proposed Rate Base of $1,026,026 as shown in Rate Filing Exh.B, Ch.1, Sec.1,Table 1 (and also Ch.4, Sec.1, Table 1 for the O&M). A complete GO revenue requirement calculation does not appear anywhere in the rate filing. We cannot account for an apparently contradictory 2009 revenue requirement calculation of $15,677,624 on CalAm Workpaper GO-100, or the associated Monterey allocation (including smaller districts noted above) of $4,987,647, because it does not agree with the amount in the rate filing schedules in Exh.B, Chapters 1 and 4, and it is not referenced to anything.

Executive Summary

3. Remove Business Development Expense - Overland recommends no ratepayer funding of expenses allocated from NSC and LSC business development functions. This recommendation reduces GO expense allocated to CalAm by $371,469 in budget year 2008 and $383,185 in test year 2009 (Chapter 2, page 7).

4. Remove NSC Corporate Contributions Expense - Overland recommends removing charitable contribution and related expense allocated to CalAm by the NSC. This recommendation reduces GO expense allocated to CalAm by $20,623 in budget year 2008 and $20,623 in test year 2009 (Chapter 2, page 8).

5. Remove Legislative and Political Influence Expense - We recommend removing expenses incurred to influence legislation from CalAm's test year revenue requirement GO expense. Our recommended adjustment reduces GO expense allocated to CalAm by $211,004 in budget year 2008 and by $218,213 in the 2009 test year. (Chapter 2, page 9)

6. Remove Unsupported "NSC Functions" Expense - Overland recommends removing expenses in the"NSC Functions" rate filing category that do not meet regulatory standards required for ratepayer recovery. This recommendation reduces GO expense allocated to CalAm by $545,959 in budget year 2008 and $82,520 in test year 2009 (Chapter 2, page 10)

7. Correct NSC Income Tax Expense and Interest Income - We recommend adjustments to NSC-allocated income tax and interest income. The adjustments increase CalAm's GO expense by $38,195 in budget year 2008 and $38,195 in the 2009 test year (Chapter 2, page 11).

8. Remove NSC Sales and Marketing Expense - We recommend removing marketing and sales expenses incurred and allocated to CalAm from the NSC. This adjustment reduces CalAm's GO expense by $72,056 in budget year 2008 and in the 2009 test year. (Chapter 2, page 12)

9. Limit Customer Service Center (CSC) Expense to 2003 Expense Plus Inflation - We recommend limiting CalAm's CSC expense to $1,971,507 based on per-customer expense incurred in 2003, adjusted upward by for inflation. This reduces CalAm's GO expense by $831,111 in budget year 2008 and in the 2009 test year (Chapter 2, page 12).

10. Remove Unnecessary Payroll Reserve - Overland recommends an adjustment to remove a CalAm-allocated LSC payroll reserve for "bonus or promotional increase[s]." 2009 LSC expense allocated to CalAm already includes pay and benefit increases ranging from 3 to 5%, as well as incentive compensation. This reduces CalAm's GO expense by $30,050 in budget year 2008 and by $30,801 in the 2009 test year (Chapter 2, page 13).

Executive Summary

11. Correct Omission of Operating Risk Department Salaries - Overland recommends an adjustment to correct this error by adding back the expense. This adjustment increases CalAm's GO expense by $83,036 in test year 2009. The adjustment does not change budget year 2008 expense (Chapter 2, page 13).

12. Reverse Allocation Impact of Re-Branding LSC Employees as California-Only - Overland recommends that 12 of 17 employees reclassified in 2006 and 2007 from the LSC organization to the Cal Corp organization be allocated to the states served by the LSC as they were before they we re-branded as Cal Corp employees. This reduces CalAm's GO expense by $321,011 in budget year 2008 and by $334,197 the 2009 test year (Chapter 2, page 13).

13. Remove Cal Corp Labor Separately Requested in Rate Case Expense - CalAm has requested recovery of more than 100% of the labor costs of four Cal Corp employees in its filing. Overland recommends adjusting labor costs to correct this error. This adjustment reduces GO expense allocated to CalAm by $33,236 in budget year 2008 and $34,664 in the 2009 test year. (Chapter 2, page 14)

14. Correct Allocations to CalAm - Overland recommends adjustments to CalAm's proposed test year NSC and LSC allocation factors to properly reflect an allocation of test year NSC expenses to regulated and non-regulated segments and among the regulated utilities. The adjustments reduce CalAm's allocated GO expense by $765,157 in budget year 2008 and $767,334 in 2009 (Chapter 2, page 15).

Recommended Basis for District-Level GO Revenue Requirement Allocations (Chapter 8)

1. District Allocation - For ratemaking purposes, all national service company expenses and a majority of regional service company expense are allocated to the State of California jurisdictional level based on customers. We recommend the Commission require CalAm to use the same customer-based method for further allocation to the district level (Chapter 8, page 2).

Summary of Other Recommendations

1. Rate Filing and Workpaper Support - In future rate filings Overland recommends that the Commission require CalAm to organize rate filing and workpaper support in a hierarchical fashion, with summarized rate filing information rolling up from more detailed workpaper support, and with all workpapers and rate filing schedules properly numbered and referenced (Chapter 1, page 8).

2. Rate Base and Overall Revenue Requirement Calculations - We recommend for future rate filings that the Commission require CalAm to provide a calculation of its rate base, rate base revenue requirement and overall GO revenue requirement. (Chapter 1, page 9).

3. Support for Expenses Allocated from the National and Local Service Companies - We recommend for future rate filings that the Commission require CalAm to provide supporting documentation in the filing for expenses allocated from both the National and Local Service Companies. (Chapter 1, page 9).

4. An Affidavit or a Statement in Testimony Confirming That Commission Requirements Have Been Met - To the extent the Commission adopts the recommendations above, we further recommend that the Commission require CalAm to include an affidavit in the rate filing or a statement by the appropriate witness that the specific rate filing support recommendations required by the Commission have been met (Chapter 1, page 9).

5. DRA Access to Non-Regulated and Affiliate Transactions Data - To the extent that it is not clear that DRA already has the right to review the financial and operating data of CalAm's affiliates, we recommend the Commission specifically require CalAm to make such information available in future rate and other proceedings in which affiliate transactions, cost allocations and related possible cross-subsidization are potential subjects or issues (Chapter 1, page 10).

6. Support for Cost Allocations to Non-Regulated Customer Services - With respect to non-regulated services provided by the Customer Service Center, to prevent CalAm from cross-subsidizing CSC services provided to non-regulated municipal customers, Overland recommends that the Commission require CalAm to credit all revenue from non-regulated CSC revenue sources against CSC management fees before the fees are distributed to CalAm (Chapter 4, page 10).

7. Conditions Relating to the Spinoff From RWE - CalAm has represented that its customers will benefit from the spin-off from RWE. However, given the substantial pressure imposed by a capital program that exceeds cash flows available from operations, and the significant goodwill that remains on the company's books, it appears evident that the recent downgradings by S&P and Moody's indicate an erosion in financial position; not an enhancement. Regulated utilities, in the face of such conditions, generally attempt to either raise customer rates, cut costs, or both. Overland assumes that, in imposing conditions reflected in previous decisions, the Commission did so as a basis to: evaluate the delivery of benefits represented by CalAm; and to assess and safeguard against potential harm to ratepayers. As such, the Commission may wish to consider the conditions described in Chapter 6, in the Findings and Conclusions section of the Transfer of Control discussion (Chapter 6, page 10).

8. Gain from the Sale of Felton - With regard to the gain from the sale of the Felton properties, we believe that the facts and circumstances associated with this transaction, in light of the acquisition premium in current CalAm rates that are potentially attributable to these properties, now warrants further Commission scrutiny. We believe that the gain on

these properties may be in the range of $5-6 million.[2] It is clear that the Commission reserves the right of review for the disposition of utility property; particularly in case-specific circumstances where its general policy may not apply. Given our previous discussion on this subject, it may be appropriate to reduce the current acquisition premium by the gain realized in the Felton transaction. However, without more detailed information, we cannot make any final recommendations at this time (Chapter 6, page 20).

[2] The Company has refused to produce specific information that would provide details regarding to actual gain on the Felton transaction. General market indicators support a market-to-book ratio of about 2x. However, actual transaction data may vary materially from this general assumption.

1. Summary of CalAm's General Office Rate Filing and 2009 Test Year Revenue Requirement

This chapter summarizes Overland's review of California American Water Company's (CalAm) General Office (GO) rate filing and revenue requirement. It includes a summary discussion of CalAm's revenue requirement, a discussion of the support for the revenue requirement CalAm provided in its rate filing, a discussion of non-regulated and affiliate transactions and problems Overland encountered in reviewing them, and recommendations relevant to these discussions.

Components of CalAm's General Office Revenue Requirement

The GO revenue requirement consists of the following components:

- National Service Company (NSC) Allocations - The NSC consists of corporate functions such as finance, treasury and planning and various shared services (accounting, human resources, customer service, information technology, procurement and water quality). NSC expense allocated to CalAm accounts for approximately one-half of CalAm's GO revenue requirement request.

- Local Service Company (LSC) Allocations - The LSC consists of American Water's (AW's) western region operations. Western Region expenses are allocated primarily between California and Arizona, which contain a majority of the region's customers. Smaller amounts are allocated to Texas, New Mexico and Hawaii.

- Charges from California Corporate (CalCorp) - The CalCorp unit contains operating expenses from former LSC employees who were previously allocated to multiple states in American Water's (AW's) Western Region, but who are charged entirely to California in CalAm's current rate filing. CalCorp also includes expenses of employees who have been hired to serve operations only in California. CalCorp expenses are charged entirely to CalAm.

Comparison of CalAm's Previously Authorized, CalAm's Proposed and Overland's Recommended Test Year General Office Revenue Requirements

The table below compares the summarized General Office revenue requirements: 1) as authorized in the previous General Rate Case proceeding; 2) test year 2009 as proposed by CalAm; and 3) test year 2009 as recommended by Overland. A comparison of CalAm's and Overland's recommended revenue requirements distributed to the district level is shown in Chapter 8, Table 8-2.

Chapter 1

Table 1-1 California American Water Comparison of Previously-Authorized Company-Requested and Overland-Recommended General Office Test Year Revenue Requirements					
	Last Authorized	Test Year 2009			
		Per CalAm		Per Overland (DRA)	
Components of CalAm's General Office Revenue Requirement	(2006 Test Year)	Amount	Change from Authorized	Amount	Change from Authorized
O&M Expense Revenue Requirement	11,298,350	16,858,609	5,560,259	13,226,419	1,928,069
Rate Base Rev. Req. (1)	823,405	140,066	(683,339)	140,066	(683,339)
CalAm General Office Revenue Req.	12,121,755	16,998,675	4,876,920	13,366,485	1,244,730
Percentage Increase			40.23%		10.27%

Sources: CalAm numbers: Rate Filing Exhibit B, Ch 1, Sec 3, Table 1 ; Overland numbers: Report Table 1-2 (Rate Base); Table 2-1 (Operating Expense) (1)
Last Authorized rate base rev reqmt is calculated using data provided by CalAm in Rate Filing Exh B, Ch 1, Sec 3, Table 1
Overland does not have high confidence in this amount, but it is the only amount available It does not appear to include either the Citizens acquisition premium or the RWE merger synergy savings (for which approved amounts are shown in D 06-11-050, Att 3)

Operations and Maintenance Expense - Differences between the Overland and Company revenue requirements for test year 2009 are due entirely to Overland's recommended adjustments to CalAm's proposed General Office O&M expense. These adjustments are summarized and discussed in Chapter 2. The individual service company components of operations and maintenance expense are discussed in Chapters 3 and 4 (for the NSC) and Chapter 5 (for the LSC and CalCorp). The following table summarizes the General Office O&M revenue requirement by service company component.

Table 1-2 California American Water General Office Operating & Maintenance Expense Revenue Requirement By Service Company Component Before and After Allocation to CalAm			
	Test Year 2009		
	Per CalAm	Per Overland (DRA)	Recommended Adjustment to CalAm
Allocable to CalAm:			
National Service Company	154,529,094	126,987,350	(27,541,744)
Local Service Company	9,798,017	7,529,236	(2,268,781)
Cal Corp	4,954,495	4,251,268	(703,227)
Total	**169,281,606**	**138,767,854**	**(30,513,752)**
After Allocation to CalAm:			
National Service Company	8,357,126	6,221,706	(2,135,420)
Local Service Company	3,546,988	3,099,132	(447,856)
Cal Corp	4,954,495	3,905,580	(1,048,915)
Total	**16,858,609**	**13,226,419**	**(3,632,190)**
Source: CalAm Rate Filing, Overland Report Chs. 2, 3, 4, 5			

Chapter 1

Rate Base - Rate base does not contribute significantly to the test year 2009 General Office revenue requirement. As far as Overland can determine, CalAm's rate filing does not include a direct calculation of the revenue requirement associated with rate base. As such, there is also no total revenue requirement (O&M, return and tax) calculation in the rate filing. Rate base amounts presented in CalAm's filing include the following:

Exhibit B, Chapter 1, Section 2, Table 1:
- Proposed Test Year 2009 Rate Base $1,269,864
- Proposed Year 2010 Rate Base $ 782,388

Exhibit B, Chapter 1, Section 3, Table 1:
- Proposed Costs $1,026,126

The second table (Section 3, Table 1) also contains information to permit a calculation of CalAm's intended rate base revenue requirement, including a rate of return of 7.8% and a net-to-gross (tax) multiplier of 1.75. The amount in the second table is the average of the two amounts in the first table. Overland used the second amount to calculate what we believe is CalAm's requested 2009 test year rate base revenue requirement, as shown in the table below. This calculation does not appear in the rate filing.

Table 1-3
California American Water
General Office Rate Filing
Calculation of Rate Base Revenue Requirement

Item	2009
Proposed Average Rate Base per Cal-Am	1,026,126
Rate of Return per Cal-Am	7.80%
Requested Return	80,038
Tax Multiplier	1.75
Rate Base Revenue Requirement	140,066

Source: Rate Base Amounts: General Office Rate Filing, Exhibit B, Chap 1, Section 3, Table 1

Primarily because rate base revenue requirement is so small (less than one percent of the total General Office revenue requirement per CalAm), we did not attempt to audit it.

Rate Filing Support for CalAm's General Office Revenue Requirement

We found CalAm's rate filing lacking in support for specific components of the GO revenue requirement.

- Lack of Tables Summarizing the General Office Revenue Requirement and Rate Base - As noted in the discussion of rate base above, CalAm's rate filing does not include an overall calculation of the test year General Office revenue requirement. It also does not include a calculation of the General Office rate base or the revenue requirement associated with rate base. With some effort it can be determined what CalAm probably intends these amounts to be, but they are not set forth directly in the filing.

- Support for NSC Expense - CalAm's rate filing contains virtually no support for the NSC portion of the General Office expenses, which, as noted above, accounts for about one-half of the total GO revenue requirement. The test year quantitative expense data for the NSC consists entirely of nine summarized test year-proposed O&M expense amounts (one for each of nine NSC rate filing categories). These nine amounts are repeated in several tables, but there is nothing in the filing, in the workpapers or in the accompanying testimony that discloses the business units, budgeted total expenditures, budgeted management fees, or the allocation factors from which CalAm's proposed test year NSC expense is derived.

- LSC and Cal Corp - Filed support for the LSC and Cal Corp allocations to CalAm is marginally better than for the NSC. While CalAm provided details of total costs incurred by each entity on an object account basis, amounts did not always agree from one exhibit to the next, the handful of filed workpapers lacked a discernible audit trail, and testimony did not provide insight into contentious issues. However, by the time that data requests were issued to CalAm on LSC and Cal Corp matters, many of the delays experienced in the NSC area had been "ironed out", and responses were generally, but not always, on point.

- Rate Filing Presentation Problems - In general, there is a lack of organization in the rate filing and workpapers. Depending on the schedule or workpaper, cross-referencing between the rate filing schedules and workpapers and within the workpapers is limited or non-existent. In many places it is difficult to determine the source for amounts in summarized schedules, and where the amounts in detailed schedules are summarized.

Discovery Problems

Data Supporting the NSC Component of the General Office Revenue Requirement - As noted above, the rate filing and accompanying CalAm workpapers contain virtually no support for NSC expenses that comprise about one-half of the GO revenue requirement. In addition to lack of support in the filing, CalAm and AW made it difficult to compile, through discovery, the NSC expense support included and discussed in this report. It took more than three months and several rounds of discovery to obtain the business-unit budget data on which test year NSC expense is based. Just determining how the NSC's business units correlated with the NSC categories in CalAm's rate filing required several rounds of data requests. We also encountered problems obtaining lists of NSC employees. On two different occasions (once early in the project and later in response to a followup request) CalAm determined that, somehow, it was in its interest to provide schedules of NSC employees and positions with the employee names removed.

Data Supporting Cost Allocations Between AW's Regulated and Non-Regulated Segments - We also encountered difficulties in obtaining information about the subsidiaries in AW's non-regulated business segment. As discussed below, the inability to obtain financial results for unregulated subsidiaries negatively affected our ability to evaluate affiliate relationships and the reasonableness of allocations of NSC expenses between regulated and non-regulated segments.

Discovery Related to Conditions Imposed by the Commission in Decisions Associated with the RWE's Acquisition of and Subsequent Divestiture of American Water - In the absence of compliance with Commission Orders in its application regarding conditions in the RWE acquisition and divestiture decisions, Overland attempted to illicit this information in formal discovery in initial and subsequent data requests. However, in spite of these requests, CalAm has maintained that it need not provide such information, as it represents that it has met its burden of proof concerning these Commission requirements. Overland strongly disagrees, and addresses these deficiencies in Chapter 6.

Discovery Related to the Sale of Felton - Upon learning of the sale of the Felton assets, Overland issued discovery to ascertain details about the transaction necessary to address potential ratemaking issues in the current proceedings. Aside from providing a copy of the settlement agreement, CalAm declined to provide the requested information.

Affiliate Transactions and Common Cost Allocations to the Non-Regulated Segment

The Settlement Agreement as to Certain Issues for General Office between the Office of Ratepayer Advocates and CalAm, dated October 13, 2005, states that "ORA will retain an outside audit firm to review the GO operations and its cost allocations to the various ratemaking districts." It further states that "[t]he scope of the audit will be to review if GO allocations to the districts are reasonable and properly allocated in accordance with applicable Commission decisions, rules and policies regarding cost allocations. Administrative and General expenses that were previously part of GO allocations will also be audited. In addition, a review of CAW's compliance with the Commission's affiliate transaction rules will be covered as part of the audit scope."

We found that there are significant interrelationships between AW's regulated and non-regulated businesses. To properly understand and assess the reasonableness of these relationships and the transactions and cost allocations between regulated and non-regulated subsidiaries, it is necessary to have a thorough understanding of the financial and operational aspects of a company's regulated and non-regulated businesses. This requires unfettered access to operating and financial information about non-regulated subsidiary operations and results. Because of discovery difficulties, including the time consumed in attempting to obtain non-regulated segment financial information that was not provided, and the time it took to acquire budget support for NSC allocations, Overland was unable to fully assess the reasonableness of cost allocation results and CalAm's compliance with California affiliate transactions rules.

Summary of Regulated and Non-Regulated Segments - AW's regulated and non-regulated businesses are summarized as follows.

- Regulated Businesses Segment - AW describes the regulated segment as including the water and wastewater utility businesses subject to economic regulation. Cost allocation support provided in data responses indicates that this provides services to industrial, commercial and residential customers in 20 states.

- Non-Regulated Businesses Segment - According to AW, the non-regulated business segment is administered by subsidiary American Water Enterprises. Non-regulated businesses include homeowner water and sewer line maintenance, water and wastewater operations and maintenance services (for municipalities, water districts, U.S. military bases and similar entities), carbon technologies for water cleansing, water and wastewater facilities engineering and wastewater residuals management.[1]

In many cases, non-regulated business activities are linked operationally or administratively to the regulated water utilities. For example:

- The National Service Company includes many "corporate" and shared operating functions, including treasury, finance, accounting, operations and customer services, that are shared by regulated and non-regulated activities. Although the non-regulated segment accounted for about 12% of 2007 corporate revenue, less than 8% of 2007 National Service Company's national expenses were allocated or directly charged to non-regulated subsidiaries.[2]

- AW's business development function, which is primarily focused on development of non-regulated business opportunities, is situated organizationally within the National and Regional service companies that exist primarily to serve the regulated water utilities. Other functions in the Regional (Local) service companies, including engineering, accounting and others, contribute services to the non-regulated businesses.

- Non-regulated operations, maintenance and customer services are sometimes performed by employees of the regulated water utilities. For example, CalAm's Coronado district provides management, system operations, customer call center, meter reading and other services to the Descanso water system under a "regulated O&M" contract.[3] Costs are not allocated "below-the-line" (to shareholders) for these services; instead, it is Overland's

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[1] American Water Works Company, Inc., S.E.C. Form 424B3 (Prospectus), filed May 12, 2008, p. F-36.

[2] Based on analysis of data from OC-52. In 2007, NSC incurred approximately $183.4 million (this excludes amounts from regional service companies that was mixed in with national expenses). Of this, $14.1 million was directly charged or allocated to non-regulated subsidiaries, including amounts charged to what appear to be non-regulated water operations managed for municipalities whose revenues are actually included in the regulated segment. $169.3 million was charged to regulated water utilities.

[3] Response to data request OC-72.

understanding that in this case, in return for the use of regulated employees and assets, CalAm's ratepayers are credited with 10% of the revenues from the contract.[4]

<u>Non-Regulated Services Provided by the Customer Service Center</u> - We asked about services provided by the NSC to non-regulated companies and non-regulated customers. We learned that the Customer Service Center (CSC), from which CalAm is requesting to recover significantly higher costs than authorized in the prior rate case, performs services for a large number of non-regulated municipal customers. For the municipally-owned Liberty and Edison water companies and for a few smaller systems owned by others, AW provides customer services that it defines to be "comparable" to what it provides to the regulated water utilities. Operating agreements show that AW also provides other operating services, including system maintenance and management, to certain municipalities. Available time did not permit a detailed analysis of whether costs were properly allocated for all of the services provided.[5] We did investigate the services provided by the CSC. CalAm acknowledged that the CSC did not allocate any cost for the customer services provided to non-regulated municipal customers such as Liberty and Edison.

We found that revenue from non-regulated sources can be recorded by a regulated water utility. Several months after we asked about non-regulated customer services, CalAm provided a list of more than 100 municipalities that receive customer service under contract.[6] Although the contracts are between the municipalities and AW's regulated water companies, the services are provided by the National Service Company's Customer Service Center (CSC). AW declined to respond to our data request regarding the ratemaking treatment of the revenues associated with the contracts. However, the costs incurred by the CSC to provide the services are allocated to the regulated water companies, including CalAm (even though CalAm does not have any such contracts).[7] AW's failure to allocate any of the CSC's costs to the non-regulated category for these services increases the cost allocated by the CSC to CalAm.

<u>Attempts to Review Non-Regulated Financial Results and Potential Affiliate Relationships</u> - Early in the discovery process, we requested American Water's consolidating workpapers.[8] Consolidating workpapers typically provide a high level, pre-consolidation view of non-

[4] It is Overland's understanding that such services are authorized by the California Public Utilities Commission under Advice Letters. It was beyond the scope of our review to audit the details of these arrangements.

[5] Many of these costs would be incurred by regulated AW water companies located near the municipality being served, rather than by the NSC.

[6] Supplemental response to data request OC-71 received August 12, 2008.

[7] Response to data request OC-216-E states that AW objects to the question about rate case treatment, asserting "it is not relevant to the current proceeding." Response to data request OC-210-A indicates "no customer service expense for 2007 or year-to-date 2008 was allocated to regulated state subsidiaries of American Water."

[8] Data Request OC-23. Overland routinely requests consolidating workpapers in reviewing affiliate transactions and cost allocations. We have obtained these workpapers from utilities in California and in other jurisdictions. Other than by American Water, we have never been denied access to a company's consolidating workpapers.

regulated subsidiary's financial results and are a starting point in the process of understanding the financial results of a company's non-regulated businesses. Consolidating eliminations and footnotes to the schedules in the workpapers often also provide insight into affiliate relationships and transactions. AW declined to provide its consolidating workpapers and the accompanying non-regulated financial information. After spending the equivalent of approximately 50 consulting hours chasing the information, we ceased efforts to acquire it.[9]

The accounting profession requires public companies to file a limited amount of high-level information about business segment operations and affiliate transactions in the notes to financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). In American Water's case, such data is limited because, as a subsidiary of a German utility and British water company, AW was not required to file annual GAAP financials in recent years. Fortunately, AW's recent decision to raise public equity capital created a requirement to file public financial information, without which even high level financial information concerning the non-regulated segment would have been non-existent. With the information filed in a prospectus related to the public equity offering and recent quarterly financial reports filed with the Securities and Exchange Commission, we were able to determine that the non-regulated segment accounted for about 12 percent of AW's total "size" in 2007.

<u>National Service Company Allocations (Regulated / Non-Regulated and to CalAm)</u> - As discussed in Chapter 2, under Adjustment 14 (Correct Allocations to CalAm), CalAm was unable to provide calculation support for its test year-requested NSC allocation factors. We found CalAm's test year included an expense allocation to CalAm that is higher than suggested by a reasonable size-based allocation between the regulated and non-regulated business segments and between CalAm and other water companies within the regulated segment. As shown in Chapter 3, Table NSC-1, CalAm requests an overall 5.41% allocation of common NSC management fee expense to CalAm in the test year, after an ostensible (but incalculable) allocation to the non-regulated segment, even though CalAm's December, 2007 share of regulated customers is only 5.18%. Overland's composite allocation to CalAm, which Overland recommends for six of the NSC's nine rate filing categories, is 4.59%. It is based on an 88% regulated segment allocation (using relative regulated and non-regulated segment revenue and expense) and a 5.18% regulated expense allocation to CalAm (based on actual year-end 2007 customers).

<u>Local Service Company Allocations (Regulated / Non-Regulated)</u> - A review of schedules that show the distribution of the expenses of the Western Region Local Service Company (LSC) indicates that employees of the LSC's Business Development business unit spend approximately two-thirds of their efforts on non-regulated projects in the Western Region. These expenses are charged to American Water Enterprises (AWE), AW's largest non-regulated legal subsidiary.[10]

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[9] Overland requests consolidating workpapers as a routine part of its review of affiliate transactions and cost allocations in regulatory audits. This is the first time that our request for such workpapers has been denied.

[10] CalAm rate filing workpaper GO-126 shows the proposed test year distribution of expense between AWE and the regulated state jurisdictions in the Western Region.

Although expense distributions indicate that about two-thirds of Western Region business development activity is non-regulated, with the exception of two Administration unit employees who appear to be dedicated entirely to non-regulated subsidiary AWE (a Project Engineer and a Contract Operations Manager), no expenses from other LSC business units serving the Western Region (External Affairs, Finance, Human Resources, Legal, Environmental Management, Maintenance, Network, Operational) are allocated to AWE or to other non-regulated subsidiaries. As discussed above, early in this review we attempted to review the financial results of AWE and other non-regulated subsidiaries. AW and CalAm declined to provide consolidating financial results for AWE and other non-regulated subsidiaries. Given that more than half of the LSC's business development activities are non-regulated, it is likely that other LSC supporting activities should also be allocated to the non-regulated segment.

Recommendations

1. Rate Filing and Workpaper Organization and Referencing - We recommend the Commission require CalAm to organize rate filing and workpaper support in a hierarchical fashion, with summarized rate filing information rolling up from more detailed workpaper support. Quantitative information in the workpapers should tie forward either to more summarized workpapers, or to tables in the rate filing. All rate filing schedules and workpapers should be referenced so that the source data, and the workpapers that contain detail tying forward to the schedules, can be located. In other words, the filing and workpapers should contain referencing, cross-referencing and source identification that is standard in utility regulatory filings containing accounting data.

2. Rate Base and Overall Revenue Requirement Calculations - We recommend the Commission require CalAm to provide a calculation of its rate base, rate base revenue requirement and overall General Office revenue requirement in future rate filings.

3. Support for Service Company Expenses Included in the General Office Revenue Requirement - We recommend the Commission require CalAm to provide adequate support for expenses allocated from both the National and Local Service Companies in its next rate filing. The required support should include the following:

    - A table summarizing total test year and historical expenses allocable to CalAm for each expense category (e.g., for the NSC, customer service, shared services, finance, etc.).
    - A table summarizing test year and historical allocation factors applicable to CalAm for each expense category.
    - A table summarizing test year and historical amounts allocated to CalAm for each expense category.

- Business unit budget detail - Budgeted amounts by account for each business unit included in the NSC and LSC filings (equivalent to what was provided to Overland in OC-91).[11]
- Business unit allocation factors - Supporting allocation factor detail showing how the factors each budget unit separately allocated or charged to CalAm were calculated. In this filing CalAm asserted (in response to OC-51)for the NSC that no supporting detail for budgeted allocation factors exists.
- As described in additional detail in Chapter 4, should CalAm attempt to recover *any* cost associated with the NSC's Customer Service Center in future rate filings, we recommend the Commission require CalAm to file workpapers showing how expenses for CSC services provided to non-regulated customers (such as the billing and collection services provided to more than 100 municipalities) are fully distributed to the non-regulated segment and / or customers.

4. An Affidavit or a Statement in Testimony Confirming That Commission Requirements Have Been Met - To the extent the Commission adopts the recommendations above, we further recommend that the Commission require CalAm to include an affidavit in the rate filing or a statement by the appropriate witness that the specific rate filing support recommendations required by the Commission have been met.

5. DRA Access to Non-Regulated and Affiliate Transactions Data - As discussed elsewhere in this report, our ability to assess the impact of non-regulated operations on CalAm and its revenue requirement was limited because of limits CalAm and AW placed on non-regulated subsidiary data. When access to financial and operating data is limited, it is not possible to assess the reasonableness of affiliate transactions and common cost allocations. Prior to this review, it was Overland's understanding that DRA and auditors working on DRA's behalf have the right, under the California Public Utility Code, to review non-regulated financial and operating data for any utility affiliate that they deem necessary to determine whether cross subsidization of non-regulated activities by regulated utility customers may be occurring. To the extent that it not clear that DRA already has the right to review the financial and operating data of CalAm's affiliates, we recommend the Commission specifically require CalAm to make such information available in future rate and other proceedings in which affiliate transactions, cost allocations and related possible cross-subsidization are potential subjects or issues. We also recommend the Commission require that CalAm include, in its next rate filing, an affidavit or a statement in the testimony of an appropriate witness confirming that the books and records of non-regulated subsidiaries will be made available for review by DRA or its agents subject to the execution of an appropriate confidentiality agreements.

[11] Labor detail showing the names and salaries of employees, included on a separate sheet within each business unit budget excel file, can be omitted if determined to be confidential. However, rate filing support should include a note to the effect that labor expense detail is available for review upon request by auditors covered by an appropriate confidentiality agreement.

2. Adjustments to CalAm's General Office Revenue Requirement

This chapter summarizes Overland's adjustments to California American Water Company's (CalAm's) General Office (GO) operating expense revenue requirement. Overland's recommended adjustments affect: 1) GO O&M expense incurred by the service companies; 2) allocations of GO O&M expense to CalAm; and 3) allocations of CalAm's GO O&M to CalAm's districts. Overland is not recommending adjustments to CalAm's proposed test year rate base or rate base revenue requirement. This chapter addresses adjustments at the CalAm level. Allocations of CalAm's revenue requirement to CalAm's California districts is discussed in Chapter 8.

Overland's Recommended Adjustments to Test Year as Filed by CalAm

The table below summarizes CalAm's GO operations and maintenance (O&M) expense, as filed by CalAm for the 2008 and 2009 forecast years. It also shows Overland's recommended O&M adjustments and test year GO O&M as recommended by Overland.

Table 2-1
California American General Office Operating Expense Revenue Requirement
Summary of Adjustments to Test Year - Total California (All Districts)

Adj. No.	Item	2008	2009
	GO Operating Expense, Per CalAm, As Filed	**17,060,572**	**16,858,609**
	Overland Recommended Adjustments:		
1	Annualize Labor Expense Based on May 31, 2008 Actual Staff Levels	(338,591)	(380,171)
2	Reduce Incentive Compensation to 2007 Actual Award Levels	(589,158)	(598,546)
3	Remove Business Development Expense	(371,469)	(383,185)
4	Remove Corporate Contributions	(20,623)	(20,623)
5	Remove Legislative Influence Expense	(211,004)	(218,213)
6	Remove Unsupported "NSC Functions" Expense	(545,959)	(82,520)
7	Correct Non-Deparmental Interest Income and Income Tax	38,195	38,195
8	Remove Sales and Marketing Expense	(72,056)	(72,056)
9	Limit Customer Service Center Expense to 2003 Expense per CalAm Customer (Before National Call Centers) Plus Price Inflation	(831,111)	(831,111)
10	Remove Unnecessary Payroll Reserve	(30,050)	(30,801)
11	Correct Omission of Operating Risk Dept Salaries	-	83,036
12	Reverse Allocation Effect of Re-branding LSC Employees as CalCorp	(321,011)	(334,197)
13	Remove CalCorp Labor Separately Requested as Rate Case Expense	(33,236)	(34,664)
14	Correct Service Company Allocations to CalAm	(765,157)	(767,334)
	Total Adjustments Recommended by Overland	**(4,091,231)**	**(3,632,190)**
	GO Operating Expense, As Recommended by Overland	**12,969,341**	**13,226,419**

Source: Attachment 2-1

Attachment 2-1 provides additional detail for the adjustments listed above. NSC 2009 test year expenses, as calculated by CalAm for the rate filing, are based on the NSC's 2008 budget. The salary component of labor expense, and labor costs tied to salaries (e.g. payroll taxes) are budgeted for 2008 based on 2007 salaries plus across-the-board salary inflation of 4%. Overland did not adjust these basic assumptions made by CalAm about test year NSC expense.

Chapter 2

1. Adjustment to Annualize Labor to Reflect Actual Budget Year Staffing - Labor expense accounts for more than two-thirds of CalAm's GO revenue requirement request. Overland recommends test year labor expense for General Office employees based on actual employees on the payroll as of May 31, 2008. We believe actual staffing at a point nearly mid-way through the 2008 budget year is a better indicator of the test year labor expense AW is likely to incur than expense based on a budget prepared in the fall of 2007.

Calculating test year labor expense using actual 2008 staffing reduces CalAm's requested test year GO expense, using CalAm-requested allocation factors, by $338,591 in 2008 and by $380,171 in 2009. The individual components of the adjustment are as follows:

- NSC - The adjustment reduces total NSC expense by $1,989,537 and reduces regulated expense allocated to CalAm (using CalAm-requested factors) by $69,934 in 2008 and 2009. These amounts exclude an adjustment to Customer Service Center (CSC) labor expense, which would need to be added if the Commission rejects our recommended adjustment to CSC expense, discussed below.[1]

- LSC and Cal Corp - The adjustment reduces total LSC and Cal Corp expense by $296,949 in 2008 and $340,253 in 2009. It reduces CalAm-allocated expense by $268,657 (2008) and $310,237 (2009). LSC allocations to CalAm include the impact that Overland's calculated labor expense would have on non-labor calculated allocators.

The Basis for Overland's Recommended Labor Expense - Overland conducted an analysis comparing staffing in the budget to actual staffing as of May 31, 2008. The table below summarizes this analysis.

[1] Overstated budget labor expense associated with the Customer Service Center (CSC) is $2,161,256 (total NSC) / $117,140 (CalAm-allocated using CalAm's factor) for both 2008 and 2009. As discussed below, we recommend test year CSC expense be limited to 2003 expense recorded by CalAm (2003 was prior to the implementation of national call centers), adjusted for inflation between 2003 and the test year. If the Commission rejects the recommendation to limit CalAm CSC expense, but accepts our test year labor expense calculation, the NSC component of the test year labor adjustment would need to be revised to $4,150,793 (total NSC) / $208,065 (CalAm-allocated). The revision is necessary to account for the overstated labor expense associated with the CSC in the test year labor expense calculation.

Table 2-2 **American Water Service Company** **Budgeted vs. Actual Headcount, May, 2008**		
	May 31, '08 Headcount	
Rate Filing Category	Budgeted	Actual
NSC Belleville Lab	36	30
NSC Customer Service	750	697
NSC Finance	59	58
NSC Human Resources	36	30
NSC Info Technology	185	165
"NSC Functions"	51	48
NSC Operations / Netwk	69	63
NSC Shared Services	202	179
NSC Supply Chain	37	38
Total NSC	1,425	1,308
Total LSC	57	54
Total Cal Corp	51	40
Total Service Co. Staff Allocable to CalAm	**1,533**	**1,402**
Source: OC-91 and OC-92- Excludes Interns		

Service company employee levels have increased steadily in the past few years. For example, the NSC had 1,111 employees at the beginning of 2006.[2] AW's budget predicts a mid-year, 2008 NSC employee level of 1,425, 28% more than at the beginning of 2006, and 9% higher than actual end-of-May, 2008 staff levels. Meanwhile, CalAm's regulated customers, on which allocation of NSC expense to CalAm is based, have increased only 2% over the past five years.[3] The forecasted increase in staffing, without a commensurate increase in customers, shows that CalAm is projecting that GO services provided to California will continue to become *less* efficient in the test year, continuing (and perhaps accelerating) a trend that has been in place for the past several years.

<u>Overland's Calculation of Test Year General Office Labor Expense</u> - Overland's calculation of NSC labor expense is based on the salaries, benefits and payroll taxes for *actual* employees as of May 31, 2008. 2008 budgeted salaries are based on 2007 salary levels plus a 4% across-the-board increase. Overland's recommended labor expense calculation also incorporates AW's budgeted salary increase. AW's NSC labor expense calculation includes an allowance for vacancies. The vacancy allowance is a fraction of the difference between actual and budgeted labor expense as of May 31, 2008. Overland's labor expense adjustment reverses AW's vacancy allowances to avoid double-counting the related expense reduction AW recognized in its 2008 budget.

[2] Analysis of data provided in response to OC-92.

[3] 171,444 (12/31/2007 customers per OC-90) / 167,834 (2003 customers per Rate Filing Exh.B, Ch.9, Sec.1, Tbl. 6) = 1.0215.

Chapter 2

Our recommended test year labor expense for the LSC and Cal Corp is also based on the actual employees in each of these organizations as of May 31, 2008. Since the company budgeted labor costs at an employee level, projected positions that were vacant were deducted from CalAm's request - 8 from the LSC and 12 from Cal Corp.[4] The LSC had 7 employees in its organization in May 2008 that were not specifically included in its request.[5] For these 7 employees, Overland increased the company's request by using actual 2008 annualized salary and benefits along with jurisdictional and operating expense/capital expenditure allocations. Overland assumed a 4% annual increase in labor expense for 2009 for these additional employees, the middle of the 3% to 5% range budgeted by AW for LSC and Cal Corp employees. Finally, the LSC's projected non-labor allocations are a function of cumulative labor cost allocations. Overland recalculated these non-labor allocations based on the LSC organization as it existed in May 2008.[6]

2. Reduce Budgeted Employee Incentive Compensation - CalAm's requested test year incentive compensation appears to be based on the following assumptions: 1) that all budgeted positions at management levels eligible for incentive compensation will receive it; and 2) that eligible positions will receive 100% of their incentive awards using a budget assumption that 100% of the plan (corporate and regional) income targets are achieved.[7] Overland questions both of these assumptions. Overland recommends that GO incentive compensation be limited to amounts actually paid for 2007, adjusted for salary inflation, and limited to employees in salary bands for which CalAm provided requested incentive plan documents.[8] This amount is significantly lower than CalAm's test year-request incentive compensation, which is based on budgeted GO incentive compensation of $7.2 million for the NSC (2008 and 2009), $0.8 million for the LSC (2008 and 2009) and $0.5 million for Cal Corp (2008 and 2009) (before allocation to CalAm).

Using CalAm's allocation factors, Overland's recommended incentive compensation adjustment reduces CalAm's NSC-allocated expense by $328,033 in 2008 and in 2009. Our recommended

[4] Two Business Development positions in the LSC that were vacant as of May 2008 were excluded from this adjustment as they were captured in Overland's recommendation to disallow the costs of this entire function.

[5] Cal Corp had one employee in May 2008 that was not included in CalAm's request (see response to OC-166). Because this employee had been captured in the LSC organization for GO rate filing purposes, Overland elected not to remove the costs of this employee from the LSC and to add back the costs to Cal Corp.

[6] Even though the LSC was effectively reduced by 1 net position (8 vacancies LESS 7 new positions), Overland's recalculation of CalAm's allocation resulted in an increase to the company's request. This is due to the nature of the positions adjusted (vacant positions had on average smaller allocations to CalAm than the "new" positions added by Overland) both directly on labor costs and indirectly on non-labor costs.

[7] According to Attachment A of the 2007 AIP document provided in response to OC-16, payouts could conceivably be as much as 150 percent of budgeted payout if operating income is as high as 125% of target.

[8] AW's General Office service company budgets reflect across-the-board 4% salary increases for all employees. Overland accepts this estimate, and it is applicable to both salary and incentive compensation.

adjustment reduces CalAm's LSC-allocated and Cal Corp-charged expense by $261,125 in 2008 and by $270,513 in 2009 (in both cases based on CalAm's requested LSC allocation factors).

Regulatory Background - Incentive compensation was not included in revenue requirements in the prior two General Office rate filings. The most recent General Office rate case decision (D.06-11-050) states that in reaching a settlement with DRA, CalAm agreed to remove incentive compensation from its rate request.[9] In the 2003 Monterey rate case decision (which also addressed General Office expenses), the Commission denied CalAm's request for recovery of forecasted incentive compensation, noting that the requested amounts were "only estimates," and that CalAm had paid substantially less incentive pay than it had budgeted in two of three historical periods it cited.[10]

In its direct testimony, CalAm references the Commission's 2003 finding that CalAm's actual incentive compensation payout was substantially less than had been budgeted. CalAm's witness Buls states that "under the present mechanism, the forecasted AIP payouts should much more closely track actual payouts."[11] However, Overland found that in 2007 only 35 of approximately 700 NSC management employees received any incentive plan payments, and not all of these employees received 100% of their potential payout.[12] For the NSC, actual 2007 payments were about 12% the amount budgeted for the NSC in 2008. For the LSC, 2007 actual incentive plan payments were approximately 63% of the 2008 budget, and for Cal Corp 2007 actual payments were approximately 56% of the 2008 budgeted amount.

Background on AW's Annual Incentive Plan - We requested AW's Annual Incentive Plan (AIP) documents in data requests OC-16 and OC-182. CalAm sent us 2007 (and later 2008) plan documents applicable to lower and middle management employees (those from salary bands 14 through band 5). These employees are eligible for incentive pay of between 5% and 20% of their base salaries. Business unit budgets provided in response to OC-91 show that 2008 budgeted incentive compensation also includes compensation for employees in salary bands ML4, 3 and 2 (Vice President and above). These employees are eligible for incentive compensation of up to 50% of their base salaries. CalAm did not provide AIP documents applicable to these higher-level employees. Because the documents were not provided, Overland did not evaluate the basis for incentive compensation for these employees.

Based on the AIP document provided for lower and middle-management employees, incentive compensation for employees in salary bands 14 through 5 is based on up to four performance components, including separate regional and corporate financial performance, operational

[9] Decision 06-11-050, p.30.

[10] Decision 03-02-030, General Office - Salaries, p.24.

[11] Direct testimony of Christopher Buls, p.26.

[12] Response to data request OC-194, attachment OC-194.xls.

performance (measured in terms of customer satisfaction, service quality, environmental and health and safety factors), and individual employee performance.

Test year budgeted incentive plan payments for the financial performance components are based on achieving 100% of an operating income target, but no incentive compensation based on *any* component can be paid unless Corporate Operating Income is at least 75% of the corporate targeted amount.[13] With respect to financial performance for 2008, in the first quarter AW was required to write off more than $700 million in goodwill and recognize an associated impairment loss. As a result, AW recorded a net loss of $687 million for the first half of 2008, compared with net income of $52 million for the six months ending June, 2007.[14] In addition, concern over cash flow improvement caused Standard & Poor's to downgrade AW's bonds to BBB+ from A- in June, 2008.[15]

With AW's large impairment loss, a net loss for the year is very likely. Although a goodwill impairment loss does not necessarily affect the incentive plan's Corporate Operating Income target, it is hard to imagine AW awarding the significantly higher incentive compensation for 2008 (compared with 2007) if it records a net loss for the year. Although an impairment loss does not necessarily affect the incentive plan's income target, operating cash flow can. The S&P downgrade, which is based on concern about cash flow growth, does not augur well for operating income. Given that a 75%-of-targeted income threshold must be achieved before incentive compensation can be awarded, it is not clear whether any incentive compensation can be awarded for 2008. We believe it is also an open question whether significant incentive compensation will be paid in 2009.

With respect to the individual performance component of the incentive plan applicable to lower and middle management employees, AW's budget assumption appears to be that every incentive plan-eligible employee will be rated as having performed at a level that qualifies for the maximum payment attributable to the individual, a result we believe is unlikely. If it were to occur, it would render meaningless any "incentive" linking compensation and performance.

<u>Overland's Recommended Incentive Compensation Expense</u> - As discussed above, we believe it is possible, if not probable, that AW will not meet the minimum Corporate Income threshold necessary to award the first dollar under its the 2008 lower and middle management incentive compensation plan. Nevertheless, Overland conservatively recommends providing test year ratepayer funding based on actual 2007 incentive awards made to lower and middle management employees (for which AIP documents were provided), plus inflation based on AW's budgeted salary increases. 2007 payments under the incentive plan were significantly below what AW budgeted in 2008. For example, as noted above, 2007 incentive compensation was awarded to only 35 NSC employees in the business units allocated to CalAm, whereas the 2008 NSC budget

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[13] Response to OC-182, 2008 Annual Incentive Plan, Salary Bands 14-5, p.5.

[14] American Water Works 10Q, 3 months ending June 30, 2008, as summarized by MarketWatch (www marketwatch.com/news/story/10-q-american-water-works-company).

[15] Reuters, June 19, 2008, Standard and Poors Ratings Services news release.

reflects incentive compensation for more than 700 NSC employees. Overland's recommended General Office incentive compensation is summarized below.

Table 2-3
California American Water
CalAm General Office Revenue Requirements
Overland-Recommended Test Year General Office Employee Incentive Compensation

Ln	Item	NSC		LSC		CalCorp		Total	
		2008	2009	2008	2009	2008	2009	2008	2009
1	2007 Actual Incentive Pay - Employees in Management Salary Bands 5-14	275,862	275,862	385,121	385,121	257,810	257,810	918,793	918,793
2	Labor Inflation	1.04	1.04	1.04	1.08	1.04	1.08		
3	2008 Recommended Incentive Pay Based on 2007 Actual Incentive Pay - Adjusted for Salary Inflation	286,896	286,896	400,526	415,931	268,122	278,435	955,545	981,262
4	Subtract NSC Incentive Pay Attributable to CSC (1)	22,227	22,227						
5	Test-Year Recommended GO Incentive Comp Based on 2007 Actual Incentive Comp Payments	264,669	264,669	400,526	415,931	268,122	278,435	933,318	959,035

(1) It is not necessary to provide incentive pay for the CSC because Overland is recommending 2008 budgeted CSC expense be replaced with 2003 actual CSC expense adjusted for inflation.

After allocation to CalAm, using CalAm's recommended allocation factors, Overland's recommended ratepayer-funded General Office incentive compensation is $252,625 in 2008 and $261,156 in 2009.[16]

3. Remove Business Development Expense - CalAm's current General Office rates do not include business development expenses. CalAm's regulated customer base has been stagnant since at least 2003. Overland recommends no ratepayer funding of expenses allocated from NSC and LSC business development functions. The adjustment to remove business development expense reduces General Office expense allocated to CalAm by $371,469 in 2008 and $383,185 in 2009, calculated using CalAm-requested allocation factors.

NSC - The Corporate business development function is included in a business unit within the "NSC Functions" rate filing category. It took approximately three months of discovery effort to uncover that Corporate Business Development was allocated to CalAm as part of "NSC Functions" rate filing category. Once we became aware of its existence, we asked CalAm to

[16] For 2008: NSC, $15,395; LSC, $112,271; Cal Corp $124,959. For 2009: NSC, $15,395; LSC, $116,308; Cal Corp, $129,453

describe corporate business development projects benefiting CalAm's regulated operations. CalAm responded:[17]

> The role of the Corporate Business Development function is to provide coordination, tools, training and support the Business Development (BD) teams in the local operations . . . In many of these activities, there is no project number or specific state / location to charge and time is charged accordingly. In recognition of the fact that a significant proportion of the activities are non-regulated, 2008 budgeted charges for this function are allocated to regulated subsidiaries in a much lower proportion that other corporate functions.

We found that a "much lower proportion" allocated to regulated companies is still a majority of the total cost (56.43%).[18]

There is no evidence that the NSC's corporate Business Development unit has added or will add customers or revenue to CalAm's regulated operations. Overland therefore recommends excluding the expense from allocation to CalAm for purposes of rate-recovery. Removing business development reduces expense allocated to CalAm by $30,439 in 2008 and the 2009 test year, using CalAm's requested allocation factors.

<u>LSC</u> - CalAm proposes to recover LSC business development expense by suggesting that current ratepayers benefit from the customers added by business development efforts, which permits CalAm to spread its overhead over a larger group of customers. This might be justified if the benefits of adding new regulated customers exceed the costs, but in this case, they do not. CalAm proposes incurring $352,746 of additional <u>annual</u> LSC Business Development costs at the same time it projects to add only 3,400 customers to its customer base over a two-year period. Even ignoring the fact that some of the customer increase, if it occurs, will result from internal growth, CalAm's proposal effectively increases the LSC's expense allocation per CalAm customer by nearly 9% ($20.44 vs. $18.78 annually – see Chapter 5 for more details). Coupled with the fact that a portion of the "regulated" business being generated by this LSC group is being categorized as coming from "regulated O&M" projects (the revenues from which are primarily attributed below-the-line, to non-regulated business), Overland believes that ratepayer funding of LSC business development should not be permitted. Our adjustment to remove business development expense allocable to CalAm reduces total LSC expense by $1,953,711 and $2,020,833 in 2008 and 2009, respectively. The adjustment reduces LSC business development expense allocated to CalAm by $341,030 in 2008 and $352,746 in the 2009 test year, using CalAm's requested allocation factors.

<u>4. Remove NSC Corporate Contributions Expense</u> - Utility regulators, including the California Public Utilities Commission, have traditionally prohibited utilities from charging ratepayers for their charitable contributions. Perhaps the most obvious reason for recording

[17] Response to OC-141.

[18] Response to OC-91 (NSC budget data), 032020_CorpBusDev_2008-2012.xls, "Rates" sheet.

charitable contributions below-the-line (in expense accounts other than those recovered from ratepayers) is that if the expense is charged to ratepayers, it is the ratepayer, not the utility, that makes the donation. To the extent a utility selects a charity and chooses to make a donation, either in the form of cash or donated labor, the utility (through its shareholders) should actually pay it. Ratepayers should be free to select their own charities and make their own donations; they should not be compelled to make donations on behalf of a utility.

Our adjustment removes $240,500 charged to account 575140 - Charitable Contributions Expense from budgeted NSC expense allocable to CalAm regulated ratepayers. In addition, we recommend removing $195,670 from several accounts (Other Employee Welfare, Contract Services and others) budgeted for NSC business unit 32087 - Corporate Social Responsibility. After the impact of locational overheads is factored into the amounts removed, our adjustment reduces NSC budgeted non-labor expense by $420,021. Using CalAm's requested allocation factor, the adjustment reduces expense recoverable from CalAm's ratepayers by $20,623 in 2008 and the 2009 test year.

5. Remove Legislative and Political Influence Expense - In the 2004 General Office rate case, the Commission disallowed expense associated with a Government Affairs Director when it became clear that the position included legislative influence responsibilities.[19] It is Overland's experience that regulators in general, and the California Public Utilities Commission in particular, prohibit utilities from charging ratepayers for expenses incurred to influence politicians or legislation. Overland identified legislative influence expenses in the NSC and Cal Corp budgets. We recommend removing all such expenses from ratepayer-funded GO expense. Our recommended adjustment reduces expense allocated to CalAm by $211,004 in 2008 and by $218,213 in the 2009 test year.

NSC - In data request OC-21 we requested the job descriptions for all NSC positions. One of the job descriptions omitted from the response was the NSC Director of Government Affairs. We re-requested this job description in OC-192. In this request we also asked for a description of consulting expenses budgeted for the NSC's Government Affairs business unit (part of the "NSC Functions" rate filing category). It is clear from the response that both the Director's responsibilities and the consulting efforts involve legislative influence. For example, the job description includes the following:

> Federal level - Provide a strategy that will bring American Water to the table with federal lawmakers.

The description of the budgeted consulting expense indicates that the consultant's responsibilities include working as an extension of the External Affairs department to develop and implement a successful legislative strategy.

[19] Decision 0302030. General Office - Salaries, pp. 21-22.

Overland recommends removing the expense budgeted for business unit 32022 - NSC Government Affairs, from expense recoverable from ratepayers. This adjustment reduces allocable NSC expense by $459,562 in 2008 and the 2009 test year. Using CalAm's requested allocation factor, our recommended adjustment reduces NSC expense allocated to CalAm by $22,564 in 2008 and 2009.

Cal Corp - While not always referred to in a consistent manner from data response to data response, Cal Corp employed an individual in May 2008 that was responsible for governmental affairs. This position reported to the regional president.[20] The only Cal Corp job description provided that remotely matches this position is the Director of Governmental Affairs. As described in this position's job responsibilities, this employee was to "influence proposed legislation", develop working relationships with legislators, and coordinate personal contacts with elected and appointed officials among other duties.[21] These are the same responsibilities of a position specifically reviewed and disallowed by the Commission in a previous case. Overland recommends the same rate treatment in this application. Overland's recommended adjustment reduces Cal Corp expense charged to CalAm by $188,440 in 2008 and $195,648 in the 2009 test year for labor expense associated with the Director of Governmental Affairs. No adjustment to LSC expense is necessary.

6. Remove Unsupported "NSC Functions" Expense - Overland recommends removing expenses in the"NSC Functions" rate filing category that do not meet regulatory standards required for ratepayer recovery. Our recommended adjustment includes the three separate components. In total, it reduces expense allocated to CalAm by $545,959 in 2008 and $82,520 in the 2009 test year.

- 2008 "NSC Functions" Expense Not Supported by the 2008 NSC Budget - Supporting NSC budget data provided in OC-91 includes amounts for the business units CalAm disclosed as belonging to the "NSC Functions" rate filing category that, when allocated to California using CalAm's proposed factors, total $1,026,220. For 2008, CalAm included $463,439 in additional NSC Functions expense in the rate filing (CalAm, post-allocation), for a total "NSC Functions" expense of $1,489,659.[22] The additional amount is unsupported. It may have been added to 2008 to show a declining amount of NSC-allocated expense between 2008 and the 2009 test year. This component of our adjustment reduces CalAm-allocated NSC expense by $463,439 in 2008 only.

- $1 million Risk Reserve - The "Non-Departmental" business unit includes a $1 million expense described in the budget as "risk reserve for EW."[23] In response to our data

[20] Responses to OC-2 and OC-92.

[21] Response to OC-21.

[22] See, for example, Exhibit B, Chapter 4, Section 1, Table 1 in CalAm's original (January 30, 2008) or updated (May 9, 2008) General Rate Case Application, A.08-01-024.

[23] "EW" are the Chief Financial Officer's initials, who authorized the budgeted reserve.

request on the subject, it was described as a contingent expense included because "it is impossible to identify every event that could occur."[24] The data response further indicates that such expenses might be incurred in California after an earthquake. Overland recommends removing this speculative, contingent expense from NSC expense charged to CalAm ratepayers. In addition, it is Overland's understanding that such a risk reserve is unnecessary because the California Public Utility Code permits utilities to set up a memorandum account to capture the costs associated with a catastrophic event. Using CalAm's requested allocation factor, this adjustment component reduces CalAm expense by $57,100 in 2008 and 2009.

- <u>Labor Expense for a "Non-Departmental" External Affairs Director</u> - Included in the "Non-Departmental" business unit is the labor expense for an employee listed as "Director External Affairs". We asked CalAm to explain what this employee's responsibilities were, why the employee was not included in one of the External Affairs business units, why an External Affairs Director's position paid a salary higher than the Senior Vice President of External Affairs and whether the responsibilities of the position included lobbying government officials.[25] AW declined to provide the information. Overland recommends that this unsupported, and likely unrecoverable, expense be removed from NSC expense charged to CalAm ratepayers. Using CalAm's requested allocation factor, this component of our recommended adjustment reduces CalAm's requested test year expense by $25,420.

<u>7. Correct NSC Income Tax Expense and Interest Income</u> - Among the items in the "Non-Departmental" business unit budget are interest income and income tax expense. Based on updated budget estimates provided by CalAm, Overland recommends adjustments to income tax and interest income that increase total NSC expense by $668,910, and increase CalAm's ratepayer-funded expense by $38,195, using CalAm-requested allocation factors. The adjustment amounts apply to 2008 and the 2009 test year.

- <u>Interest Income</u> - The 2008 NSC budget includes $2.4 million in interest income associated with NSC bank balances. In response to a data request, AW stated that interest income was over-estimated when budgeted in 2007. AW estimated that based on the first half of the year, interest income for 2008 will be about $1 million, rather than $2.4 million.[26] Overland recommends accepting AW's updated, lower estimate of interest income. This requires an adjustment reducing NSC-budgeted interest income by $1,427,200 (from $2,443,000 to $1,016,000). Because it an income item within the NSC expense budget, the adjustment *increases* CalAm's ratepayer funded expense by $81,493 in 2008 and 2009, using CalAm's recommended allocation factor.

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[24] Response to OC-162.

[25] OC-163.

[26] Response to OC-191.

- Income Tax Expense - AW stated that $879,828 in income tax expense (pre-allocation) included in the "Non-Departmental" business unit is associated with expense that is not deductible for tax purposes, primarily non-deductible business meals.[27] There is not nearly enough non-deductible meal expense budgeted in 2008 in the business units allocable to CalAm to account for the income tax expense. AW offered a new, lower calculation of income tax based primarily on $546,000 in non-deductible meals and $12,000 in non-deductible dues. The actual amount budgeted in 2008 for non-deductible meals is $334,275. Overland recommends income tax expense on non-deductible employee meals be limited to the amount budgeted for the NSC business units that CalAm is requesting to recover from California ratepayers. Before allocation, the revised calculation of income tax expense is $121,537. This component of our recommended adjustment reduces AW's 2008 budgeted NSC tax expense by $758,291. Using CalAm's recommended allocation factor, this adjustment component *reduces* CalAm expense by $43,298 in 2008 and in 2009.

8. Remove NSC Sales and Marketing Expense - Overland recommends that corporate Marketing and Sales expenses involving promotion of the corporate brand be removed from NSC expenses recovered from CalAm's ratepayers. Sales and Marketing business unit 32068 includes a Marketing Director, a Brand Manager, a Manager of Advertising and Trade Events and a Communications Specialist. The responsibilities of the Brand Manager include "leading the development and rollout of American Water's new visual style and new brand policy and standards." The responsibilities of the Trade Events and Advertising Manager include "lead[ing] initiatives that promote brand American Water or any of its products & services." We did not receive a requested job description for the Marketing Director.

Regulators do not typically permit utilities to charge captive utility customers for advertising or marketing unless the efforts are aimed at educating the customer about safety issues or service usage. NSC Marketing and Sales positions focused on brand management and brand promotion are far removed from the objective of educating CalAm customers about safety or service usage. Our recommended adjustment removes $1,467,534 from NSC total expense. Using CalAm's requested allocation factors, this adjustment reduces CalAm expense by $72,056 in 2009.

9. Limit Customer Service Center (CSC) Expense to 2003 Expense Plus Inflation - CalAm requests that it be permitted to recover from ratepayers nearly 70 percent more for customer service in the test year than it incurred in 2003.[28] Overland recommends limiting CalAm's CSC expense to $1,971,507 based on the *per-customer* expense incurred in 2003, adjusted upward by for inflation.[29] CSC expense comprises about one-third of the total NSC expense requested by

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[27] Id.

[28] General Office Rate Filing Exhibit B, Chapter 4, Section 1, Table 1, Service Company - Call Center, $2,802,618 in 2009, 69.5% higher than $1,653,390 in 2003. 2,802,618 / 171,444 (OC-90) = $16.347.

[29] Inflation is based on the change in the Consumer Price Index between May, 2003 and May, 2008 (U.S. BLS., 125.6 / 107.6 = 1.1673; Dec. 1999 base=100, Chained, U.S. City Avg.). $1,653,390 (Ex.B, Ch.4, Sec.1,Tbl.1) / 167,834 (Ex.B, Ch.6, Sec.1, Tbl.3) = $9.8513 x 1.1673 x 171,444 (OC-90) = $1,971,507.

CalAm, and about one-sixth of requested General Office expense. CalAm requests to recover test year expense of $16.24 per customer for the CSC (based on CalAm's proposed test year customers), up from just $9.85 in 2003, the year before national-scope call centers were fully deployed. The requested increase far exceeds consumer price inflation during this period, which results in expense per customer of $11.50.[30] As discussed more fully in Chapter 4, CalAm's transition from a local customer call center in Chula Vista to the allocated expense of national call centers in Alton, IL and Pensacola, FL has produced dis-economies for CalAm. One factor contributing to a significantly higher expense for CalAm may be AW's provision of call center services to non-regulated customers.

In light of the significant, unexplained increases in CSC expense per customer, Overland recommends that CalAm be prohibited from passing along apparent dis-economies associated with the implementation of the Alton and Pensacola centers, some of which may be attributable to non-regulated activities. Our adjustment reduces CalAm's requested level of CSC expense by $831,111, from $2,802,618 to $1,971,507 in 2009.

10. Remove Unnecessary Payroll Reserve - Overland recommends an adjustment to remove a CalAm-allocated LSC payroll reserve for "bonus or promotional increase[s]." 2009 LSC expense allocated to CalAm already includes pay and benefit increases ranging from 3 to 5%, as well as incentive compensation. Layered on top of the salary increases and incentive compensation, CalAm proposes to include a "catch-all" reserve for unexpected raises, promotions, and unanticipated, market-driven increases to fill vacant positions. No apparent consideration is given to mitigating circumstances such as the possibility of filling position vacancies with employees who have less seniority than those being replaced, the potential softening of future job markets, or the ability of management to control future pay increases. Overland does not believe that the additional payroll reserve is warranted and proposes that it be excluded from CalAm's allocated GO costs. Our recommended adjustment reduces CalAm-allocated expense by $30,050 in 2008 and $30,801 in 2009, using CalAm-requested allocation factors.

11. Correct Omission of Operating Risk Department Salaries - CalAm inadvertently excluded the base salaries of two employees from the LSC Operating Risk Department projections in 2009. These same employees' base salaries were included in the 2008 projections. Total labor expense omitted was $154,092 for the LSC, of which $83,036 distributes to CalAm using CalAm-requested factors. Overland recommends an adjustment to correct this error by adding back the expense. This adjustment increases CalAm expense by $83,036 in 2009.

12. Reverse Allocation Impact of Re-Branding LSC Employees as California-Only - Overland recommends that 12 of 17 employees reclassified in 2006 and 2007 from the LSC organization to the Cal Corp organization be allocated to the states served by the LSC as they were before they we re-branded as Cal Corp employees. In 2006 and 2007 AW moved 17 regionally-allocated LSC employees to the California-specific Cal Corp. Under the auspices of creating a "strong state organizational structure", these employees, who were once allocated to as

[30] $9.8513 x 1.1673

many as five different regulated jurisdictions, are 100 percent attributable to CalAm for purposes of CalAm's project test year expense request. Although they have new locations on AW organization charts and new California-only cost attributions, 16 of the employees have continued to work in the same city, most with the same or similar job titles as they did when they were considered part of the LSC.

The re-branding of LSC employees as Cal Corp poses a potential for the manipulation of cost allocations. For example, an employee deemed to be part of Cal Corp in this rate application can be transferred back to the LSC or to another jurisdiction soon afterwards and be claimed as a partially- or wholly-dedicated employee of the transferred-to jurisdiction in a different rate case. We attempted to obtain information concerning rate cases in the other states served by AW's Western Region LSC and did not receive a meaningful response.[31]

We also found that the increase in Cal Corp costs associated with the re-branding was not offset by any meaningful decrease in CalAm-allocated costs from the LSC (as one would expect if the services being provided had actually been transferred).

Taking into consideration subsequent employee reclassifications and a few cases in which employees had obvious new job responsibilities, Overland recommends that 12 of the 17 reclassified employees be allocated across LSC cost objectives as they were before the re-branding to Cal Corp occurred. For purposes of this calculation, Overland used the allocations from the calendar year most representative of the date the employee "shift" took place.[32] Our recommended reallocation reduces CalAm expense by $321,011 in 2008 and $334,197 in 2009.

13. Remove Cal Corp Labor Separately Requested in Rate Case Expense - In its request, CalAm has included a portion of the labor costs of four Cal Corp employees in both its allocated operating expenses and deferred rate case expenses.

For 2009 test year purposes, labor for each employee of Cal Corp was assigned by management to either 1) operating expense or 2) capital expenditures and/or rate case expense through the use of allocation factors. In total, these allocation factors summed to 100 percent. Based on a review of deferred rate case expense support, Overland discovered that some employees had more time allocated to rate case expense than management had allowed for in its allocation factors. As a result, more than 100 percent of these particular salaried employees' labor costs were effectively requested for recovery from ratepayers.

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[31] States served by the Western Region LSC, in addition to California, include Arizona, Texas, New Mexico and Hawaii. Operations in New Mexico, Texas and Hawaii are relatively small in comparison to California and Arizona.

[32] If the reclassification occurred near the end of a calendar year, we used the LSC allocation factors for that year. If the reclassification occurred near the beginning of a calendar year, we used the LSC allocation factors for the year prior to the move.

Taking into consideration previous proposed adjustments that affect the recommended allocations of two of the four employees, Overland proposes to adjust the remaining two employees' labor costs so that no more than 100 percent of their cumulative time is included in any area of the rate application. The impact of this adjustment is a reduction of $33,236 and $34,664 to CalAm-allocated operating expense in 2008 and 2009, respectively.

<u>14. Correct Allocations to CalAm</u> - We reviewed the distribution of NSC and LSC expenses to CalAm. As discussed below, Overland recommends adjustments to CalAm's test year-requested NSC and LSC allocation factors for CalAm. Our adjustments reduce CalAm's NSC-allocated expense by $716,334 in 2008 and 2009 and reduce LSC-allocated expense by $48,823 in 2008 and $51,000 in 2009. In total, CalAm expense is reduced by $765,157 in 2008 and by $767,334 in the 2009 test year.

<u>NSC Allocations to CalAm</u> - The NSC serves both the regulated and non-regulated segments of American Water. Within the regulated segment AW allocates costs among 20 regulated state-based water companies. AW has two levels of allocation. "Tier 1" factors distribute expense between the regulated and non-regulated segments based on various measures of relative segment size, including revenues, expenses and employees. Tier 2 allocations distribute regulated segments costs (after Tier 1 allocation) among the 20 regulated water companies. Tier 2 allocations are based on customers.[33]

[33] Customers are used only for Tier 2 allocation. They are not used to allocate between the regulated and non-regulated segments. For example, in the regulated water companies a customer is a residential or commercial user of water service. On the non-regulated side, AW may have an operating agreement with a city to perform services for the city's water users. The "customer" in this case is the city, not the residents and businesses that use the city's water service.

Chapter 2

Table 2-4
CalAm Percentages of NSC Rate Filing Category Allocations and American Water Regulated Customers

Rate Filing Category	2006	2007	Test Year per CalAm	Test Year per Overland
Belleville Lab	5.41%	5.42%	5.40%	4.56%
Customer Service Center (1)	5.28%	5.41%	5.42%	4.56%
Finance	4.67%	5.03%	5.16%	4.56%
HR	4.12%	4.37%	4.70%	4.70%
IT	4.92%	5.22%	5.42%	4.56%
NSC Functions (2)	5.93%	5.33%	5.02%	4.56%
Operations / Network	4.34%	4.89%	5.05%	4.56%
Procurement	5.21%	6.89%	6.48%	6.48%
Shared Services	5.62%	6.45%	6.12%	4.56%
Weighted Avg Allocation	5.38%	5.43%	5.41%	4.59%
	2006	2007	2008	
Regulated Customers	5.29%	5.38%	5.18%	5.18%

(1) Included for calculation of weighted average only. Our recommendation for the CSC negates the use of an allocation factor. (2) The common cost pool used for the NSC Functions calculation excludes Northeast, charged to CalAm.

Sources: Allocation Percentages calculated from analysis of OC-52. Customers are from OC-85.

As shown Table 2-4, even with an ostensible allocation to the non-regulated segment, CalAm's test year composite allocation of common NSC expenses (5.41%), is greater than its 2007 year-end share of regulated customers (5.18%). We asked CalAm to support its proposed test year NSC allocation factors. These are shown in the "Test Year per CalAm" column above. CalAm responded:[34]

> Regarding 2008 and 2009 information, there is no "common" cost allocation, as the data for these periods are forecast. The distribution of costs by function is developed based on prior period overall cost assignment experience.

Overland interprets this to mean that there is no calculation support for the test year factors used to distribute NSC costs to CalAm's rate filing. CalAm states that the "distribution of costs" is "based on prior period overall cost assignment experience"; yet, while CalAm's share of regulated customers is *lower* at December 31, 2007 that at the end of 2006, its 2008 share of budgeted NSC expense, based on "prior period overall cost assignment experience," is *higher* than in 2007 and also higher than its share of total regulated customers (even after an ostensible allocation to the non-regulated segment). Our own analysis of historical NSC allocations showed that a significant portion of the NSC's expense was assigned to cost pools that were allocated *only* to the regulated water companies.

[34] Response to OC-51.

Chapter 2

As discussed in Chapter 4, we found that the CSC serves non-regulated customers, but that no CSC expenses are allocated to these non-regulated customers or to the non-regulated business segment. Specifically, we determined that for some time the CSC has provided operating services to municipal water systems for the Township of Edison, NJ and for the City of Elizabeth, NJ (Liberty Water) without allocating any CSC expense to these non-regulated customers. AW acknowledged that it should be allocating expense for "comparable" CSC services to non-regulated customers.[35]

Months after we submitted our data request, AW supplemented its response concerning CSC expense allocations with a list of an additional 104 municipal customers from which AW currently collects \$5.7 million for billing services.[36] As with the non-regulated Edison and Liberty contracts, CSC expenses are also not allocated to the 104 municipal customers receiving CSC billing services. In the case of the customers receiving billing services, it appears that AW believes allocations should not be made because the services are not "comparable" to those provided to the regulated segment. Overland notes that AW's opinion and its procedure are inconsistent with fully distributed cost allocation principles required by most regulators.

<u>Calculation of Overland's Recommended NSC Allocation Factors</u> - Overland's recommended allocation of NSC expense to CalAm is simple. For each appropriate rate filing category, NSC expense should be allocated using the following "Tier 1" and "Tier 2" factors:

- <u>Tier 1 NSC Expense Allocation</u> - All NSC expense should be subjected to a reasonable allocation between the regulated and non-regulated segments. This should be based on revenue and expense, measures to which each segment contributes in amounts comparable to the size of its operations.[37] Although AW declined to provided requested non-regulated financial data, AW's 2008 public equity offering required AW to file GAAP-based segment information. From this, we were able to obtain recent regulated and non-regulated revenues and expenses. Overland's recommended regulated non-regulated calculation is summarized in the table below.

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[35] Response to OC-73-C.

[36] Response to OC-210 and attachment.

[37] AW uses relative customers to allocate NSC expense among the regulated water companies. This works because customers are comparable within the regulated segment; that is, customers in each regulated water company consist of thousands of residential and commercial water users. Since Tier 1 and Tier 2 allocations are components of the same cost distribution process, the allocation basis should be consistent to the extent possible (in other words, if customers is the accepted basis, it would ideally be used for both regulated and non-regulated companies, reducing the process to one tier). Unfortunately, AW's regulated and non-regulated customers are not comparable and do not properly reflect the relative size of segment operations. As noted, regulated "customers" consist of millions of residential and commercial water users. On the non-regulated side, "customers" consist of (a few hundred?) water system owners and operators, on average producing a significantly greater amount of revenue than the average regulated customer. The result of combining these two would be a customer ratio not reflective of relative segment size, and therefore not reasonable for use as an "unattributable" allocator ("unattributable" is what all of AW's size-based allocators are).

Chapter 2

Table 2-5 Overland-Recommended Allocation of Common NSC Management Fee Expense Between Regulated and Non-Regulated Operations Based on Average of Relative Segment Revenues and Operating Expenses					
	Revenue		Expense		Average
Segment	Amount	Percent	Amount	Percent	Percentage
Regulated	$ 1,987,565	89.12%	$ 1,490,794	86.86%	87.99%
Non-Regulated	242,678	10.88%	225,600	13.14%	12.01%
Total	**$ 2,230,243**	**100.00%**	**$ 1,716,394**	**100.00%**	**100.00%**
Source: American Water Form 424B3, Filed 5/12/2008, Segment Information, pp. F35 & F36					
Amounts are from Year Ended December 31, 2007					

- Tier 2 NSC Expense Allocation - AW allocates the NSC's regulated segment expense among its regulated water companies based on customers. Although customers is a relatively blunt method for allocating all regulated NSC expense, Overland did not have the resources or the time to conduct a detailed review of or redesign the process. Although we concur with AW's use of customers, we note that the test year factors should be based on the most recently available, accurate customer counts. Using year-end 2007 counts, CalAm's customers are 5.18% of total regulated customers.

Overland's recommended test year allocation to CalAm, applicable to most of the NSC rate filing categories, is 4.56%, as summarized below.

Table 2-6 Overland-Recommended Allocation of Common NSC Management Fee Expense to California American Water		
Component	Percentage	Basis
1. Regulated Share	87.99%	Regulated average pct. of combined segment revenue & expense
2. California Jurisdictional Share	5.18%	CalAm percent of of total regulated customers
3. CalAm Regulated Allocation	4.56%	Line 1 x Line 2
Source: American Water Form 424B3, Filed 5/12/2008, pp. F35 & F36		
Amounts are from Year Ended December 31, 2007		

We recommend a 4.56% allocation for 7 of 9 NSC rate filing categories (6 if the Customer Service Center is limited, as recommended, to 2003 CalAm expense plus inflation). As indicated in Table 2-4 above, we concur with AW's proposed CalAm allocations in the Human Resources function (4.70%) and the Procurement category (6.48%). The allocator for Human Resources is reasonably close to the overall NSC allocator we found to be reasonable (4.56%). Procurement is a unique category. Because a majority of AW's non-regulated operations do not involve the construction of AW-owned plant, we concur with AW's assessment that the Procurement function primarily serves the regulated segment. In recognition of the possibility that construction levels are somewhat higher in California than in other states, and due to the lack of time or resources to perform a detailed analysis, Overland has chosen not to contest the fact that CalAm's proposed test year Procurement factor (6.48%) is 25% higher than CalAm's share of regulated customer (5.18%).

Combining reasonable allocations for each NSC rate filing category results in Overland's recommended weighted average (overall) allocation of 4.59% of common NSC to CalAm, as shown in Table 2-4. The change in allocation factors reduces NSC expense allocated to CalAm by $716,334 in 2008 and 2009.

<u>LSC Allocations to CalAm</u> - Underlying the total charges from the LSC to CalAm are jurisdictional labor cost allocations of 23 employees that are entirely based on projected customer count data. Overland believes actual year-end 2007 customers counts are a more objective basis for the allocation. The adjustment associated with this allocation factor change reduces CalAm ex by $48,823 and $51,000 in 2008 and 2009, respectively. In addition, allocations of non-labor expenses were also affected by the synchronization of labor costs to May 31, 2008 employee levels. The impact of this change is included in adjustment to calculate labor expense based on end-of-May, 2008 employee levels.

General Office Operations and Maintenance Expenses
As Filed By CalAm, Summary of Overland-Recommended Adjustments, As Adjusted by Overland
2008 and 2009 Per CalAm, Overland-Recommended Adjustments, and As Recommended by Overland

2008 Description	**As Filed 2008**	1. Annualize Labor Expense Based on May 31, 2008 Actual Staff Levels	2. Reduce Incentive Compensation to 2007 Actual Award Levels	3. Remove Business Development Expense	4. Remove Corporate Contributions	5. Remove Legislative Influence Expense	6. Remove Unsupported "Non-Departmental" & "NSC Functions" Expense	7. Correct "Non Departmental" Interest Income and Income Tax	8. Remove Sales and Marketing Expense	9. Limit CSC Expense to 2003 Plus Inflation	10. Remove Unnecessary Payroll Reserve	11. Correct Ommission of Oper Risk Dept Salaries	12. Reverse Allocation Effect of Re-branding LSC Employees as Cal-Corp	13. Remove CalCorp Labor Separately Requested as Rate Case Expense.	14. Correct NSC & LSC Allocations to Cal-Am	Total Adjustments	**Adjusted 2008 Totals**
Operating Expenses - Dollars:																	
National Service Company																	
Service Company - Belleville Laboratory	302,875	(24,655)	(6,162)	-	-	-	-	-	-	-	-	-	-	-	(42,320)	(73,137)	229,738
Service Company - Call Center	2,802,618	-	-	-	-	-	-	-	-	(831,111)	-	-	-	-	-	(831,111)	1,971,507
Service Company - Finance	581,351	(23,198)	(44,076)	-	-	-	-	-	-	-	-	-	-	-	(59,776)	(127,050)	454,301
Service Company - Human Resources	296,649	(28,306)	(19,204)	-	-	-	-	-	-	-	-	-	-	-	-	(47,509)	249,140
Service Company - Information Technology	1,786,495	(53,939)	(93,007)	-	-	-	-	-	-	-	-	-	-	-	(260,150)	(407,096)	1,379,399
Service Company - "NSC Functions"	1,489,659	139,976	(35,795)	(30,439)	(20,623)	(22,564)	(545,959)	38,195	(72,056)	-	-	-	-	-	(81,524)	(630,790)	858,869
Service Company - Operation / Network	267,594	(11,639)	(50,729)	-	-	-	-	-	-	-	-	-	-	-	(19,913)	(82,282)	185,312
Service Company - Shared Services	1,141,013	(70,099)	(59,540)	-	-	-	-	-	-	-	-	-	-	-	(252,651)	(382,290)	758,723
Service Company - Procurement	152,311	1,926	(19,520)	-	-	-	-	-	-	-	-	-	-	-	-	(17,594)	134,717
Subtotal National Service Company	8,820,565	(69,934)	(328,033)	(30,439)	(20,623)	(22,564)	(545,959)	38,195	(72,056)	(831,111)	-	-	-	-	(716,334)	(2,598,859)	6,221,706
Local Service Company	3,471,949	26,341	(121,159)	(341,030)	-	-	-	-	-	-	(30,050)	-	-	-	(48,823)	(514,721)	2,957,228
California AW GO Function (Cal Corp)	4,768,058	(294,998)	(139,966)	-	-	(188,440)	-	-	-	-	-	-	(321,011)	(33,236)	-	(977,651)	3,790,407
TOTAL	**17,060,572**	**(338,591)**	**(589,158)**	**(371,469)**	**(20,623)**	**(211,004)**	**(545,959)**	**38,195**	**(72,056)**	**(831,111)**	**(30,050)**	**-**	**(321,011)**	**(33,236)**	**(765,157)**	**(4,091,231)**	**12,969,341**

2009 Description	**As Filed 2009**	Annualize Labor Expense Based on May 31, 2008 Actual Staff Levels	2. Reduce Incentive Compensation to 2007 Actual Award Levels	3. Remove Business Development Expense	4. Remove Corporate Contributions	5. Remove Legislative Influence Expense	6. Remove Unsupported "Non-Departmental" & "NSC Functions" Expense	7. Correct "Non Departmental" Interest Income and Income Tax	8. Remove Sales and Marketing Expense	9. Limit CSC Expense to 2003 Plus Inflation	10. Remove Unnecessary Payroll Reserve	11. Correct Ommission of Oper Risk Dept Salaries	12. Reverse Allocation Effect of Re-branding LSC Employees as Cal-Corp	Correct Labor Costs Requested More Than Once	14. Correct NSC & LSC Allocations to Cal-Am	Total Adjustments	**Adjusted 2009 Totals**
Operating Expenses - Dollars																	
National Service Company																	
Service Company - Belleville Laboratory	302,875	(24,655)	(6,162)	-	-	-	-	-	-	-	-	-	-	-	(42,320)	(73,137)	229,738
Service Company - Call Center	2,802,618	-	-	-	-	-	-	-	-	(831,111)	-	-	-	-	-	(831,111)	1,971,507
Service Company - Finance	581,351	(23,198)	(44,076)	-	-	-	-	-	-	-	-	-	-	-	(59,776)	(127,050)	454,301
Service Company - Human Resources	296,649	(28,306)	(19,204)	-	-	-	-	-	-	-	-	-	-	-	-	(47,509)	249,140
Service Company - Information Technology	1,786,495	(53,939)	(93,007)	-	-	-	-	-	-	-	-	-	-	-	(260,150)	(407,096)	1,379,399
Service Company - "NSC Functions"	1,026,220	139,976	(35,795)	(30,439)	(20,623)	(22,564)	(82,520)	38,195	(72,056)	-	-	-	-	-	(81,524)	(167,351)	858,869
Service Company - Operation / Network	267,594	(11,639)	(50,729)	-	-	-	-	-	-	-	-	-	-	-	(19,913)	(82,282)	185,312
Service Company - Shared Services	1,141,013	(70,099)	(59,540)	-	-	-	-	-	-	-	-	-	-	-	(252,651)	(382,290)	758,723
Service Company - Procurement	152,311	1,926	(19,520)	-	-	-	-	-	-	-	-	-	-	-	-	(17,594)	134,717
Subtotal National Service Company	8,357,126	(69,934)	(328,033)	(30,439)	(20,623)	(22,564)	(82,520)	38,195	(72,056)	(831,111)	-	-	-	-	(716,334)	(2,135,420)	6,221,706
Local Service Company	3,546,988	29,170	(125,515)	(352,746)	-	-	-	-	-	-	(30,801)	83,036	-	-	(51,000)	(447,856)	3,099,132
California AW GO Function (Cal Corp)	4,954,495	(339,407)	(144,998)	-	-	(195,648)	-	-	-	-	-	-	(334,197)	(34,664)	-	(1,048,915)	3,905,580
TOTAL	**16,858,609**	**(380,171)**	**(598,546)**	**(383,185)**	**(20,623)**	**(218,213)**	**(82,520)**	**38,195**	**(72,056)**	**(831,111)**	**(30,801)**	**83,036**	**(334,197)**	**(34,664)**	**(767,334)**	**(3,632,190)**	**13,226,419**

3. National Service Company Allocations to CalAm

American Water's National Service Company Allocations to CalAm

Approximately half of CalAm's General Office revenue requirement request consists of allocations from the National Service Company (NSC). The basis for CalAm's test year NSC allocations is summarized below.[1]

Table NSC-1
American Water National Service Company
CalAm Test Year Requested (2008 Budgeted) NSC Expense and Allocations to CalAm

Rate Filing Category	Budgeted Total Spend	Budgeted Amounts Not Allocated	Allocable Management Fee	Cal-Am Management Fee Allocation	CalAm Allocation Percentage
Belleville Lab	$ 5,610,705	$ -	$ 5,610,705	$ 302,877	5.40%
Customer Service Center	51,741,509	51,765	51,689,744	2,802,618	5.42%
Finance	20,839,179	9,577,992	11,261,187	581,348	5.16%
HR	6,457,758	142,202	6,315,556	296,648	4.70%
IT	39,949,862	7,005,708	32,944,154	1,786,496	5.42%
NSC Functions	22,524,749	2,101,012	20,423,737	1,026,224	5.02%
Operations / Network	10,409,267	5,105,618	5,303,649	267,596	5.05%
Procurement	4,495,619	2,146,500	2,349,119	152,312	6.48%
Shared Services	19,846,131	1,214,889	18,631,242	1,141,015	6.12%
Totals	**$181,874,779**	**$27,345,686**	**$154,529,093**	**$8,357,134**	**5.41%**

Source: CalAm Rate Filing (CalAm Amounts); OC-91 (NSC Total Amounts)

Approximately one third of CalAm's requested NSC revenue requirement is expense from the Customer Service Center (CSC) rate filing category. Because of its size, and because of issues unique to it, we discuss the CSC in a separate chapter. The other rate filing categories that comprise the remaining two-thirds of CalAm's NSC revenue requirement request are discussed below.

NSC Expenses by Rate Filing Category

The NSC's forecasted test year allocation to CalAm is based on the NSC's 2008 budget plan. The NSC budget plan is made up of the sum of the budgets of approximately 85 business units.[2] For the rate filing CalAm classified these business units into nine categories. The rate filing contains one line of cost information for each category, showing the historical and 2008 budget year (test year) NSC management fee allocated to CalAm.

After requesting budget support for the NSC revenue requirement, Overland found that the categories presented in the rate filing did not directly correspond with the organizational categories built into AW's budget and accounting system. We found that some rate filing

[1] Of the amounts in this NSC summary table, only the CalAm-allocated amounts are shown in the rate filing. It took approximately 3 months of discovery effort to obtain the amounts in the other columns in the table.

[2] Business units are the basic control (responsibility) areas in AW's budgeting process.

categories, such as the CSC, corresponded with an "Office" category in AW's accounting system. Others consisted of business units from various "offices" and "functions" (e.g. "NSC Functions"), or an "office" subset of a particular "function" (e.g., Human Resources, which includes business units in the Human Resources "function", but only for the Corporate "office"). None of this information is documented in the rate filing.

Understanding the relationship between the organizational categories in AW's accounting system; in particular, understanding which business units roll up to the amounts for each rate filing category, is fundamental to reviewing the reasonableness of NSC expense charged to CalAm. There is no information in the rate filing or the filing workpapers supporting the NSC expense CalAm is requesting to recover from California ratepayers. In fact, accounting support for test year NSC expenses charged to CalAm consists entirely of what is in this report, its workpapers, and CalAm's responses to Overland data requests. It required more than three months and several rounds of discovery effort to obtain the underlying business unit budget support for the amounts included in the NSC component of the GO revenue requirement and the organizational information necessary to map the business units to their corresponding categories in the rate filing. It was particularly difficult to obtain complete business unit budget detail for the "NSC Functions" rate filing category.

A summary of CalAm's requested level of NSC expense, before and after CalAm allocations, as requested by CalAm, Overland's recommended adjustments, and as recommended by Overland, is shown in Attachment 3-1.

NSC Belleville Lab

NSC Belleville Lab consists of a single business unit, physically located in Illinois. CalAm requested to include the expense of 36 employees in California rates. As of May 31, 2008 it consisted of 30 employees, including chemists, lab technicians, analysts and clerical employees performing water quality testing and assurance. Belleville Lab staffing is summarized below.

Table LAB-1
American Water National Service Company
NSC Belleville Lab Rate Filing Category - Business Units and Staffing

	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
Belleville Lab	34517	BVLAB-Water Quality	34	32	33	30	36
Total Belleville Lab			**34**	**32**	**33**	**30**	**36**
Source: Responses to OC-7, OC-91 & OC-92							

Expense - Belleville Lab expense is summarized in the table below.[3]

[3] For most rate filing categories, it is not possible to compare individual categories of historical expense with the budget, because the budget data was provided on a "total spend" basis, while only the "management fee" portion of total expense was provided for the 2006 and 2007 historical periods. In the case of Belleville Lab, "total spend" and "management fee" were the same in the budget period, and given the nature of the function, it is probable that the same is true for the historical periods. Thus, for this rate filing category, we decided it was reasonable to

Table LAB-2 American Water National Service Company NSC Belleville Lab Expense			
Cost Category	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M	$2,097,224	$2,572,176	$2,846,242
Non-Labor O&M	$ 2,063,623	$1,878,474	$2,035,861
Depreciation	$509,103	$239,516	$601,260
Interest	$156,612	$147,868	$127,356
Belleville Lab Total Spend	$ 4,826,562	$ 4,838,034	$5,610,719
Belleville Non-management Fee	$0	$0	$0
Belleville Management Fee	$4,826,562	$4,838,034	$5,610,719
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$1.55	$1.47	$1.70

Source: Dollars - OC 1, 8 & 9 and OC-91; Customers per OC-85
(1) For 2006 and 2007, customers are average year end figures per OC-85, for

- Labor expense - The 2008 budget (and the CalAm rate filing) is based on salaries for 36 employees. As of May 31, 2008, the additional budgeted staff was not on the payroll; in fact, staffing decreased from 33 at the end of 2007 to 30 at the end of May, 2008.

- Depreciation expense - Belleville Lab depreciation was significantly lower in 2007 than in 2006, and is significantly higher than 2007 in the budget year. AW indicated that the lower expense in 2007 was due to an error that resulted in the company not recording depreciation expense for the Belleville business unit from June through December, 2007.[4] Although 2008 budgeted depreciation is 18 percent higher than 2006, the California impact of the higher expense (about $5,000) is not enough to warrant additional audit effort.

Allocations to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

compare individual categories of expense between the budget (test year) and historical periods.

[4] Response to OC-169, part 1.

Table LAB-3 American Water National Service Company Historical and CalAm Proposed Test Year NSC Management Fees Belleville Lab Rate Filing Category			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Yr per CalAm
NSC Totals:			
Direct Charges	1,502	31,635	
National Allocations	4,824,937	4,806,016	
Regional Allocations	122	385	
Total Management Fee	**4,826,561**	**4,838,036**	**5,610,705**
CalAm Cost Distributions:			
Direct Charges	-	2,001	
National Allocations	261,229	260,027	
Regional Allocations	-	-	
CalAm Distribution	**261,229**	**262,027**	**302,877**
CalAm Percent	**5.41%**	**5.42%**	**5.40%**
Source: Data from OC-52			

In 2007 a majority of Belleville Lab expense other than overhead was distributed only to the regulated water companies using allocation method 10533, described as "CP-All Regulated Water Companies." The California percentage for this allocator, 5.52 percent, was somewhat higher than the California share of other commonly used allocators. Allocation workpapers provided in response to OC-84 and 85 do not describe the basis for allocator 10533.[5] The 2007 Belleville Lab expense distribution shows that very small amounts were allocated to non-regulated subsidiaries such as American Water Enterprises and to water companies that AW runs under non-regulated contracts with municipalities.[6] The composite allocation of 5.40% budgeted for 2008 is similar to the actual composite distribution for 2007 (5.42%), which included virtually no non-regulated allocation.

NSC Belleville Lab Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 30 employees actually on the payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

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[5] OC-84 and 85 describe the basis for many factors; for example, the basis for calculating one commonly-used factor, method 100003, is revenue, plant and employees (tier 1 - regulated / non-regulated) and customers (tier 2 - regulated utility jurisdictional). No such description is provided in OC-84 or 85 for allocation method 10533.

[6] Response to OC-168. For 2008 AW budgeted a 0.25 percent allocation of Lab to its largest non-regulated subsidiary, American Water Enterprises. It has budgeted an $89 (0.003 percent) allocation to the water contract for the City of Edison, NJ, and a $224 (0.01 percent) allocation to the Liberty water contract for the City of Elizabeth, NJ. On a combined basis, 2008 budgeted allocations from Lab to non-regulated cost objectives appear to be less than one third of one percent of the Lab's budgeted expense.

Chapter 3

2. Expense Allocation to CalAm - Overland recommends that a regulated distribution of Belleville Lab expenses of 88% (non-regulated allocation of 12%). This is based on the average regulated share of 2007 corporate revenues and expenses before consolidations.[7] Overland recommends California jurisdictional regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[8] This results in an overall allocation to CalAm of 88% x 5.18%, or 4.56%.

NSC Customer Service Center

The Customer Service Center is discussed in Chapter 3.

NSC Finance

The NSC Finance rate filing category consists of finance, planning and reporting, compliance (Sarbanes-Oxley), investor relations, income tax and treasury functions. Finance business units and headcount are summarized in the following table. The business units that make up the Finance rate filing category include units in the Corporate "office" of AW's Finance "function."

Table FIN-1
American Water National Service Company
NSC Finance Rate Filing Category - Business Units and Staffing

	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-CORP Finance	32007	CORP-Finance	10	11	11	11	11
SC-CORP Finance	32017	CORP-Planning & Reporting	12	14	13	13	14
SC-CORP Finance	32027	CORP-Reporting & Compliance	2	3	5	4	7
SC-CORP Finance	32037	CORP-Investor Relations	2	2	2	3	3
SC-CORP Finance	32047	CORP-Income Tax	4	8	12	16	15
SC-CORP Finance	32057	CORP-Treasury	8	10	11	10	9
Total Finance			**38**	**48**	**54**	**57**	**59**

Source: Responses to OC-7, OC-91 & OC-92

Expense - Finance expense is detailed below.

[7] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[8] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

Chapter 3

Table FIN-2 American Water National Service Company NSC Finance Expense			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$8,525,150
Non-Labor O&M			$12,314,051
Interest			$0
Finance Total Spend	unknown	unknown	$20,839,201
Finance Non-Management Fee	unknown	unknown	$9,577,992
Finance Management Fee (1)	$21,757,808	$41,093,310	$11,261,209
Customers	3,113,038	3,292,081	3,308,296
Management Fee per Customer, per AW	$6.99	$12.48	$3.40

Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007

(1) In 2006 and 2007 Finance includes a large amount of non-recurring expense associated with Sarbanes-Oxley attributable to the RWE divestiture and public offering.

- Labor Expense - The 2008 budget is based on the salaries of 59 positions. The budgeted increase in labor expense is largely the result of budgeted increases in income tax, treasury and compliance unit headcount.

- Non-Labor O&M and Non-Management Fee - A large portion of Finance non-labor O&M consists of contract services associated with Sarbanes-Oxley. Most of this is related to efforts required as a result of AW's decision to separate itself from its parent company, RWE, and become a public company. These contract services peaked in 2006 and are expected to be non-recurring in the test year. As such, AW removed them from the Finance management fee it requests to recover from California ratepayers. The amounts removed make up most of the budget period "non-management fee" shown in the table above. Finance contract services for the three years ending with the 2008 budget are as follows:

2006 Actual	$16,317,291
2007 Actual	$32,865,640
2008 Budget	$10,715,840

Of the contract services in the 2008 budget, AW included $1,485,140 in the management fee to be allocated to CalAm and other cost objectives.

Allocations to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

Table FIN-3 American Water National Service Company Historical and CalAm Proposed Test Year NSC Management Fees Finance Rate Filing Category			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	307,081	154,665	
National Allocations	21,900,379	41,315,470	
Subtract: Sarbox	13,684,387	31,812,944	
Adjusted Nat'l Allocation	8,215,992	9,502,526	
Regional Allocations	9,980	12,692	
Total Management Fee	**8,533,053**	**9,669,883**	**11,261,187**
CalAm Cost Distributions:			
Direct Charges	5,089	(10)	
National Allocations	1,023,713	2,039,865	
Subtract: Sarbox	632,219	1,555,652	
Adjusted Nat'l Allocation	391,494	484,213	
Regional Allocations	1,682	1,821	
CalAm Distribution	**398,264**	**486,023**	**581,348**
CalAm Percent	**4.67%**	**5.03%**	**5.16%**
Source: Data from OC-52			

The 2008 budgeted allocation is a composite factor.[9] A majority of 2007 Finance expenses, excluding overhead, were allocated with the following methods:

Formula #	Formula Description	CalAm Pct
100001 Total	CP-ALL REGULATED CO'S (W & WW)	5.18%
100003 Total	CP-PLANT/REV/EMPLOY W/O CHILE	4.85%

Slightly less than half of 2008 Finance expense other than overhead was distributed only to the regulated water companies using allocation method 100001. Slightly more than half of the non-overhead expense was distributed using method 100003. Method 100003 results in a lower California allocation because it includes a Tier 1 allocation to the non-regulated segment. Overheads, allocated based on direct labor in each physical location, made up most of the remaining 2007 expense allocation. CalAm's allocated share of Finance overhead expense was slightly more than 5% in 2007.

NSC Finance Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 57 employees actually on the payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid

[9] AW was unable to break composite budget period allocation factors into the separate components (individual cost pools and allocation methods) that make up the composite.

in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - Finance is a corporate function serving the entire American Water structure. As such, a majority of its expenses should not be withheld from distribution to the non-regulated segment as was done in 2007.[10] We do not know how the 2008 composite allocator was developed because there is no supporting calculation. However, CalAm's 2008 allocation percentage is higher than 2007, so it is reasonable to assume that a significant share of 2008 expense is withheld from allocation to the non-regulated segment in the 2008 composite factor.

   Overland recommends CalAm's allocation of NSC Finance expense reflect both a Tier 1 allocation to the non-regulated segment and a Tier 2 jurisdiction regulated allocation based on CalAm's year-end 2007 share of customers, 5.18%.[11] Overland recommends the test year regulated / non-regulated (Tier 1) distribution of Finance based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[12] Overland recommends test year California jurisdictional (Tier 2) regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007. This results in an overall allocation to CalAm calculated as follows: 88% x 5.18% = 4.56%.

NSC Human Resources

This rate filing category consists of business units in the Corporate "office" of AW's Human Resources "function." Additional Human Resources business units, from the Customer Service Center "office," are included in the Customer Service Center rate filing category, discussed above.

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[10] A relatively insignificant $168,000 (0.4% of $41.5 million) of finance expense was directly charged to non-regulated subsidiaries in 2007.

[11] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

[12] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

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Table HR-1 American Water National Service Company NSC Human Resources Rate Filing Category - Business Units and Staffing							
	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-CORP Human Resources	32002	CORP-HR Comp/Benefits	3	3	5	5	5
SC-CORP Human Resources	32003	CORP-HR Talent Development	4	3	1	1	2
SC-CORP Human Resources	32004	CORP-HR Labor Relations		2	2	2	2
SC-CORP Human Resources	32006	CORP-Business Center HR	6	5	5	5	7
SC-CORP Human Resources	32013	CORP-HR Systems & Processes	2	2	2	2	2
SC-CORP Human Resources	32014	CORP-Benefits Service Center	13	15	14	13	16
SC-CORP Human Resources	32018	CORP-Human Resources	2	2	2	2	2
Total Human Resources			**30**	**32**	**31**	**30**	**36**
Source: Responses to OC-7, OC-91 & OC-92							

Expense - NSC Human Resources expense is summarized in the following table:

Table HR-2 American Water National Service Company NSC Human Resources Expense			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$4,164,007
Non-Labor O&M			$2,293,756
Human Resources Total Spend	unknown	unknown	$6,457,763
Human Resources Non-Mgt Fee	unknown	unknown	$142,202
Human Resources Management Fee	$5,375,713	$6,035,312	$6,315,561
Customers	3,113,038	3,292,081	3,308,296
Management Fee per Customer, per AW	$1.73	$1.83	$1.91
Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007			

- Labor Expense - The 2008 budget and the CalAm rate filing are based on salaries for 36 Human Resources employees. Midway through the budget period, staffing has not increased to 36; in fact, headcount decreased from 31 at the end of 2007 to 30 at the end of May, 2008. As discussed below, Overland recommends allocating test year NSC labor expense to CalAm based on *actual* headcount and salaries as of May 31, 2008.

- Non-Labor Expense - 2008 budgeted non-labor costs consist primarily of contract services, software licensing and employee expenses. Mid-way through the budget year, AW is on track to spend approximately what it budgeted for 2008.[13]

Allocation to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

[13] Response to OC-109, OC-109 Attachment, update to data provided in OC-1, 8 & 9

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Table HR-3 American Water National Service Company Historical and CalAm Proposed Test Year NSC Management Fees Human Resources Rate Filing Category			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	618,040	508,924	
National Allocations	4,653,498	5,439,576	
Regional Allocations	105,196	86,812	
Total Management Fee	**5,376,734**	**6,035,311**	**6,315,557**
CalAm Cost Distributions:			
Direct Charges	-	-	
National Allocations	221,012	263,217	
Regional Allocations	245	400	
CalAm Distribution	**221,257**	**263,617**	**296,648**
CalAm Percent	**4.12%**	**4.37%**	**4.70%**
Source: Data from OC-52			

In 2007 about two-thirds of Corporate Human Resources was subject to a Tier 1 allocation between regulated and non-regulated segments (86% regulated / 14% non-regulated) using relative employees (allocation method 100008 - CP - Employees) and among regulated companies using customers.[14] One fourth was allocated only to the regulated water subsidiaries using customers (100001 - CP All Regulated Water Companies W & WW).[15] Most of the remainder was overhead allocated using a labor-based methodology. As shown above, CalAm's 2008 budgeted Corporate Human Resources allocation (4.7%) is higher than 2007 (4.37%). The 2008 factor is a composite; AW does not have a calculation breaking it down into its components.

NSC Human Resources Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 30 employees actually on the payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - We do not know how the 2008 composite allocator was developed because there is no supporting calculation, but it appears that a smaller non-

[14] Data from response to OC-52; factors from responses to OC-84 & 85.

[15] Ibid.

regulated (Tier 1) employee percentage (7.5% in 2008 vs. nearly 14% in 2007) may translate to a higher regulated, and therefore higher CalAm percentage in 2008.[16]

The Corporate office of AW's Human Resources function serves the entire American Water structure. Overland therefore recommends that test year Corporate Human Resource expense be allocated between regulated and non-regulated segments based on relative employee levels, consistent with the methodology AW used for about a majority of the expense in 2007. The regulated Tier 1 employee factor (method 100008) being used for 2008 allocations is 92.5%.[17]

Overland recommends California jurisdictional (Tier 2) regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[18] This results in an allocation to CalAm of 92.50% x 5.18%, or 4.79%. This is close enough to the composite 2008 factor being used by CalAm (4.70%) that we do not propose to adjust CalAm's requested test year allocation factor.

NSC Information Technology

The NSC Information Technology (IT) rate filing category includes a large number business units, primarily in the Corporate "office", performing administration, maintenance and development of AW's computer and information systems. IT accounts for approximately 15 percent of the NSC employees allocated to CalAm customers in this rate filing.

[16] Responses to OC-84 and 85.

[17] Response to OC-85, Tier 1 Formulas, factor inputs as of 12/31/2007.

[18] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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Table IT-1 American Water National Service Company NSC Info Technology Rate Filing Category - Business Units and Staffing							
	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-ITS Location	032030	CORP-ITS Client Rel Admin	1	1	0	1	3
SC-ITS Location	032031	CORP-Service Desk	7	8	8	9	11
SC-ITS Location	032032	CORP-ITS Bus Development	4	5	5	5	5
SC-ITS Location	032033	Chg Ctrl & Desktop Automation	2	3	3	3	3
SC-ITS Location	032034	CORP-ITS Appl Adm & Security	6	6	5	6	7
SC-ITS Location	032071	CORP-ITS Admin	2	3	3	3	4
SC-ITS Location	032072	CORP-ITS PMO	10	9	9	11	11
SC-ITS Location	032073	CORP-ITS Infra/Oper Admin	2	2	2	2	2
SC-ITS Location	032074	CORP-ITS Production	10	9	9	9	9
SC-ITS Location	032075	CORP-System Maint & Perf	8	11	14	14	19
SC-ITS Location	032076	CORP-Communications	6	6	8	6	8
SC-ITS Location	032077	CORP-ITS Telecom	1	0	0	0	0
SC-ITS Location	032078	CORP-Adm Business Solutions	3	3	3	4	1
SC-ITS Location	032079	CORP-Technical Applications	15	18	22	21	27
SC-ITS Location	032080	CORP-Functional Applications	11	11	16	15	19
SC-ITS Location	032081	CORP-ITS Quality Assurance	4	6	8	6	8
SC-ITS Location	032082	Client Relationship Management	1	1	1	3	2
SC-ITS Location	032083	CORP-ITS Strategy/Governance	0	1	0	1	1
SC-ITS Location	032093	CORP-ITS Design Authority	1	1	4	8	6
SC-ITS Location	033031	WE-ITS Client Relations	2	0	0	0	0
SC-ITS Location	033531	CE-Western CS & S	14	0	17	17	18
SC-ITS Location	035031	SE-ITS Client Relations	1	15	0	0	0
SC-ITS Location	036531	NE-Eastern CS & S	16	20	21	21	21
Total Information Technology			**127**	**139**	**158**	**165**	**185**
Source: Responses to OC-7, OC-91 & OC-92							

<u>Expense</u> - IT expense is summarized in the table below:

Table IT-2 American Water National Service Company NSC Information Technology Expense			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$21,206,376
Non-Labor O&M			$9,619,873
Depreciation			$8,695,908
Interest			$427,764
Information Technology Total Spend	unknown	unknown	$39,949,921
Information Technology Non-Mgt Fee	unknown	unknown	$7,005,708
Information Technology Management Fee	$29,036,711	$30,245,524	$32,944,213
Customers	3,113,038	3,292,081	3,308,296
Management Fee per Customer, per AW	$9.33	$9.19	$9.96
Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007			

- Labor Expense and Vacancies - CalAm's test year IT labor expense is based on a 2008 labor budget for 185 positions. AW built vacancy adjustments into the labor budgets of some of IT business units, reducing labor and labor-related costs by approximately $1.4 million (the expense equivalent of about 12 employees). After vacancy adjustments, CalAm is asking California ratepayers to fund the salaries of approximately 173 NSC IT employees. Approximately mid-way through the 2008 budget year, the business units in the IT rate filing category had a headcount of 165 employees, about eight fewer than CalAm is requesting (after vacancy allowances). In other words, at a point near the middle of the budget year, AW's budgeted vacancy allowance captures approximately 60 percent of the budget savings created by actual IT vacancies. As discussed under the heading test year adjustments, Overland recommends test year NSC IT labor expense allocated to CalAm based on 165 employees actually on the payroll as of May 31, 2008.

Allocation to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

Table IT-3
American Water National Service Company
Historical and CalAm Proposed Test Year NSC Management Fees
Information Technology Rate Filing Category

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	3,970,693	2,625,547	
National Allocations	23,819,777	26,803,704	
Regional Allocations	1,246,210	815,385	
Total Management Fee	**29,036,680**	**30,244,635**	**32,944,156**
CalAm Cost Distributions:			
Direct Charges	147,535	110,578	
National Allocations	1,186,522	1,372,603	
Regional Allocations	93,367	95,622	
CalAm Distribution	**1,427,424**	**1,578,803**	**1,786,496**
CalAm Percent	**4.92%**	**5.22%**	**5.42%**

Source: Data from OC-52, Rate Filing category amounts based on Overland analysis

As shown in the table above, CalAm is proposing to increase its share of IT expense from 5.22% in 2007 to 5.42% in the test year (based on the 2008 budget). As noted throughout this report, 2008 allocation factors are composites for which AW does not have calculation support.

In 2007, approximately $110,000 in IT expense was directly charged to CalAm and approximately $95,000 was the result of regional allocations. Of the $1.4 million allocated nationally, slightly more than half was allocated using method 100001 - CP All Regulated Cos - W& WW. Method 100001 is a Tier 2-only allocation, distributing costs only among the regulated subsidiaries based on customers. CalAm's 2007 percentage under method 100001 was 5.18 percent. Most of the remaining nationally allocated cost consisted of overhead, of which

4.8% was allocated to CalAm. There was virtually no allocation of Corporate IT to the non-regulated segment. A relatively insignificant $805,000 (2.7% of $30,245,000 in total distributions) was directly charged to non-regulated subsidiaries.

NSC Information Technology Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 165 employees actually on AW's payroll mid-way through the budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - IT is a corporate function serving the entire American Water structure. As such, we cannot conclude that its expense, apart from relatively minor directly charged amounts, should be withheld from distribution to the non-regulated segment as was done in 2007.[19] We do not know how the 5.42% 2008 composite factor for CalAm was developed because there is no supporting calculation. However, CalAm's 2008 allocation percentage is higher than 2007, so it is reasonable to assume that most of the IT expense in the 2008 budget (and the rate filing) comes from allocation pools charged only to the water companies in the regulated segment.

   Overland recommends CalAm's Corporate IT allocation reflect both a Tier 1 regulated / non-regulated segment allocation and a Tier 2 jurisdictional allocation based on CalAm's year-end 2007 share of regulated customers, 5.18%.[20] As with other NC expense categories, we recommend the regulated / non-regulated distribution be based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[21] Overland recommends California jurisdictional (Tier 2) regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007. This results in an overall recommended allocation to CalAm calculated as follows: 88% x 5.18% = 4.56%.

NSC Functions

The NSC Functions category includes corporate audit, legal, external affairs and regulatory functions. It also includes corporate facilities expenses. Business units and employees are summarized below.

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[19] A relatively insignificant $168,000 in corporate finance was directly charged to non-regulated subsidiaries in 2007.

[20] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

[21] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

Table NSCF-1 American Water National Service Company NSC - "NSC Functions" Rate Filing Category - Business Units and Staffing							
	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
Audit	32060	Corp - Audit	8	11	8	8	10
Business Developmen	32020	Corp - Business Development	8	5	6	5	5
External Affairs	32022	Corp - Government Affairs	1	1	1	1	1
External Affairs	32025	Corp - External Affairs	1	2	2	2	2
External Affairs	32068	Corp - Marketing / Sales	1	5	5	4	4
External Affairs	32085	Corp - External Communications	1	1	4	2	3
External Affairs	32086	Corp - Internal Communications	3	2	2	2	2
Legal	32015	Corp Legal	8	9	10	11	11
Building & Property	32062	Corp - Buidling Services	6	5	6	5	5
Building & Property	32063	Corp - Bldg Services - Woodcres	3	3	5	5	5
Regulatory	32069	Regulatory UFS	2	2	1	2	2
Non-Departmental	32098	Non-Departmental	?	?	?	1	1
Total			**42**	**46**	**50**	**48**	**51**
Source: Responses to OC-7, OC-91 & OC-92							

It took a significant discovery effort just to determine the business units that make up the NSC Functions rate filing category. As discussed below, Overland recommends that much of the cost in several NSC Functions business units be removed from CalAm's revenue requirement.

<u>Expense</u> - NSC Functions test year expense (based on the 2008 budget) is summarized below.

Table NSCF-2 American Water National Service Company NSC - "NSC Functions" Expense (1)			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$6,808,644
Non-Labor O&M			$12,138,517
Depreciation			$1,720,768
Interest			$976,991
Income Tax			$879,828
NSC Functions Total Spend	unknown	unknown	$22,524,748
NSC Functions Non-Management Fee	unknown	unknown	$2,101,011
NSC Functions Management Fee	$ 65,064,964	$ 29,024,093	$20,423,737
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$20.90	$8.82	$6.17
Source: Dollars - OC 1, 8 & 9 (2006 & 2007) OC-91 (2008); Customers OC-85 (Year-end 2007) (1) Cal-Am included regional expenses in the NSC Functions category Only an incidental amount (about $50,000) of regional expenses is charged to Cal-Am As such, Overland excluded regional expenses from this table, as they only serve to distort the calculation of management fee per customer			

Unlike other rate filing categories, we cannot readily compare the 2008 budget for NSC Functions with 2006 and 2007 costs because AW did not provide actual expense data on a business unit basis. The “office” and “function”-based actual and budget data provided in response to OC 1, 8 and 9 contained a number of mis-classifications, and were skewed upward on a pre-allocation basis by expenses from the Central, Southeast and Northeast regions which charged only incidental amounts to CalAm and are not included in test year allocations to CalAm.[22] After considerable effort to reconcile “office” and “function” based data from OC 1, 8 and 9 with business unit budget data ultimately obtained in responses to OC-91 and OC-128, we are confident that the business units included in the test year NSC Functions allocations are accurately reflected in the amounts in the tables above. However, because our ability to reconcile was limited to 2008 data, we cannot compare the 2008 budget detail to 2006 or 2007 actual expense detail.

- <u>Labor Expense</u> - The 2008 budget and the CalAm rate filing are based on salaries for 51 Human Resources employees. As discussed under the heading test year adjustments, Overland recommends NSC labor expense allocated to CalAm based on *actual* headcount of 48 employees as of May 31, 2008.

- <u>Labor Expense Vacancy Adjustment</u> - Embedded in the labor budget for the Non-Departmental business unit is a “global vacancy adjustment” that removes $3,764,000 from the 2008 labor budget to account for vacancies in positions budgeted but not filled during the budget period. CalAm’s share of this adjustment is 5.5%, or a reduction of approximately $207,000. AW built separate vacancy adjustments into the Information Technology and Shared Services Center office labor budgets. The vacancy adjustment in the NSC Functions Non-Departmental unit contains the vacancies associated with the business units in other rate filing categories (Finance, Belleville Lab, Human Resources, etc.).

- <u>Non-Labor Expense</u> - Like labor expense, NSC Functions non-labor includes expense associated with legislative influence activities, corporate charitable contributions and certain other expenses that Overland recommends not be funded by California ratepayers. Adjustments to these items are discussed elsewhere. Non-labor expense also includes a $1 million “risk reserve for EW” in the Non-Departmental business unit’s budget. When we asked about this, CalAm stated that the California allocation was a contingent expense for earthquakes.[23] Overland also recommends removing this made-up expense from the California revenue requirement.

- <u>Interest Income</u> - Offsetting recorded interest expense, which is largely associated with capital leases on property, is $2.4 million in interest income associated with NSC cash

[22] According to the reconciliation obtained in response to OC-107, NSC Functions data provided in response to OC 1, 8 and 9 excluded Business Development business unit 32020, excluded Corporate Social Responsibility business unit 32087, and included business unit 32019, Corporate Operational Risk. The NSC Functions data provided in OC 1-8-9 was skewed high by the inclusion of more than $53 million in Central, Northeast and Southeast Region expense. Only a small amount of the regional-source expense was charged to CalAm.

[23] Response to OC-162.

balances included in the "Non-Departmental" business unit. AW stated that interest income (which reduces requested expense) was over-estimated when budgeted in 2007, and will be only about $1 million, rather than $2.4 million for 2008.[24] As discussed below, Overland recommends accepting AW's updated, lower estimate of interest income.

- Income Tax Expense - AW stated that $880,000 in income tax expense included in the "Non-Departmental" business unit is associated with expense that is not deductible for tax purposes, primarily non-deductible business meals.[25] There is not nearly enough non-deductible meal expense budgeted in 2008 in the business units allocable to CalAm to account for the income tax expense. AW offered a new, lower calculation of income tax based primarily on $546,000 in non-deductible meals and $12,000 in non-deductible dues. However, the actual amount budgeted in 2008 for non-deductible meals is $334,275.

- Non-Management Fee - Nearly all of the NSC Functions non-management fee is associated with capitalized "locational overhead" expenses. As discussed above, it was not possible within the scope of this audit to perform a review of the NSC's capitalization policies and procedures.

Allocation to CalAm - The table below summarizes "NSC Functions" expense allocated to CalAm by AW's Corporate Office.[26] The 2008 budget percentage is the composite percentage CalAm is requesting for this rate filing category.

[24] Response to OC-191.

[25] Id.

[26] 2006 and 2007 GO expense data provided to Overland for the "NSC Functions" rate filing category contained large amounts of expense incurred by the Central, Northeast and Southeast regional "offices," small amounts of which were charged to CalAm in 2006 and 2007. Regional office expense was not included in 2008 budgeted amounts. To improve the comparability of historical and budgeted expense in the table, we removed expense incurred and allocated by "regional" offices. Note that there are still "regional allocations." These are Corporate expenses allocated *to* the regulated water companies in a region (in this case, the Western Region); they are not expenses incurred *by* the regional offices, which, as noted, have been removed.

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Table NSCF-3 American Water National Service Company Historical & CalAm Proposed Test Year NSC Management Fees "NSC Functions" Rate Filing Category - Corporate Office Only			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Total			
Direct Charges	23,242,351	1,890,480	
National Allocations	40,869,866	26,975,861	
Regional Allocations	952,747	157,751	
Total Management Fee	**65,064,964**	**29,024,093**	**20,423,828**
CalAm Distributions:			
Direct Charges	1,778,786	82,100	
National Allocations	2,002,473	1,419,639	
Regional Allocations	79,278	46,601	
CalAm Distribution	**3,860,538**	**1,548,341**	**1,026,224**
CalAm Percent	**5.93%**	**5.33%**	**5.02%**
Source: Data from OC-52			

To improve the comparability of historical and budgeted amounts, we removed expense incurred by the Central, Southeast and Northeast regional "offices" from the 2006 and 2007 historical data summarized above, leaving only the historical expenses from the Corporate office. As far as we can determine, 2008 budget expense for NSC Functions does not contain any expense incurred by regional offices. Even with regional expense removed, there are significant differences between historical and budgeted allocations to CalAm. For example, in the historical periods, large amounts of expense were directly charged to CalAm, skewing CalAm's composite distribution above what would be expected.

Overland was unable to obtain comparable historical data on a business unit basis, so we do not know what "NSC Functions" business units directly charged large amounts to CalAm in 2006 and 2007. It is likely that 2006 and 2007 expenses are based on a different set of business units than the budget period. Therefore, for this category, even with regional amounts removed from the historical columns, it probably does not make sense to compare budgeted and historical CalAm expense allocations, either in total or on a percentage basis. As discussed below, Overland believes that CalAm's share of allocable expense should reflect 1) the regulated segment's share of total corporate revenue and expense and 2) CalAm's share of total regulated customers.

NSC Functions Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of employees actually on AW's payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Labor Expense Vacancy Adjustments - Consistent with our recommendation to base test year labor expense on actual employee levels mid-way through the budget period, Overland recommends reversing AW's budgeted "global vacancy adjustment", adding back the amounts removed for vacancies in other rate filing categories.

3. Non-Recoverable Expenses - Overland recommends removing the following expenses included in NSC Functions from allocation to CalAm ratepayers. These expenses have either been disallowed by the Commission in prior CalAm rate case decisions, have been traditionally allocated to ratepayers in California utility rate proceedings, or benefits to regulated water utility customers are not supported.

   - Business development expenses (Business Development business unit 32020)
   - Legislative influence expenses (Government Affairs business unit 32022)
   - Charitable contributions (Corporate Social Responsibility business unit 32087 and account 575140 - Charitable Contributions)
   - Unsupported "Non-Departmental" business unit expense, which includes a $1 million unsupported contingent risk expense and $446,000 in expense for a non-departmental employee whose responsibilities AW declined to disclose
   - Marketing and sales expense (business unit 32068)

4. Adjustment to Interest Income - Based on a decline in interest rates since 2007, Overland recommends recognizing lower interest income on NSC cash balances, as calculated by CalAm. AW's updated calculation is based on actual 2008 interest income through June, which totals $508,000. Overland agrees that interest income should be adjusted to reflect an updated estimate of likely income for the budget year. The updated test year estimate of $1,016,000 requires an adjustment reducing the original 2008 budget estimate by $1,427,200.

5. Adjustment to Federal Income Tax - Overland recommends that federal income tax expense on non-deductible expenses be limited to the non-deductible expense actually budgeted in 2008. Non-deductible meals are budgeted at $334,275. Other items included in AW's income tax expense calculation total $12,973.[27] Using AW's tax rate of 35%, federal income tax on these amounts is $121,537. This is a reduction of $758,291 from AW's test year income tax on non-deductible items estimate of $879,828.

6. Expense Allocation to CalAm - NSC Functions contains the corporate audit, external affairs and legal business units. It also includes the corporate facilities expense. The business units in this rate filing category serve the entire corporate structure. Overland recommends CalAm's allocation of NSC Functions include a Tier 1 regulated / non-regulated segment allocation, based on relative regulated and non-regulated revenue and expense and a Tier 2 jurisdictional allocation based on CalAm's year-end 2007 share of regulated customers. As with other NSC expense categories, we recommend the regulated / non-regulated distribution be based on the average regulated and non-

[27] Response to OC-191.

regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[28] We recommend the California jurisdictional (Tier 2) share of regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[29] This results in an overall recommended allocation to CalAm of 88% x 5.18% = 4.56%.

NSC Operations / Network

The Operations / Network rate filing category includes Chief Operating Officer, operational risk, performance, engineering, asset management and technical services business units. Business units and staffing are summarized below.

Table ON-1
American Water National Service Company
NSC Operations - Network Rate Filing Category - Business Units and Staffing

	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-CORP Operations	32011	CORP-Chief Operating Officer	4	4	3	3	3
SC-CORP Operations	32019	CORP-Operational Risk	11	10	10	13	15
SC-CORP Operations	32064	CORP-Operational Performance	5	4	4	5	6
SC-CORP Operations	32065	CORP-Asset Management	5	7	8	9	10
SC-CORP Operations	32066	CORP-Research & Env Excellence	12	13	14	16	14
SC-CORP Operations	36550	CORP-COE-Engineering	5	6	8	11	11
SC-CORP Operations	36551	CORP-COE-Technical Services	6	7	8	10	10
Total Operations-Network			**48**	**51**	**55**	**67**	**69**

Source: Responses to OC-7, OC-91 & OC-92

<u>Expense</u> - Operations / Network expenses, as reported by American Water, are summarized in the following table.

[28] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[29] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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Table ON-2 American Water National Service Company NSC Operations-Network Expense			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$8,925,744
Non-Labor O&M			1,414,565
Depreciation			45,700
Interest			23,258
Operations / Network Total Spend	unknown	unknown	$10,409,267
Operations / Network Non-Mgt Fee	unknown	unknown	$5,105,618
Operations / Network Management Fee	8,201,502	5,759,146	$5,303,649
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer	$2.63	$1.75	$1.60
Source: Dollars - OC 1, 8 & 9 for 2006 & 2007 & OC-91 for 2008; Customers OC-85			

Nearly half of total expenditure in Operations / Network is withheld from allocation in the non-management fee. Most of this consists of capitalized amounts. For example, more than 80% of 2008 budgeted total spend for the Asset Management business unit is budgeted for capital. Time constraints prevented a review of the breakdown between capital and expense.

<u>Expense Allocation to CalAm</u> - The table below summarizes NSC Functions allocations to CalAm in 2006 and 2007, and budgeted by AW for 2008. The 2008 budget percentage CalAm requests for assignment to California ratepayers, 5.05%, is 16% higher than the percentage allocated in 2006 (4.34%), and 3% higher than the 2007 percentage.

Table ON-3 American Water National Service Company Historical & CalAm Proposed Test Year NSC Management Fees Operations / Network Rate Filing Category			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
<u>NSC Totals:</u>			
Direct Charges	2,839,169	539,411	
National Allocations	5,305,658	5,212,131	
Regional Allocations	56,675	7,605	
Total Management Fe	**8,201,502**	**5,759,146**	**5,303,649**
<u>CalAm Cost Distributions:</u>			
Direct Charges	81,437	28,948	
National Allocations	272,309	252,699	
Regional Allocations	2,161	257	
CalAm Distribution	**355,907**	**281,904**	**267,596**
CalAm Percent	**4.34%**	**4.89%**	**5.05%**
Source: Data from OC-52			

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CalAm is proposing an increase in its share of expense in the Operations / Network category from 4.3% in 2006 to 5.05% in the test year. As in other rate filing categories, the 2008 budgeted allocation percentage is a composite estimate for which there is no calculation support.

NSC Operations / Network Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on the annualized compensation for 67 employees actually on AW's payroll for this rate filing category as of May 31, 2008. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - As with other NSC expense categories, we recommend a regulated / non-regulated (Tier 1) expense distribution based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[30] We recommend the California jurisdictional (Tier 2) share of regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[31] This results in an overall recommended allocation to CalAm of 88% x 5.18% = 4.56%, consistent with the actual composite distribution of 2007 expense.

Shared Services Center

The Shared Services Center (SSC) contains most of AW's corporate accounting and some of its corporate treasury function. Among its business units are one which appears primarily dedicated to the regulated segment (BU 32574 - Rates & Regulation) and one primarily dedicated to the non-regulated segment (BU 32580 - AWE).

[30] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[31] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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Table SSC-1 American Water National Service Company NSC Shared Services Center Rate Filing Category - Business Units and Staffing							
	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-SSC Location	32084	SSC-Accounts Payable	18	26	28	31	29
SC-SSC Location	32505	SSC-Administration	8	10	10	10	11
SC-SSC Location	32560	SSC-Financial Reporting	0	0	0	0	0
SC-SSC Location	32570	SSC-General Accounting	21	32	34	36	38
SC-SSC Location	32571	SSC-Tax	5	9	9	8	10
SC-SSC Location	32572	SSC-Business Support Services	8	8	8	8	10
SC-SSC Location	32574	SSC-Rates & Regulation	10	10	11	11	11
SC-SSC Location	32575	SSC-Cash Management	17	18	18	16	20
SC-SSC Location	32577	SSC-Fixed Assets/Job Cost	15	16	18	18	21
SC-SSC Location	32578	SSC-Project Management	3	2	2	2	3
SC-SSC Location	32579	SSC-Employee Services	23	32	29	29	32
SC-SSC Location	32580	SSC-AWE	7	12	14	10	17
Total Shared Services Center			**135**	**175**	**181**	**179**	**202**
Source: Responses to OC-7, OC-91 & OC-92							

Expense - SSC expenses are summarized below.

Table SSC-2 American Water National Service Company NSC Shared Services Center Expense - Per American Water			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$18,385,787
Non-Labor O&M			$1,455,371
Depreciation			$5,004
Interest			$0
Shared Services Ctr Total Spend	unknown	unknown	$19,846,162
Shared Services Ctr Non-Mgt Fee	unknown	unknown	$1,214,889
Shared Services Ctr Management Fee	$16,792,259	$17,302,697	$18,631,273
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$5.39	$5.26	$5.63
Source: Dollars - OC 1, 8 & 9; Customers OC-85			

- Labor Expense - Test year labor expense is based on a budget that includes compensation for 202 positions. The budget for business unit 32505 - SSC Administration includes vacancies removing $570,000 for the equivalent of 6 positions. Net of vacancies, CalAm is requesting rate recovery for its allocated share of 196 positions (202 minus an allowance of 6 vacancies). As of May 31, 2008, about halfway through the budget year, the SSC had 179 employees, 17 fewer than the positions for which CalAm is requesting funding.

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- Non-Management Fee - A majority of the Operations / Network category's non-management fee consists of the assignment of expense from business unit 32574 - Rates and Regulation to specific rate cases. About half of the Rates and Regulation budget is assigned to specific rate cases.

Expense Allocation to CalAm - The table below summarizes AW's allocation of the SSC management fee to CalAm.

Table SSC-3
American Water National Service Company
Historical & CalAm Proposed Test Year NSC Management Fees
Shared Services Center Rate Filing Category

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	1,093,599	1,822,114	
National Allocations	15,684,516	13,036,638	
Regional Allocations	14,144	2,449,272	
Total Management Fee	**16,792,258**	**17,308,023**	**18,631,244**
CalAm Cost Distributions:			
Direct Charges	93,192	74,069	
National Allocations	847,683	753,332	
Regional Allocations	2,771	289,127	
CalAm Distribution	**943,645**	**1,116,528**	**1,141,015**
CalAm Percent	**5.62%**	**6.45%**	**6.12%**

Source: Data from OC-52

In 2007 AW directly charged and allocated to AWE (American Water Enterprises, the most significant non-regulated subsidiary) an amount approximate to the 2008 budget for business unit 32580 - SSC - AWE. This suggests that the budget period composite factor is based on AWE being charged for business unit 32580, but nothing more from the accounting and treasury functions that should be common to both the regulated and non-regulated segments.

Although lower than the 2007 percentage, the 2008 budget composite factor attributed to CalAm (6.12%) is considerably higher than a Tier 1 allocation using relative revenue and expense and a Tier 2 allocation based on year-end 2007 customers would suggest (4.56%). The components of the 6.12% composite factor CalAm requests for ratepayer funding cannot be directly analyzed, since there is no supporting calculation for it.

SSC Recommendations

1. Labor Expense - Instead of rising from 181 employees at the end of 2007 to 202 employees (196 with AW's vacancy allowance) near the mid-point of the 2008 budget year, SSC headcount has fallen to 179 employees. Overland recommends test year labor expense based on the annualized compensation for 179 employees actually on AW's payroll for this rate filing category as of May 31, 2008. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and

middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - As with other NSC expense categories, we recommend the regulated / non-regulated distribution be based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[32] We recommend the California jurisdictional (Tier 2) share of regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[33] This results in an overall recommended allocation to CalAm of 88% x 5.18% = 4.56%, consistent with the actual composite distribution of 2007 expense.

NSC Procurement (Supply Chain)

The NSC Procurement, or Supply Chain, rate filing category aligns with AW's Corporate and regional (Western, Central, Southeast and Northeast) Procurement "offices". Business units and staffing are summarized below. Most of the expense is incurred by the Corporate office, which includes a Supply Chain Director, several Managers, Buyers and Procurement Analysts. In addition to the Corporate location, AW's Procurement function maintains a local staff of two (a Manager and an Analyst) in each region.

Table PROC-1
American Water National Service Company
NSC Procurement (Supply Chain) Rate Filing Category - Business Units and Staffing

	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-Supply Chain Locatior	32010	CORP-Supply Chain-Sourcir	24	27	28	30	29
SC-Supply Chain Locatior	33010	WE-Supply Chain		1	2	2	2
SC-Supply Chain Locatior	33510	CE-Supply Chain	2	2	2	2	2
SC-Supply Chain Locatior	35010	SE-Supply Chain	3	3	2	2	2
SC-Supply Chain Locatior	36510	NE-Supply Chain	3	2	2	2	2
Total Supply Chain			**32**	**35**	**36**	**38**	**37**

Source: Responses to OC-7, OC-91 & OC-92

Expense - Procurement expenses are summarized below.

[32] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[33] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

Table PROC-2 American Water National Service Company NSC Procurement (Supply Chain) Expense			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$4,068,743
Non-Labor O&M			$426,864
Interest			$0
Procurement Total Spend	unknown	unknown	$4,495,607
Procurement Non-Mgt Fee	unknown	unknown	$2,146,500
Management Fee	$3,705,706	$4,217,506	$2,349,119
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$1.19	$1.28	$0.71
Source: Dollars - OC 1, 8 & 9; Customers OC-85			

- Labor Expense - Labor and labor related costs have increased in the budget period due to a small increase in staffing, as well as salary inflation (the budget contains 4% across the board salary increases). Procurement is the only rate filing category in which actual headcount as of May 31, 2008 exceeds 2008 budgeted headcount (by one employee). We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

- Non-Labor Expenses - This consists primarily of employee expenses, insurance and telephone and other office expenses. The decrease from 2006 to 2007 is primarily attributable to a lower contract services.

- Non-Management Fee - About three-fourths of Procurement's budgeted non-management fee represents capitalized expenditures. Overland was not able to conduct a review of the NSC's capitalization procedures.[34] The remainder of the non-management fee is location overhead.

Expense Allocations to CalAm - 2006, 2007 and 2008 budgeted Procurement allocations to CalAm are summarized below.

[34] Capitalization procedures affect the distribution of expenditures between the income statement and the balance sheet. As such, they should be subject to review by the company's external auditors. Our notation that the external auditors should review capitalization procedures should not be understood to mean that we are relying on their review.

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Table PROC-3 American Water National Service Company Historical & CalAm Proposed Test Year NSC Management Fees Procurement (Supply Chain) Rate Filing Category			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	24,651	5,651	
National Allocations	3,176,719	3,526,029	
Regional Allocations	504,335	685,825	
Total Management Fee	**3,705,706**	**4,217,505**	**2,349,119**
CalAm Cost Distributions:			
Direct Charges	-	-	
National Allocations	167,058	205,718	
Regional Allocations	25,873	84,728	
CalAm Distribution	**192,931**	**290,446**	**152,312**
CalAm Percent	**5.21%**	**6.89%**	**6.48%**
Source: Data from OC-52			

In 2007 only about 2 percent of NSC Procurement expenditures were allocated to non-regulated subsidiaries. Although AW's unregulated segment contracts to perform water system operations with municipalities, it does not usually own the facilities it operates.

NSC Procurement Recommendations

1. Labor Expense - Overland recommends test year labor expense based on the annualized compensation for 38 employees actually on AW's payroll for this rate filing category as of May 31, 2008.

2. Expense Allocation to CalAm - Overland was not able to obtain information about the non-regulated segment sufficient to determine whether AW's 2% non-regulated allocation in 2007 was reasonable. However, given what we know about AW's regulated and non-regulated segments, in comparison to other NSC activities it is less likely that the non-regulated segment benefits significantly from Procurement. As such, even though we are not able to directly review the 2008 allocation factor calculation (because there is no supporting calculation), we recognize that it is lower than the 2007 allocation, the components of which we are able to review, and we therefore recommend no adjustment to the CalAm's proposed test year Procurement allocation of 6.48%.

Attachment 3-1

American Water National Service Company
Operations and Maintenance Expense Before and After Allocation to CalAm
2008 and 2009 Per CalAm, Overland-Recommended Adjustments, and As Recommended by Overland

Rate Filing Category	NSC O&M Per American Water, 2008 & 2009	Adjust Labor to May 31, 2008 Actual Headcount	Reduce Budgeted Incentive Pay to 2007 Payout Level	Remove Business Development	Remove Charitable Contributions	Remove Legislative Influence Expense	Remove Unsupported "Non-Dept" Expense	Correct "Non-Dept" Interest Income and Income Tax	Remove Marketing & Sales Expense	Maintain CSC at 2003 Cost per Customer Plus Inflation	Correct NSC Allocation Factors to Include Allocations to Non-Reg	NSC O&M Per Overland, 2008 & 2009
National (Before Allocation)												
Belleville Lab	5,610,705	(458,476)	(114,113)	-	-	-	-	-	-			5,038,116
Customer Service	51,689,744									(15,315,076)		36,374,668
Finance	11,261,187	(444,266)	(854,182)	-	-	-	-	-	-			9,962,738
Human Resources	6,315,557	(606,122)	(408,589)	-	-	-	-	-	-			5,300,845
Information Technology	32,944,154	(978,177)	(1,715,995)	-	-	-	-	-	-			30,249,982
"NSC Functions"	20,423,738	2,177,295	(747,140)	(1,007,903)	(420,021)	(459,562)	(1,445,188)	668,910	(1,467,534)			17,722,594
Operations	5,303,648	(235,239)	(1,004,542)	-	-	-	-	-	-			4,063,868
Shared Services	18,631,242	(1,475,625)	(960,038)	-	-	-	-	-	-			16,195,579
Procurement	2,349,119	31,074	(301,233)	-	-	-	-	-	-			2,078,960
Total NSC	154,529,094	(1,989,537)	(6,105,833)	(1,007,903)	(420,021)	(459,562)	(1,445,188)	668,910	(1,467,534)	(15,315,076)	-	126,987,350
After Allocation to CalAm												
Belleville Lab	302,875	(24,655)	(6,162)	-	-	-	-	-	-		(42,320)	229,738
Customer Service	2,802,618									(831,111)		1,971,507
Finance	581,351	(23,198)	(44,076)	-	-	-	-	-	-		(59,776)	454,301
Human Resources	296,649	(28,306)	(19,204)	-	-	-	-	-	-			249,140
Information Technology	1,786,495	(53,939)	(93,007)	-	-	-	-	-	-		(260,150)	1,379,399
"NSC Functions"	1,026,220	139,976	(35,795)	(30,439)	(20,623)	(22,564)	(82,520)	38,195	(72,056)		(81,524)	858,869
Operations	267,594	(11,639)	(50,729)	-	-	-	-	-	-		(19,913)	185,312
Shared Services	1,141,013	(70,099)	(59,540)	-	-	-	-	-	-		(252,651)	758,723
Procurement	152,311	1,926	(19,520)	-	-	-	-	-	-			134,717
Total Cal-Am	8,357,126	(69,934)	(328,033)	(30,439)	(20,623)	(22,564)	(82,520)	38,195	(72,056)	(831,111)	(716,334)	6,221,706

4. NSC Customer Service Center

The Customer Service Center (CSC) rate filing category accounts for about one-third of CalAm's test year-proposed NSC revenue requirement. It corresponds directly with the Customer Service Center "office" in AW's accounting system. The CSC consists of call centers in Alton, IL and Pensacola, FL. Prior to 2003 CSC functions were performed on a state or regional basis.

The Alton and Pensacola call centers perform call handling (order taking and responses to customer inquiries), customer billing and account collection for regulated AW water systems in 29 states. The CSC also provides non-regulated services to more than 100 municipalities. Expense incurred to provide these services, attributable to non-regulated activities under fully distributed cost principles, is instead allocated to AW's regulated water systems. In addition to call handling, billing and collections, the CSC includes supporting administrative, operations, education / training and human resources functions.

The CSC rate filing category includes more than half of the employees included in the NSC budget charged to CalAm. CSC business units and staffing are summarized below.

Table CSC-1
American Water National Service Company
Customer Service Center Rate Filing Category - Business Units and Staffing

	Business Unit		Actual Headcount As Of (1)				Budget
Call Center	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	May '08(1)
Alton	34005	CCA Administration	13	13	12	12	17
Alton	34018	CCA Human Res.	6	5	5	9	6
Alton	34070	CCA Call Handling	170	181	199	231	240
Alton	34071	CCA Billing	120	120	116	118	120
Alton	34072	CCA Collections	39	41	39	39	38
Alton	34073	CCA Operations/ Perf.	13	13	13	13	14
Alton	34074	CCA Business Services	16	15	14	14	17
Alton	34075	CCA Educ/ Developmt	22	19	16	14	14
Alton Subtotal			399	407	414	450	466
Pensacola	37005	CCP Administration	1	3	3	2	3
Pensacola	37018	CCP Human Res.	3	2	2		2
Pensacola	37070	CCP Call Handling	198	246	242	235	269
Pensacola	37071	CCP Billing	1				
Pensacola	37073	CCP Operations Support	5	3	3	3	3
Pensacola	37074	CCP Business Services	1				
Pensacola	37075	CCP Educ/ Developmt	8	7	7	7	7
Pensacola Subtotal			217	261	257	247	284
Total Customer Service Center			**616**	**668**	**671**	**697**	**750**

Source: Responses to OC-7, OC-91 & OC-92

(1) The budget for the Call Handling business unit is seasonal and varies, peaking around June. Actual headcount for May, 2008 is as of May 31. For comparability to May 31 actual headcount, the May, 2008 budgeted headcount for Alton and Pensacola Call Handling in this table are an average of May and June headcounts in the budget.

Call center staffing has a seasonal element. Temporary employees are added as the calendar progresses toward the summer. The budget for December, 2008 shows 42 fewer employees than the May-June, 2008 budget average shown above. Notwithstanding the seasonal element, as shown above, AW had 53 fewer employees on the payroll at the end of May, 2008 than the headcount on which revenue requirement is based.

Expenses

Historical and budgeted CSC operating expenses are summarized below.[1] As the table shows, there is a significant increase in expense per customer between 2006 and 2007 and between 2007 and the test year. Although actual CSC expense per customer has been increasing at a pace significantly higher than inflation since at least 2004, test year expense shown below is also higher by approximately 50 call center staff that had not been hired approximately mid-way through the 2008 budget year.

Table CSC-2
American Water National Service Company
NSC Customer Service Call Center Expense

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M	$23,826,223	$29,849,509	$36,124,149
Non-Labor O&M	$11,885,407	$ 12,689,257	$12,917,979
Depreciation	$ 2,249,022	$ 689,319	$1,747,344
Interest	$ 1,400,058	$ 1,248,732	$952,044
Customer Call Center Total Spend (1)	$39,360,710	$44,476,817	$51,741,516
Customer Call Center Non-Mgt Fee			$51,765
Customer Call Center Management Fee	$39,360,710	$44,476,817	$51,689,751
Customers (1)	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$12.64	$13.51	$15.62

Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007
(1) Estimated for 2006 and 2007 - assumed management fee = total spend.

Changes in Call Center Operations - In 2003 AW began to transition from local and regional call centers to centers with a national footprint. CalAm's test year includes the expense of two national call centers. National-scope customer services were first deployed in 2003 from the Alton, Illinois call center.[2] Alton performs all of AW's key customer service functions (inbound call handling, billing and collection). For a time Alton handled most or all of the customer service functions for AW's regulated water companies. In 2004 AW made the decision to

[1] For most rate filing categories it is not possible to compare individual historical expense categories with the budget, because the budget data was provided on "total spend" basis, while only the "management fee" portion of total expense was provided for the 2006 and 2007 historical periods. In the case of the CSC rate filing category, "total spend" and "management fee" were nearly the same in the 2008 budget period, and given the nature of the function, it is probable that the same is true for 2006 and 2007. Thus, for this rate filing category, Overland determined it was reasonable to compare individual categories of expense between the budget year and the two most recent historical years.

[2] Interview with Glenn Milton, AW Vice President of Customer Service, June 16, 2008.

implement a second national call center, in Pensacola, FL. Calls were first routed to Pensacola in the third quarter of 2005. The 2008 budget indicates that Pensacola is focused primarily on the call handling function.

Cost Impact of Migrating from a Regional to a National Call Center Model - Centralized operations should enable cost efficiencies to be obtained from economies of scale. Contrary to what normally happens with scale economies, AW's customer service expense per customer increased significantly as AW moved from a local to a national call center model. As far as Overland can determine, this is because the regulated customer base (to which AW apparently allocates *all* CSC costs) has grown at an anemic pace, while CSC costs have grown significantly as the national centers have been deployed. As shown below, CalAm's requested test year CSC expense per customer is nearly 70% higher than expense in 2003, before the first national call center (Alton) was fully deployed. As the table demonstrates, CSC costs have grown far faster than CalAm's regulated customer base.

Table CSC-3
American Water National Service Company
NSC Customer Service Call Center Rate Filing Category
Management Fee Allocation to CalAm Water - Per CalAm

Costs to Allocate	Recorded Years					Proposed
	2003	2004	2005	2006	2007	TY 2009
CalAm CSC Allocation	$ 1,653,390	$ 1,848,207	$ 1,892,482	$ 2,077,784	$ 2,404,557	$ 2,802,618
Customers per CalAm	167,834	171,783	171,783	171,824	171,444	172,628
Customers Pct Annual Increase		2.4%	0.0%	0.0%	-0.2%	0.7%
Mgt Fee per Customer	$ 9.85	$ 10.76	$ 11.02	$ 12.09	$ 14.03	$ 16.24
Mgt Fee Pct Annual Increase		9.2%	2.4%	9.8%	16.0%	15.8%

Source: Rate Filing Exh.B, Ch.4, Sec.1, Table 1; Customers per Exh B, Ch 9, Sec.1, Tbl 6 (2003,) & OC-85 (2004-2007)

CalAm's CSC expense per customer progressed upward through the following phases of national call center deployment:

- 2003 - At some point in 2003, Alton was opened, but it was not fully operational. CalAm's annual cost per customer was $9.61.

- 2004 through Second Quarter 2005 - The Alton call center became fully operational and CalAm's annual cost per customer increased to just under $11.00.

- Third Quarter 2005 through 2006 - The Pensacola call center was added. Common (allocable) costs increased due to an increase in call center staffing that was not matched by a corresponding increase in regulated customers. CSC expense per CalAm customer rose to $12.09 in 2006 as Pensacola became fully staffed.

- 2007 - By December, 2006, combined permanent staffing for Alton and Pensacola stabilized at a headcount of approximately 670.[3] 2007 was the first complete year that both centers were fully staffed. At the end of 2007, staffing remained at about 670. Primarily due to full staffing at Pensacola for a full year, CalAm's CSC expense per customer rose to $14.03 for 2007.

- Test Year (Based on 2008 Budget) - Forecasted expense allocated to CalAm continued to increase in the 2008 budget because of a projected increase of approximately 50 employees over the permanent (non-seasonal) level of about 670 achieved at the end of 2006 and maintained in 2007. Nearly halfway through the budget year, these extra employees have not actually been hired. As of May 31, 2008, headcount was 53 employees under budget. After adjusting for temporary seasonal employees, CSC headcount mid-way through the budget year remained at approximately the same level as year-end 2006. With the added expense of 2008 budgeted employees that have not been hired, test year-forecasted expense rises to $16.24 per Cal Am customer.

The Business Case for Adding Pensacola - Given the apparent lack of cost efficiencies achieved in moving from local centers to the national Alton center, and the additional increase in expense per customer when Pensacola was opened, Overland investigated the decision to add the Pensacola center. A business case covering three options (add the Pensacola center, expand Alton or outsource incremental needs) cited the following items in a page titled "rationale for a second national call center:"[4]

- 23 % increase in the customer base
- Business continuity
- "Quality resource availability" (which could reflect a lack of confidence in Alton's employees or difficulties experienced in dealing with them).

The business case does not say over what period the 23 % increase in customers was realized, but as the table below shows, there has been barely any increase in regulated customers nationally since 2004. For CalAm there has been virtually no increase in customers since Alton's deployment was completed in 2004. CalAm did not contribute the customer growth that helped compel AW to add Pensacola and incur its additional expense, but as the rate filing shows AW clearly expects CalAm to help pay for it.

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[3] As shown in table 1, combined staffing was approximately 670 at the end of 2006 and at the end of 2007. The increase of 30 FTEs from December 2007 and May, 2008, to 700, is due to seasonal employment. The remaining additional 50 FTEs have not been hired.

[4] OC-18, American Water Customer Service Center - Dual Center Strategy Report, p.3.

Table CSC-4 American Water and California American Water Summary of Customer Levels and Customer Growth 2004-2007				
	AW Total Regulated		California American	
Dates	Customers	Growth Rate	Customers	Growth Rate
12/31/2004	3,193,681		171,783	
12/31/2005	3,249,453	1.7%	171,783	0.0%
12/31/2006 (1)	3,286,944	1.2%	171,824	0.0%
12/31/2007	3,308,296	0.6%	171,444	-0.2%
(1) Adjusted to remove 5,137 customers double counted in Sacramento				
Source: OC-85.				

Service Quality - Increasing expense per customer (increasing cost, stagnant customer levels) suggests a higher level of customer service. Below is a summary of customer service indicators for AW starting with January, 2003. These statistics run through the period in which national service was deployed in Alton (2003 and 2004) and the addition of Pensacola (late 2005 and 2006). The statistics do not appear to Overland to support a customer service improvement trend commensurate with a nearly 70% increase in expense per customer.

Table CSC-5 American Water Alton & Pensacola Customer Service Indicators Customer Service Indicators December, 2005 through May, 2008							
Statistic	Jan-03	Jan-04	Jan-05	Jan-06	Jan-07	Jan-08	May-08
Calls Offered to Queue				328,778	368,417	428,261	357,637
1st Call Effectiveness		91.77%	92.52%	87.13%	75.65%	92.51%	91.45%
% Service Level < 30 seconds	73.85%	72.04%	78.54%	87.40%	63.21%	35.91%	72.76%
% Customer Inquiries Response within 3 days		95.00%	95.50%	90.10%	90.65%	95.98%	94.54%
Avg Speed to Answer (m:s)		:46	:25	:18	1:36	4:07	0:59
Avg Handle Time (min:sec)		5.28	5:14	5:52	5:49	6:04	5:48
IVR Self-Service Calls	11.07%	18.70%	21.54%	NA	NA	NA	NA
Written Correspondence Answered w/in 3 days	100.00%	100.00%	NA	76.41%	88.81%	81.61%	70.65%
Track & Reduce Formal (Com.) Complete		206	171	9	2	555	601
Service Orders Completed as Scheduled	53.02%	95.00%	81.58%	99.48%	98.16%	97.30%	98.66%
Shut Offs Worked as % of Issued	63.43%	54.48%	68.98%	NA	88.82%	65.04%	74.26%
% Unscheduled Est. Readings				1.26%	0.52%	4.43%	1.16%
% Scheduled Est. Readings				-	-	12.30%	12.47%
# Executive Complaints Opened				-	22	53	57
Source: OC-75 and OC-122.							

Service Continuity - Another rationale AW put forward to justify the new Pensacola center is service continuity. To accept service continuity as a reason, it is necessary to accept two premises. First, it is necessary to believe that customer call centers are so vital that service can never be interrupted. Second, it is necessary to accept that AW was not able to insure service continuity by expanding the Alton facility or by building redundancies and protections into it; rather, that service continuity could only be achieved by adding a new center at a separate, distant location.

During our interview with Glenn Milton, AW's Vice President of Customer Service, we were told that it has been necessary on several occasions to shut down the Alton call center.[5] When we requested the statistics, we found the following service interruptions have occurred at Alton in the 4½ year period since January 1, 2004, shortly after the center opened[6]:

July 19, 2006	Alton customer service was off line for 30 minutes due to a tornado warning.
November 30, 2006	The Alton center closed at 3 PM due to a winter storm warning. It reopened the next morning at 10:30 AM.
February 21, 2008	The Alton center closed at 3 PM, again due to a winter storm warning. It reopened at 9 AM the next morning.

To put the service continuity issue into further perspective, it is important to understand that the average American Water customer contacts a call center on an average of between 1.3 and 1.5 times per year.[7] It is also important to understand that water emergencies during the hours that the call centers are not operating are handled locally by each water system. It is not at all obvious to us that reducing a customer service interruption from a rate of less than one percent to zero justifies a 42 % increase in customer service expense.[8]

Non-Regulated CSC Contracts and Customers

AW has contracts with more than 100 municipal customers to provide billing, collection and call handling services. As far as Overland can determine, AW allocates the expense associated with these services to regulated customers while recording the revenues as non-regulated. CSC services provided to non-regulated customers could help explain:

[5] Interview of Glenn Milton, Vice President of Customer Service, June 16, 2008.

[6] OC-106.

[7] OC-18 American Water Customer Service Center - Dual Center Strategy Report, p.4.

[8] 2008 budgeted expense for Pensacola is $15.7 million, about 42% more than the $37.0 million budgeted for Alton.

- Why the Pensacola call center was added in 2005.[9]

- Why, since the time national call center services were first deployed in 2003, CSC expenses allocated to Cal Am have grown significantly faster, on an inflation-adjusted basis, than regulated customers.

<u>“Comparable” CSC Services Provided to Non-Regulated Contracts and Customers</u> - In request OC-19 we asked CalAm to provide a list and copies of all contracts with municipalities and other non-AW systems that used the services of the national call centers. AW responded with a list and copies of the following four contracts:[10]

- Liberty Water (Services to a system owned by the City of Elizabeth, NJ)
- Edison Township, NJ
- City of Surprise, AZ
- Descanco, CA

Based on the wording, it did not appear the response provided a complete list of non-regulated CSC customers and contracts. In OC-71 we asked AW to confirm that it was a complete list, or to amend it and provide a complete list. AW stated that “the list (of four contracts) is a complete list of contracts for service which would include call center services *comparable to* call center services being provided to regulated utility subsidiary customers such as those of California American (emphasis added).”[11]

We also followed up with questions about how call center expenses were identified and charged to these contracts. AW acknowledged that CSC expenses were not allocated to the non-regulated contracts AW considered to be “comparable” to the services provided to CalAm.[12] AW added that it was “currently developing a new formula to apply to the call center costs in 2008.”[13]

<u>“Non-Comparable” CSC Services Provided to Non-Regulated Contracts and Customers</u> - It turned out that AW had many more than the four non-regulated contracts listed in response to OC-19. In fact, there are more than 100 contracts under which CSC billing services are provided

[9] Evidence that non-regulated services were a consideration in adding Pensacola can be found in the business case document (OC-18) which cites “[in]ability to ‘sell’ customer service as a business development opportunity to municipalities” as a “con” under an “outsourcing” option. “Outsourcing” and “Expanding Alton” were options compared with Pensacola in the business case document.

[10] Response to OC-19.

[11] Response to OC-71-A.

[12] Responses to OC-73-C and OC-74-C

[13] Overland notes that there is no evidence of the new formula in the 2008 allocation factor support provided in response to OC-85, nor is it evidenced in CalAm’s 2008 budgeted share of CSC expenses (5.42%), which is virtually the same as the 2007 allocation (5.41%), and higher than the 2006 factor of 5.28%. CalAm’s proposed test year allocation is higher even though CalAm’s share of total customers (the basis for the allocation) has declined since 2006.

to municipalities.[14] A list of the contracts is shown in Attachment 4-1.[15] Currently, the contracts for "non-comparable" services produce about $5.6 million annually in revenue, enough to offset about 12% of the CSC's 2007 operating expenses.

In responding to OC-71-B, AW objected to the follow-up question for a list of *all* non-regulated CSC contracts as "too broad and . . . burdensome."[16] However, AW then proceeded to answer the question as follows:

> There are additionally a significant number of [non-regulated municipal] contracts in which other services are provided which we have since determined could include "services" being provided by the call center to customers of the wastewater system owned and operated by the municipality in which water service is already provided. There are several contracts providing for billing and collection of trash . . . fees, and several contracts providing for billing and collection of stormwater service fees.

AW then indicated its philosophy for assessing whether or not the cost of providing a service should be allocated to a non-regulated contract.

> Our initial determination was that these contracts only provided for adding a line to the bill already being sent to a water customer, and computer services related to applying remittances to the proper municipality for amounts collected, which is all done primarily on the computer system and not involving call center personnel.

The response contains an indication of the possibilities that such services require calls to be handled by the call centers ("conceivable") and service personnel to be dispatched ("not included").

It appears from the discussion in OC-71 that AW's philosophy is that a service, such as customer service, provided to both regulated and non-regulated customers, does not need to be allocated or charged to the non-regulated segment (or below-the-line on the regulated company's books) unless it adds what AW thinks is a significant incremental cost to providing the service.[17] This is directly at odds with Overland's understanding of California affiliate transaction and cost allocation policies, which require a full distribution of all costs benefitting both regulated and non-regulated operations.

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[14] In a supplemental response to OC-71 provided several months after the initial response, AW provided a list of 104 non-regulated municipal customers of the CSC.

[15] Response to OC-210

[16] Response to OC-71-B.

[17] However, even in the cases where the company agrees that services provided to non-regulated customers are "comparable" to those provided to the regulated water systems - as in the case of the Edison and Liberty systems - it still does not actually allocate any cost to the non-regulated customers.

Expense Allocations to CalAm

Historical recorded and CalAm's test year requested distribution of CSC expense are shown below.

Table CSC-6
American Water National Service Company
Historical & CalAm Proposed Test Year NSC Management Fees
Customer Service Call Center Rate Filing Category

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	1,120,467	750,453	
National Allocations	38,121,655	43,715,739	
Regional Allocations	118,685	6,451	
Total Management Fee	**39,360,808**	**44,472,643**	**51,689,743**
CalAm Cost Distributions:			
Direct Charges	63,787	55,347	
National Allocations	2,015,206	2,349,188	
Regional Allocations	(348)	22	
CalAm Distribution	**2,078,644**	**2,404,557**	**2,802,618**
CalAm Percent	**5.28%**	**5.41%**	**5.42%**
Source: Data from OC-52			

Directly Charged Expenses - Direct charges account for 2.3 % of the 2007 and test year customer call center management fee distributed to CalAm.

Nationally Allocated Costs - These are collected and distributed from cost pool 100792, described as "CP Customer Call Center Regulated Companies." and from related benefits (888888) and general (999999) overhead cost pools. The factor used to allocate cost pool 100792 (and related overheads) in the test year was 2006 customers.

CSC Recommendations

1. Test Year Expense - Overland recommends that test year CSC expense charged to CalAm ratepayers be limited to the expense per customer recorded in 2003 (before national call centers were deployed) plus price inflation, as measured by the 2003-2008 change in the consumer price index. Our recommended test year CSC expense charge to CalAm is summarized in the table below.

Table CSC-7 California American Water Calculation of Test Year-Recommended Customer Service Expense Based on 2003 Cost per Customer Plus Consumer Price Inflation Through June, 2008		
Item	Amount	Source
2003 CSC Expenses, Customers & Cost per Customer		
Estimated Total NSC (@ 5.42% of CalAm)	$ 30,505,351	Calculated (based on 2008 allocation factor)
Cal-Am	$ 1,653,390	Rate Filing, Exhibit B, Chapter 4, Section 1, Table 1
Customers	167,834	Rate Filing, Exhibit B, Chapter 6, Section 1, Tables 3, 4, 5, 6 or 7
Cost per customer	**$ 9.8513**	Calculated
Consumer Price Inflation, July, 2003 through July, 2008		
May, 2003	107.6	U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index - Chained, Series Id SUUR0000SA0, U.S. City Average, All Items, December 1999 = 100 (http://data.bla.gov/cgi-bin/surveymost)
June, 2008	125.6	
Increase May-2003 to June, 2008	**1.1673**	
2008 Inflation-Adjusted CSC Expense		
CalAm	$ 11.4994	Calculated ($9.8513 X 1.1673)
CalAm customers 12/31/2007	171,444	OC-90
CalAm 2008 Inflation-Adjusted Cost	**$ 1,971,507**	Calculated
Total NSC Using 5.42% CalAm Allocation	$ 36,374,668	Calculated ($1,969,566 / .0542)

2. Allocation to CalAm - Even if the significantly increased level of CSC expense proposed in the test year is accepted as reasonable, CalAm's proposed test year allocation of CSC expense to CalAm is overstated due to:

   - A double count of 5,137 Sacramento customers in the CalAm customer allocation factor.
   - Failure to update CalAm's allocation for a known and measurable change in customers through the end of 2007 (California's percentage of total customers declined slightly in 2007)
   - A failure to recognize and allocate costs to non-regulated municipal contracts receiving "comparable" and "non-comparable" customer services (customer inquiry, billing and collection). As discussed above, there are more than 100 non-regulated contracts with municipalities.

   Should the Commission determine that test year CSC expenses incurred at the NSC level should be allocated to CalAm (instead of allowing previously-authorized state-level expense adjusted for inflation, as discussed above), we recommend a CalAm allocation of no more than 4.56% (as shown in Chapter 2, Adjustment 14, Table 2-4).

3. Support for Cost Allocations to Non-Regulated Customer Services - With respect to non-regulated services provided by the Customer Service Center, to prevent CalAm from

cross-subsidizing CSC services provided to non-regulated municipal customers, Overland recommends that the Commission require CalAm to credit all revenue from non-regulated CSC revenue sources (part of which is shown in Attachment 4-1) against CSC management fees before the fees are distributed to CalAm.

American Water
Contracts for Billing Services (Water, Sewer, Garbage, Stormwater)

State	District Name	Contract Description	2007 Contract Revenue	YTD June 2008 Contract Revenue
IA	Quad Cities	WW Billing Contract		
IL	Chicago Metro - Wheaton Water	WW Billing Contract		
IL	ChicagoM - Bolingbrk East-West	WW Billing Contract		
IL	Pekin	WW Billing Contract/Garbage		
IL	Sterling	WW Billing Contract		
IL	Alton	WW Billing Contract/Garbage		
IL	Peoria	Garbage Billing		
IL	Centerville	WW Billing Contract		
IL	E St Louis	WW Billing Contract		
IL	Fairmont	WW Billing Contract		
IL	Sauget	WW Billing Contract		
IL	Saunemin	WW Billing Contract		
IL	Shiloh	WW Billing Contract		
IN	Newburgh	WW Billing Contract/Stormwater/Garbage		
IN	Richmond	WW Billing Contract/Stormwater/Garbage		
IN	Summitville	WW Billing Contract		
IN	Wabash	WW Billing Contract/Stormwater/Garbage		
IN	Farmersburg	WW Billing Contract		
IN	New Albany	WW Billing Contract		
IN	Porter	WW Billing Contract/Stormwater/Garbage		
IN	Sullivan	WW Billing Contract		
IN	Terre Haute	WW Billing Contract		
IN	Winfield	WW Billing Contract		
KY	Lexington	WW Billing Contract/Garbage		
MO	Brunswick	WW Billing Contract/Garbage		
MO	Jefferson City	WW Billing Contract		
MO	Joplin	WW Billing Contract/Garbage		
MO	Parkville	WW Billing Contract		
MO	St Joseph	WW Billing Contract		
MO	Warrensburg	WW Billing Contract		
MO	City of Kansas City	WW Billing Contract		
WV	Culloden	WW Billing Contract		
WV	Advanced Environmental	WW Billing Contract		
WV	Barboursville Sanitary Board	WW Billing Contract		
WV	Belle	WW Billing Contract		
WV	Cabbell Utilities	WW Billing Contract		
WV	Chesapeake	WW Billing Contract		
WV	Elk Valley PSD	WW Billing Contract		
WV	Green Acres	WW Billing Contract		
WV	Hinton	WW Billing Contract		
WV	Linmont Sanitation	WW Billing Contract		
WV	Marmet	WW Billing Contract		
WV	N. Putnam PSD	WW Billing Contract		
WV	Huntington Sanitary Board	WW Billing Contract		
WV	Sewage Systems, Inc	WW Billing Contract		
WV	Sissonville PSD	WW Billing Contract		
WV	Smithers Sanitary Board	WW Billing Contract		
WV	Spring Valley PSD	WW Billing Contract		
WV	Town of Clendenin	WW Billing Contract		
TN	City of Chattanooga	WW Billing Contract		
TN	Hamilton County	WW Billing Contract		
TN	City of Red Bank	WW Billing Contract		
TN	Rossville, Ga	WW Billing Contract		
TN	Ft Oglethorpe, Ga	WW Billing Contract		
TN	East Ridge	WW Billing Contract		
TN	Lookout Mountain	WW Billing Contract		
TN	Walker City	WW Billing Contract		

Contracts for Billing Services (Water, Sewer, Garbage, Stormwater)

State	District Name	Contract Description	2007 Contract Revenue	YTD June 2008 Contract Revenue
VA	Alexandria	WW Billing Contract		
VA	Hopewell	WW Billing Contract		
PA	Borough of Elizabeth	WW Billing Contract		
PA	City of Warren	WW Billing Contract		
PA	Borough of Greentree	WW Billing Contract		
PA	Township of Baldwin	WW Billing Contract		
PA	Castle Shannon Borough	WW Billing Contract		
PA	Township of South Fayette	WW Billing Contract		
PA	Mount Lebanon Municipal	WW Billing Contract		
PA	Borough of Carnegie	WW Billing Contract		
PA	Borough of Dormont	WW Billing Contract		
PA	Borough of Homestead	WW Billing Contract		
PA	Borough of Crafton	WW Billing Contract		
PA	Cecil Township	WW Billing Contract		
PA	Borough of Nescopeck	WW Billing Contract		
PA	McDonald Sewage Authority	WW Billing Contract		
PA	Wallaceton Boggs Municipal Authority	WW Billing Contract		
PA	Collier Township	WW Billing Contract		
PA	Yardley Borough	WW Billing Contract		
PA	Borough of Ingram	WW Billing Contract		
PA	Caln Township	WW Billing Contract		
PA	Decatur Township	WW Billing Contract		
PA	Borough of Heide berg	WW Billing Contract		
PA	Township of Scott	WW Billing Contract		
PA	Borough of Kane	WW Billing Contract		
PA	Connoquenessing Borough	WW Billing Contract		
PA	Borough of Rosslyn Farms	WW Billing Contract		
PA	Borough of Mt Oliver	WW Billing Contract		
PA	Borough of Whitaker	WW Billing Contract		
PA	City of Clairton	WW Billing Contract		
PA	West Homestead	WW Billing Contract		
PA	Collier Town Square	WW Billing Contract		
PA	Glassport	WW Billing Contract		
PA	Thompson	WW Billing Contract		
PA	Spring Township	WW Billing Contract		
PA	Brentwood	WW Billing Contract		
PA	West Hanover	WW Billing Contract		
PA	Upper St Clair	WW Billing Contract		
PA	Clark Summit	WW Billing Contract		
PA	South Franklin Township	WW Billing Contract		
PA	Norristown Municipal Authority	WW Billing Contract		
PA	Baldwin Borough	WW Billing Contract		
PA	Pleasant Hills	WW Billing Contract		
PA	Sadsbury	WW Billing Contract		
PA	South Coatesville	WW Billing Contract		
PA	Bethel Park	WW Billing Contract		
PA	Clarion Area Sewer Authority	WW Billing Contract		
		Totals	**5,508,272**	**2,840,753**
		Annualize 2008		**2**
		2008 Annualized		**5,681,507**

5. Local Service Company and California Corporate Allocations to CalAm

This chapter discusses the Western Region (Local) Service Company (LSC) and California Corporate General Office (CalCorp). Allocations from these units make up approximately half of CalAm's 2009 test year General Office (GO) operating expense revenue requirement. The table below puts the three components of test year operating expense into context.

Table 5-1
California American Water
Test Year 2009 General Office Operating Expense
By Service Company

Description	Company Request	% of Total
National Service Company	$8,357,126	49.57%
LSC	3,546,988	21.04%
CalCorp	4,954,495	29.39%
Total	**$16,858,609**	**100.00%**

Source: CalAm Rate Filing (Exhibit B - Chapter 6 - Section 1 - Table 1A), some summing required.

CalCorp employees typically focus all of their attention on CalAm matters, and therefore charge 100% of their costs to CalAm.[1] LSC employees provide support services to American Water subsidiaries throughout AW's Western Region, which includes California, Arizona, Hawaii, New Mexico, and Texas.[2] As a result, only a portion of the LSC's total costs are attributed to CalAm. After taking into consideration the costs allocated to capital projects and rate cases, the table below summarizes the company's 2009 total projected operating costs for the LSC and CalCorp and the resulting allocations to CalAm:

[1] Response to OC-137.

[2] CalAm Rate Filing, Exhibit B, Chapter 3, Section 1.

Table 5-2 American Water West Region Service Company (LSC) and CalCorp Test Year 2009 Allocation of Total LSC and CalCorp Cost to CalAm					
Business Unit / Function	Total Costs	Allocation to Capital Expenditures and Rate Cases	Total Remaining Operating Expenses	CalAm's Allocation of Operating Expenses	CalAm Operating Expense Allocation %
LSC:					
Administration (A)	$2,788,698	($392,682)	$2,396,016	$746,600	31.16%
Business Development	2,020,833	--	2,020,833	353,278	17.48%
Asset Planning	495,073	(495,073)	--	--	N.A.
External Affairs	636,305	(95,510)	540,795	266,738	49.32%
Finance	1,638,646	(387,185)	1,251,461	451,189	36.05%
Human Resources	780,795	(72,921)	707,874	275,241	38.88%
Legal	1,292,922	(274,608)	1,018,314	569,947	55.97%
Maintenance	475,136	(71,316)	403,820	199,179	49.32%
Network	413,299	(7,954)	405,345	231,044	57.00%
Operational Risk	405,880	--	405,880	195,187	48.09%
Service Delivery	294,263	(44,167)	250,096	123,354	49.32%
Technical Services	363,187	(88,992)	274,195	135,231	49.32%
Environ Mgmt	145,167	(21,779)	123,388	--	0.00%
Total LSC	**$11,750,204**	**($1,952,187)**	**$9,798,017**	**$3,546,988**	**36.20%**
CalCorp (Note 2)	**$8,043,603**	**($3,089,108)**	**$4,954,495**	**$4,954,495**	**100.00%**

Sources: CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Tables 1B and 1C, Company Workpaper GO-125, and to OC-141.

Note 1: LSC Business Unit / Function amounts were recomputed by Overland. Due to rounding, they may be slightly different than the company's internal computations.

Note 2: While CalAm was able to provide the underlying detail of its LSC projections by business unit / function, it could not do the same for CalCorp because non-labor dollars are budgeted only in total (per e-mail correspondence from Rebekah Pool on July 26, 2008).

(A) Overland attributed minor unreconciled differences between the CalAm Rate Filing and its own recomputations to the Administration Business Unit / Function.

Past Changes in the LSC and CalCorp Organizations

As described by CalAm in its rate filing, the LSC consists of employees located predominately in Phoenix, Arizona and several offices in California that provide administrative and professional support to subsidiaries in AW's Western Region.[3] From a functional standpoint, as evident in the preceding table, these employees provide regional shared services such as Administration, Finance, Human Resources, and Legal to both regulated and non-regulated businesses of American Water.

[3] CalAm Rate Filing, Exhibit B, Chapter 3, Section 1.

Chapter 5

CalCorp employees are all located in California and exclusively support CalAm.[4] CalCorp provides many of the same types of administrative and professional services to CalAm as the LSC currently does or had done previously (e.g., finance, legal, engineering, etc.). This is not completely surprising since a significant percentage of the dramatic growth in the CalCorp organization in the past several years can be attributed to employees reclassified from the LSC to CalCorp. This is demonstrated in Attachment 5-1 which is summarized in the following table:

Table 5-3
American Water West Region Service Company (LSC) and CalCorp
Headcount Activity
December 2005 - May 2008

Description	LSC	CalCorp
December 9, 2005 Headcount	**72**	**6**
Net Reclasses Between the LSC and CalCorp	(7)	7
New Positions Added	18	4
Old Positions Eliminated	(18)	--
December 30, 2006 Headcount	**65**	**17**
Net Reclasses Between the LSC and CalCorp	(10)	10
New Positions Added	16	16
Old Positions Eliminated	(17)	(6)
December 31, 2007 Headcount	**54**	**37**
Net Reclasses Between the LSC and CalCorp	--	--
New Positions Added	7	5
Old Positions Eliminated	(7)	(2)
May 31, 2008 Headcount	**54**	**40**

Derived from responses to OC-7 and OC-92.
Note: The LSC employee headcount totals exclude 2 interns as of December 9, 2005; December 30, 2006; and May 31, 2008.

The 17 employees reclassified from the LSC to CalCorp (7 in 2006, and 10 in 2007) account for all but one of the 18-employee reduction (72 - 54) in the LSC in 2006 and 2007. CalAm attributes the exodus to a decision made by management to “shift to a strong state organizational structure.”[5] In other words, some of the multi-jurisdictional duties of the LSC organization were grouped into distinct positions and assigned primarily to single-state-focused CalCorp.

CalAm should be indifferent to this change in assignment of employees between the LSC and CalCorp since its service level should be unaffected. (For example, if each employee of a 10-person Finance department at the LSC level is charging 20% of his / her time to CalAm before the “strong state organizational” shift, this would be equivalent to having 2 Finance employees at CalCorp working exclusively on CalAm with no additional assistance from the LSC Finance

[4] Responses to OC-7, OC-92, and OC-137.

[5] Quote attributed to response to OC-203. However, the idea of a state-focused organization was also mentioned in other data responses, including OC-88 and OC-137.

Department.[6]) However, this is not what actually occurred. Even though 17 fully-dedicated employees (post-reclassification) were "moved" from the LSC to CalCorp during 2006 and 2007, the LSC headcount equivalent that continued to charge CalAm did not change (27 in both 2005 and 2007), and the amount allocated to CalAm by the LSC remained nearly the same – $4,216,853 versus $4,207,831.[7]

With the exception of the one-person Service Delivery business unit / function, no new organizations were added to the LSC between December 2005 and May 2008.[8] The only business unit / function that increased substantially at the LSC during this time period was Legal, which would only account for four or fewer equivalent headcount attributable to CalAm.[9] In combination, neither of these groups provides a plausible explanation for the level of cost that continues to be charged to CalAm by the LSC.

When a company is subject to regulation in multiple jurisdictions, the movement of employees from one organization to another must be given particular attention. Especially when rate case test years in these jurisdictions involve different time periods, employees whose costs are shuffled from one jurisdiction to another are subject to manipulation and can be effectively recouped multiple times. To evaluate this risk, Overland requested information regarding other general rate cases in AW's Western Region, but CalAm did not provide a meaningful response.[10]

Overland recommends the allocation of the labor costs of the remaining employees who were reclassified from the LSC to CalCorp in 2006 and 2007 be limited to their pre-movement allocation percentages.[11] This will partially offset the increases in costs that were artificially created by the reclassification of employees from the LSC to CalCorp and mitigate the potential for manipulation of cost allocations in multiple jurisdictions.

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[6] In this simplified example, it is assumed that the salary levels of all employees are similar. Assigning only high-cost or only low-cost employees to CalCorp would skew the results.

[7] CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Tables 2 and 1B.

[8] Derived from responses to OC-7 and OC-92.

[9] Legal had seven employees in May 2008, the same number as projected in its 2009 request. For projection purposes, those seven employees were expected to charge the equivalent of 4 headcount to CalAm. In December 2005, Legal had one employee.

While the percentage increases in Maintenance and Operational Risk were arguably significant (200% and 50%, respectively), the actual number of employee additions was not (2 and 1, respectively).

[10] Response to OC-138.

[11] Overland considered all seventeen employees in its analysis. However, we concluded that five of the employees would have no impact on our recalculation either because these employees subsequently were reclassified to another organization (and thus were not included in the 2009 CalCorp request) or because the employees' post-movement job title implied that they had different responsibilities.

Chapter 5

LSC

CalAm's 2008 budget is the basis for test year 2009 LSC costs. However, unlike the NSC, the LSC's 2009 projection was inflated over 2008 levels. Most non-labor costs were inflated from 2008 to 2009 by 2.5%. Most 2008-2009 labor cost increases ranged from 3% to 5%.[12]

CalAm presented its test year LSC cost on an object-account basis (e.g., Salaries, Employees Expenses, Legal Services, etc.).[13] Because the underlying calculation of the allocations of the LSC non-labor costs were driven largely by business unit / function, the following table summarizes the data in this more relevant format. However, because CalAm grouped some of the business unit / function data differently when providing actual costs, the presentation is slightly different than that presented in Table 5-2.

Table 5-4
American Water West Region Service Company (LSC)
LSC Costs by Business Unit / Function

Business Unit / Function	2006 Actual	2007 Actual	2008 Budget	2009 Request
Administration	$3,434,416	$3,684,466	$2,616,020	$2,788,698
External Affairs	721,306	632,551	614,390	636,305
Finance	3,228,805	1,722,629	1,577,768	1,638,646
Human Resources	698,273	585,844	752,897	780,795
Legal	763,329	704,046	1,247,575	1,292,922
Operational Risk	428,381	471,019	536,810	405,880
Environ Management	285,255	321,926	139,814	145,167
Engineering (A)	2,476,083	1,824,043	826,322	858,260
Operations (B)	4,053,064	3,477,841	3,091,854	3,203,531
Customer Service	552,594	581,028	--	--
Total Costs	$16,641,506	$14,005,393	$11,403,450	$11,750,204
Less: Capital Expenditures	(2,555,834)	(2,520,109)	(1,870,625)	(1,952,187)
Less: Non-Regulated	(4,038,461)	(2,250,914)	(1,878,574)	(1,960,594)
Total Regulated Oper Exp	**$10,047,211**	**$9,234,370**	**$7,654,251**	**$7,837,423**
CalAm's Alloc of Oper Exp	**$4,869,142**	**$4,207,831**	**$3,471,949**	**$3,546,988**
Total Employees - Average	**69**	**60**	**57 (C)**	**57 (C)**

Sources: Derived from responses to OC-110, OC-141, Workpaper GO-125, CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1B, and e-mail from Rebekah Pool dated July 21, 2008.

(A) Includes Technical Services and Asset Planning.
(B) Includes Network, Service Delivery, Maintenance, and Business Development.
(C) Amount obtained from company Workpaper GO-126 for 2008. Since there was no change in the FTE's charged to CalAm between 2008 and 2009, the 2008 total was carried forward to 2009.

Given the movement of employees between LSC business units and from the LSC to CalCorp and other organizations, we were not able to rely on fluctuation analysis at a business unit or

[12] Response to OC-141.

[13] See CalAm Rate Case Application, Exhibit B - Chapter 6 - Section 1 - Table 1B.

function level as a basis for evaluating the test year. Instead, we performed a global, top-down review. Issues identified by the review are as follows.

<u>LSC Headcount Included in CalAm's Request</u>. Underlying CalAm's request to recover LSC-allocated costs is a projection that the LSC will employ 57 people who will charge a portion of their time (21 full-time equivalents according to the company) to CalAm in 2009.[14] As of May 31, 2008, the LSC employed 54 people (excluding two External Affairs interns).[15] The following table compares the headcount trend for the past several years with CalAm's forecasted test year:

Table 5-5
American Water West Region Service Company (LSC)
LSC Employee Levels

Description	12/9/05 Actual	12/30/06 Actual	12/31/07 Actual	5/31/08 Actual	2009 Test Year
Administration	5	7	3	3	4
Business Dev	11	7	5	6	8
Asset Planning	6	9	4	2	4
External Affairs	4	2	2	4	3
Finance	14	14	14	13	11
Human Resources	5	3	5	6	5
Legal	1	3	6	7	7
Maintenance	1	1	3	3	3
Network	8	8	5	4	5
Operational Risk	2	2	3	3	3
Service Delivery	--	--	1	1	1
Technical Svcs	1	3	2	--	2
Environ Mgmt	2	2	1	2	1
Production	5	3	--	--	--
Cust Relations	--	1	--	--	--
Engineering	7	--	--	--	--
Total	**72**	**65**	**54**	**54**	**57**

Sources: Responses to OC-7 and OC-92. Workpaper GO-126.

Note 1: LSC employee headcount totals exclude intern positions. Note 2: It is assumed that the 2009 total projected employees for the LSC are the same as 2008 since FTEs are the same for both years.

[14] CalAm Rate Case Filing, Exhibit B - Chapter 6 - Section 1 - Table 2 and Workpaper GO-126. Although Workpaper GO-125 indicates that 59 employees are included in the LSC, the underlying calculation of costs does not incorporate 2 of the positions. 2008 employee levels are assumed to be the same for 2009 since FTE's remained the same from 2008 to 2009.

[15] Response to OC-92.

As the table demonstrates, employees assigned to the LSC organization have been decreasing for several years. CalAm's test year reflects a reversal of this trend. Overland believes that employees actually hired and employed mid-way through 2008 is a more objective starting point for calculating expected labor costs. Using positions actually filled in May 2008 rather than CalAm's projections, Overland recomputed the labor expense allocated from the LSC to CalAm. In addition, because the allocation of non-labor charges is a function of the resulting allocations of labor charges (either at a business unit / function level or an entity level), Overland also recalculated non-labor allocations for the entire LSC organization.[16] These changes are included in the adjustments discussed elsewhere in this report.

<u>Jurisdictional Allocation of LSC Labor</u> - Allocation of labor costs to Western Region jurisdictions is determined by the formula or billing code chosen by employees as they fill out time cards. In 2006 and 2007, over one-third of all hours charged by LSC employees was allocated on the basis of Western Region customer counts. (formulas 100014 and 100020). Of this, a little less than half was allocated to CalAm.[17] A significant portion of the remaining hours were directly charged to specific jurisdictions.

In projecting future jurisdictional allocations, CalAm relied on the judgment of the managers of each LSC function. As part of this process, employees identified as working entirely for one jurisdiction were directly assigned and those providing services to multiple jurisdictions were assigned to the LSC.[18] Projected jurisdictional allocations for the LSC were prepared at an employee level.[19]

To evaluate test year LSC employee allocations to CalAm, Overland asked for the historical allocations of time and labor costs for all LSC employees. CalAm did not provide a meaningful response to either of these requests.[20] As such, the only comparison of jurisdictional allocations we were able to make was at the entity level. As obtained from the rate filing, the following table summarizes CalAm's allocation of costs from the LSC (after taking into consideration allocations to capital expenditures):

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[16] Theoretically, changes in assumed headcount would also impact total dollars spent on such non-labor costs as employee training, employee expenses, telephone, etc. Since the relationship is not direct, Overland did not propose changes to the totals of these types of costs.

[17] Derived from responses to OC-29 and OC-85.

[18] Response to OC-181.

[19] Workpaper GO-126 and response to OC-141.

[20] Responses to OC-139 and OC-181. In OC-139, Overland asked for the 2006 and 2007 hours charged by LSC employee to each jurisdiction. CalAm limited its response to time charged by function to CalAm. In OC-181, Overland requested the underlying support for the allocation of 2007 LSC labor between jurisdictions by employee. CalAm provided a summary of time card formulas charged by employee. No explanation was provided for the resulting formula allocations nor for the raw data used in calculating the formulas.

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Table 5-6 American Water West Region Service Company (LSC) Allocation of Costs to CalAm					
Description	2005 Actual	2006 Actual	2007 Actual	2008 Projection	2009 Projection
CalAm Allocation (A)	$4,216,853	$4,869,142	$4,207,831	$3,471,949	$3,546,988
Total LSC Costs:	12,970,330	16,641,506	14,005,393	11,403,450	11,750,204
Less: Capital Expenditures	(2,065,404)	(2,555,834)	(2,520,109)	(1,870,625)	(1,952,187)
Total O&M Expense (B)	**10,904,926**	**14,085,672**	**11,485,284**	**9,532,825**	**9,798,017**
CalAm Allocation % (C)	**38.67%**	**34.57%**	**36.64%**	**36.42%**	**36.20%**
Source: CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1B. Row (C) = Row (A) / Row (B)					

Given the organizational changes within functions, the results of this test are not definitive. However, it does suggest that the allocations from the LSC to CalAm are not unusually distorted in the test year.

Overland recommends the recomputation of jurisdictional allocations for employees whose costs were based on projected customer counts. As proposed by the company, this affects 23 employees.[21] Overland recommends that actual 2007 customer count data be used instead as it is a more objective measurement. This change in allocation factors would not have a material impact on the results of the analysis above.

<u>Capital Expenditure Assignments and Allocations</u>[22] - A portion of total LSC costs incurred are assigned to capital projects and not charged to operating expense. These capital projects are typically associated with property owned by the operating companies rather than one of the service companies.[23]

Costs assigned to capital projects occur in one of two ways. Either the employee directly charges a specific work order on his or her time card, or general capital charges are accumulated and distributed to multiple active projects using a pre-determined rate.[24] Projected capital expenditures for the rate case application were based on management estimates.[25]

[21] Response to OC-141.

[22] CalAm combined capital project and rate case amounts in its disclosure. For purposes of discussion, we refer to the amounts deferred as capital expenditures.

[23] Response to OC-189.

[24] Response to OC-189.

[25] Response to OC-180.

Chapter 5

As was the case with a request for jurisdictional allocation back-up, Overland was not provided with the capital expenditure detail requested.[26] The following table summarizes the capital expenditures as a percentage of total LSC costs for the last three years and the two projected years employed in CalAm's rate application:

Table 5-7
American Water West Region Service Company (LSC)
Capital Expenditures vs. Total Costs

Description	2005 Actual	2006 Actual	2007 Actual	2008 Projection	2009 Projection
Capital Expenditures	$2,065,404	$2,555,834	$2,520,109	$1,870,625	$1,952,187
Total LSC Costs:	12,970,330	16,641,506	14,005,393	11,403,450	11,750,204
Cap X as a % of Total	15.92%	15.36%	17.99%	16.40%	16.61%

Source: CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1B.

Based on the limited data made available to us, the amounts assigned and/or allocated to projected capital expenditures do not appear to be significantly out of proportion to the total costs projected to be incurred at the LSC.

<u>Business Development Costs</u>. In its current rate application, CalAm is requesting recovery of expense from the LSC's Business Development business unit / function. Business development expenses are not included in current rates.[27] In fact, CalAm's testimony highlights business development a "potentially contentious" issue.[28]

According to the testimony of Christopher Buls, Vice President of Finance for the Western Region:[29]

> Business Development supports the regulatory business and benefits the customers by seeking regulated acquisition and other related growth opportunities which will increase the size of the customer base and its revenue stream , allowing fixed costs to be allocated to a greater number of customers.

In the past ten years, CalAm has completed six acquisitions (excluding the 2002 Citizens Utilities acquisition), which is equivalent to one every twenty months. Since 2005, CalAm's customer base has been as follows:

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[26] Response to OC-180. Overland requested the underlying support for the allocation of 2007 LSC labor between operating expense and capital expenditures. CalAm provided a summary of time card formulas charged by employee. No explanation was provided for the resulting formula allocations nor for the raw data used in calculating the formulas.

[27] Response to OC-14.

[28] CalAm Rate Filing, Exhibit B - Chapter 1 - Section 4 - Table 1.

[29] Direct Testimony, p. 19.

Table 5-8 California American Water Customer Base			
Year	2005	2006	2007 (A)
Water	169,358	169,475	167,866
Wastewater	2,369	2,281	2,248
Total	**171,727**	**171,756**	**170,114**

Sources: CalAm Rate Filing, Exhibit B - Chapter 9 - Section 1 - Table 6 and response to OC-90.

Note: Customer count data for CalAm was not consistently applied in the rate application and at times incorrect information was used (see response to OC-90).

(A) Excludes Felton district.

Excluding wastewater customers, CalAm forecasts that total water customers will increase to 171,298 in 2009.[30] Assuming that wastewater customer counts remain constant, this amounts to an increase of 3,432 customers over 2007 counts; or 1,716 customers per year. To add this 1% per year to its customer base, CalAm proposes that it be allowed to annually recover $352,746 in Business Development allocated from the LSC, and an additional $30,439 from the NSC.[31]

On a per customer basis, the 2009 LSC costs allocated to CalAm without Business Development allocations or the projected increases in customer base are:

$18.78 per year per customer = ($3,546,988 - $352,746) / 170,114 customers

Including the Business Development function in cost of service and assuming the projected increase in customer base, the per customer amount after the second year is:

$20.44 per year per customer = $3,546,988 / (170,114 + 3,432)

Thus, CalAm's request is to add 8.8% to LSC cost per customer for Business Development.

The premise of adding business development costs to regulated expense is that customers acquired through the effort will benefit rates by spreading costs over a larger customer base. In this case there is no evidence that LSC business development efforts have noticeably added to the CalAm customer base in the past, and the minor customer count increases projected in the rate case obviously do not justify the additional costs included in CalAm's request. As a result, Overland recommends that the expense of the LSC Business Development function be excluded from CalAm's requested revenue requirement.

[30] CalAm Rate Filing, Exhibit B - Chapter 9 - Section 1 - Table 6 and response to OC-90. Adjusted to exclude Felton district (1,330).

[31] $352,746 is the amount referenced by the company in its application. This is slightly different than the amount disclosed in its workpapers and responses to data requests.

Other LSC Issues

Payroll Reserve - Before jurisdictional and capital expenditure allocations, CalAm included $102,500 for an LSC "bonus or promotional increase reserve" in its request. According to CalAm, this was intended to offset any awarded raises outside of normal merit increases, non-budgeted promotions, and vacant positions filled at higher pay due to changes in market conditions.[32] However, just as positions may be filled with people who are paid at higher rates than originally projected, some will be filled with people who are paid less than originally budgeted. CalAm has already included an average inflation component in its LSC base salary projections of 3.6% between 2008 and 2009.[33] Overland does not believe it is necessary to layer another 2.0% of unspecified labor increases on top of these projected costs. We recommend the payroll reserve be excluded from CalAm's test year expense.

Base Salary Omissions - Based on a review of the support for LSC's labor costs allocated to CalAm, Overland discovered that the base salaries of two employees in the Operational Risk business unit / function had been omitted from the 2009 projections.[34] CalAm confirmed that this had been done in error.[35] In its adjustments, Overland recommends that these omitted costs be included in CalAm's request.

Incentive Compensation - Included in the costs allocated to CalAm from the LSC are costs associated with incentive compensation ($233,430 and $241,823 in 2008 and 2009, respectively). These allocations are based on estimates for LSC employees of $764,729 in 2008 and $792,224 in 2009.[36] LSC employees received only $479,116 in incentive pay associated with the 2007 plan year.[37] Overland requested support for the higher incentive pay projections and received plan documentation for employees assigned to salary bands 14 through 5.[38] No documentation was provided for higher-level employees in salary bands 4 through 1. We recommend excluding the unsupported incentive compensation associated with employees in salary bands 4 through 1 and we recommend the 2007 plan year awards be used as a basis for the test year. Incentive compensation and our recommended adjustment is discussed in more detail in Chapter 2.

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[32] Response to OC-179.

[33] Derived from the response to OC-141. This computation adjusts for the fact that CalAm erroneously did not include the base salaries of two employees within its Operational Risk function in 2009.

[34] Response to OC-141.

[35] E-mail from Rebekah Pool dated August 2, 2008.

[36] Response to OC-141.

[37] Response to OC-20.

[38] Response to OC-182.

CalCorp

CalCorp is a service company organization with employees stationed in offices throughout California.[39] Its costs are entirely charged to CalAm.[40] CalCorp provides administrative services in functional areas similar to those in the LSC. They include:[41]

- Business Unit No. 51001 - Network
- Business Unit No. 51005 - Administrative
- Business Unit No. 51006 - Field Services (Service Delivery)
- Business Unit No. 51012 - Finance / Rates
- Business Unit No. 51014 - Engineering
- Business Unit No. 51016 - Maintenance
- Business Unit No. 51026 - Project Delivery
- Business Unit No. 51027 - Planning (Developer Services)

While CalCorp prepared its labor cost projections by employee, its non-labor cost projections were only available at the entity level by object account.[42] Attachment 5-2 presents CalCorp's 2006 and 2007 actual costs side-by-side with 2008 and 2009 projections. Differences between this exhibit and CalAm's Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1C are due to an oversight by the company when submitting its application.[43] Because the error was related to historical amounts only, it had no impact on the company's request.

As previously noted, CalCorp has undergone a transition in the past few years as employees who once were housed in the LSC have been reassigned to CalCorp. As Table 5-3 shows, at the end of 2005, CalCorp had six employees. Two and one-half years later, it had 40 employees.

CalCorp Headcount Included in CalAm's Request. CalAm has included 51 CalCorp employees in its 2009 test year GO revenue requirement.[44] As shown in the following table, this is substantially in excess of actual headcount as of May 31, 2008:

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[39] Response to OC-92.

[40] Response to OC-137.

[41] Response to OC-165.

[42] Response to OC-142 and e-mail clarification from Rebekah Pool dated July 28, 2008.

[43] Response to OC-124.

[44] CalAm rate filing, Exhibit B - Chapter 6 - Section 1 - Table 2.

Table 5-9 American Water California Corporate Service Company (CalCorp) Employee Levels					
Description	12/9/05 Actual	12/30/06 Actual	12/31/07 Actual	5/31/08 Actual	2009 Projection
Network	--	--	2	3	--
Administrative	1	10	11	9	11
Field Services	--	--	3	3	3
Finance / Rates	--	1	7	8	11
Engineering	--	--	2	7	3
Maintenance	--	--	--	2	3
Project Delivery	4	4	8	8	10
Planning	1	2	4	--	9
Legal	--	--	--	--	1
Total	**6**	**17**	**37**	**40**	**51**

Source: Responses to OC-92, OC-7, and OC-166.

Note: The 2009 projections are listed by "department." The historical data is listed by "business unit." Although both classifications use common terminology, there may be differences that would complicate any comparisons made between the two.

A significant percentage of the historical employee increase shown above is due to the reclassification of LSC employees to CalCorp. The increase in CalCorp A&G personnel in 2006 and 2007 came at a time when CalAm had a static customer base. This, together with the fact that allocations from the LSC have not decreased, indicates that the combined LSC and CalCorp organizations are becoming less efficient.

On top of increases that have already occurred, CalAm's GO revenue requirement proposes to increase the CalCorp workforce by another 27.5% between May 2008 and 2009. Overland does not believe that this increase is warranted and recommends that test year labor from CalCorp be limited to positions filled as of May 31, 2008.

<u>Reclassification of LSC Employees to CalCorp</u>. In 2006 and 2007, seventeen employees were "moved" from the multi-jurisdictional service provider LSC to the CalAm-focused CalCorp organization. Only one of these employees actually physically moved to another city, and with a lone exception, all had the same or a very similar position titles after the organizational transfer.[45] It is quite possible that sixteen of the seventeen employees worked from the very same office before and after this organizational change.

All other things being equal, the re-branding of these employees from LSC to CalCorp resulted in a shift of costs from other jurisdictions to CalAm. When working at the LSC, labor costs of many of these employees were directly assigned or allocated to five different jurisdictions. At Cal-Corp, they are assumed to work entirely for CalAm.

[45] Responses to OC-7 and OC-92 after taking into consideration global job type and description changes.

As discussed above, the decision to focus on a "strong state organizational structure" should have resulted in the same or lower cost allocation to CalAm from the combined LSC and CalCorp organizations, assuming the change "reduce[d] conflicting priorities."[46] Instead, total operating costs have increased from approximately $6,584,000 in 2005 ($4,218,000 from the LSC and $2,366,000 from CalCorp) to approximately $7,779,000 in 2007 ($4,208,000 from the LSC and $3,571,000 from CalCorp). For 2009, CalAm's requested allocations exceed $8,501,000, a 29% increase over 2005.[47]

Overland has addressed part of this increase by recommending that CalCorp only be allowed to charge CalAm for employees on the payroll as of May 31, 2008. In addition, Overland believes that the potential for cost allocation manipulation can be partially mitigated by limiting CalAm's test year to labor allocations based on the organization before management decided to adopt a "strong state organizational structure." Regarding the latter, the focus of our review was on the 17 employees who were re-assigned from the LSC to CalCorp in 2006 and 2007.

Of the 17 LSC employees re-branded as CalCorp, three were not included in CalCorp's 2009 labor projections, and two had notable changes in position descriptions. It is not necessary to make an adjustment for these employees. For the remaining 12 employees, we recommend a test year allocation to CalAm based on percentages effective in the time period immediately before they were "moved" from the LSC to CalCorp.

Costs Associated with Legislative and Political Influence - In Decision 03-02-030, the Commission disallowed the inclusion of CalAm's Director of Government Affairs position in rates. The Commission was particularly concerned with the lobbying aspects of the position. The disallowed position had the following responsibilities:[48]

- Monitors and provides input to positively influence proposed legislation and emerging issues that could affect the company.
- Assists in determining action or positions regarding governmental matters.
- Develops and maintains effective working relationships with federal, state and local legislators, officials and members of regulatory authorities.
- Assists the President in communicating with government officials at all levels regarding company positions on federal/state legislation and regulations.
- Coordinates communications and personal contacts by company management with elected and appointed officials.

[46] Response to OC-88 (B Kent Turner discussion).

[47] CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Tables 1A.

[48] CPUC D.03-02-030, pp. 22-23.

Chapter 5

In the current rate filing, CalAm has requested that costs incurred by CalCorp for a Director Government Affairs (State) be included in its rates.[49] As with the position reviewed previously by the Commission, this position reports directly to the President according to the company's organization chart.[50]

CalAm provided a job description for the Director Governmental Affairs (Job Code 450702) that lists the exact same five responsibilities as the position previously rejected by the Commission.[51]

In its adjustments, Overland recommends that the labor costs associated with this position be excluded from CalAm's rates.

Other CalCorp Issues

Incentive Compensation - O&M expense assigned from CalCorp includes forecasted incentive compensation of $264,925 and $274,451 in 2008 and the 2009 test year, respectively. These amounts are based on CalCorp incentive award estimates of $523,091 in 2008 and $541,898 in 2009.[52] Total CalCorp incentive awards for the 2007 plan year were $293,454.[53] When we requested support for the higher test year forecasts, we received incentive plan documentation for employees assigned to salary bands 14 through 5, but not for higher level manager in salary bands 4 through 1.[54] After excluding the unsupported incentive compensation for employees in salary bands 4 through 1, Overland recommends that test year incentive compensation be limited to 2007 plan year awards, adjusted for salary inflation through the test year. Incentive compensation is discussed in detail in Chapter 2.

CalCorp Labor Separately Requested as Rate Case Expense - As noted in Chapter 7, the time and associated labor costs of certain CalCorp Rate Department employees are being requested in both the operating expenses allocated by CalCorp to CalAm and deferred rate case expenses (amortized over a three-year period). This request is not particularly unusual except that CalAm has requested that more than 100% of four salaried employees' labor costs be permitted in rates.[55]

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[49] Response to OC-92.

[50] Response to OC-2.

[51] CalAm only provided one job description for the Director Governmental Affairs. As listed on the job description, this position reports to the Company President (Regional Level). While the Job Code for this job description is different than the Job Type listed in the employee listing provided in response to OC-92, it is nearly certain that the two positions are one and the same.

[52] Response to OC-142.

[53] Response to OC-20.

[54] Response to OC-182.

[55]

Chapter 5

As an example, CalAm projects that will spend 799 hours of her time on the current rate application.[56] Assuming no holidays or personal time off, this equates to 38.4% of her available annual hours (799 / 2,080). At the same time, management also concluded that Ms. will spend 90% of her time on CalAm matters charged entirely to operating expense.[57] In effect, CalAm has included nearly 2,700 hours of Ms. time (and more importantly, her labor costs) in this rate filing (799 rate case hours + 1,872 operating expense hours, the latter being 90% of 2,080 hours in a year). The company treated the labor expense of three other CalCorp employees similarly. CalAm's rationalizes this by claiming that time associated with rate cases is dictated by the way the current revenue requirement was developed in the past, but time associated with operating expenses will be guided by its new organizational structure and a new philosophy on labor distributions.[58]

Overland is not persuaded by the company's explanation. In its application, the company is requesting that ratepayers fund at least 115% of the labor costs of four different CalCorp employees, and that is a conservative estimate. As noted previously, Overland has not included any estimates of employee time off for holidays, vacation, training, or sickness. In addition, if labor costs of these employees are being recovered in rate case expenses of other jurisdictions, Overland's estimate of over-recovery is further understated.

In our adjustments, we have excluded the labor costs in excess of 100% of available hours for these four employees.[59]

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[56] Response to OC-54, Company Labor support.

[57] Derived from OC-142 ($84,274 of total allocations to operating expense / $93,638 of total labor costs).

[58] Response to OC-182.

[59] Two of the four employees were involved in the CalCorp reclassification of LSC employees. Because their allocation of labor costs was previously adjusted to levels that are consistent with the rate case costs being requested, it was not necessary to make a second adjustment.

Exhibit 7-4

Public Version
Attachment 5-1

LSC and Cal Corp
Employee Count Activity
December 2005 - May 2008

Home Business Unit	Dept Name	12/9/2005 Employee Count	Net Transfers (to) / from Other Depts	Net Movements between LSC & Cal Corp	New Positions Added to Dept	Old Positions Eliminated from Dept	12/30/2006 Employee Count	Net Transfers (to) / from Other Depts	Net Movements between LSC & Cal Corp	New Positions Added to Dept	Old Positions Eliminated from Dept	12/31/2007 Employee Count
33001	WE-Production	**5**	(2)		2	(2)	**3**	-		-	(3)	**-**
33002	WE-Network	**8**	(2)		4	(2)	**8**	-	(1)	-	(2)	**5**
33003	WE-Customer Relations	**-**	1		-	-	**1**	-		-	(1)	**-**
33004	WE-Tech Services	**1**	-		2	-	**3**	(1)		-	-	**2**
33005	WE-Administration	**5**	4		-	(2)	**7**	-	(2)	1	(3)	**3**
33006	WE-Service Delivery	**-**	-		-	-	**-**	1		-	-	**1**
33007	WE-Finance	**14**	-		2	(2)	**14**	-	(5)	5	-	**14**
33011	WE-Environmental Management	**2**	-		-	-	**2**	-		-	(1)	**1**
33014	WE-Engineering	**7**	-	(5)	-	(2)	**-**	-		-	-	**-**
33015	WE-Legal	**1**	-		3	(1)	**3**	-		4	(1)	**6**
33016	WE-Maintenance	**1**	-		-	-	**1**	-		2	-	**3**
33018	WE-Human Resources	**5**	-	(2)	1	(1)	**3**	-		2	-	**5**
33019	WE-Operational Risk	**2**	-		-	-	**2**	-		1	-	**3**
33020	WE-Business Development	**11**	(2)		1	(3)	**7**	-	(1)	-	(1)	**5**
33025	WE-External Affairs	**4**	-		-	(2)	**2**	-		-	-	**2**
33028	WE-Asset Planning	**6**	1		3	(1)	**9**	-	(1)	1	(5)	**4**
		72	-	(7)	18	(18)	**65**	-	(10)	16	(17)	**54**
51001	CAL-Corp	**-**					**-**	-	1	1	-	**2**
51005	CAL-Corp	**1**	-	6	3	-	**10**	(6)	3	7	(3)	**11**
51006	CAL-Corp	**-**					**-**	-	1	2	-	**3**
51012	CAL-Corp	**-**	-	-	1	-	**1**	-	4	2	-	**7**
51014	CAL-Corp	**-**					**-**	-	1	1	-	**2**
51016	CAL-Corp	**-**					**-**					**-**
51026	CAL-Corp	**4**	-	-	-	-	**4**	4	-	1	(1)	**8**
51027	CAL-Corp	**1**	-	1	-	-	**2**	2	-	2	(2)	**4**
		6	-	7	4	-	**17**	-	10	16	(6)	**37**

Sources: Responses to OC-7 and OC-92.

LSC and Cal Corp
Employee Count Activity
December 2005 - May 2008

Home Business Unit	Dept Name	(cont. from previous pg) 12/31/2007 Employee Count	Net Transfers (to) / from Other Depts	Net Movements between LSC & Cal Corp	New Positions Added to Dept	Old Positions Eliminated from Dept	5/31/2008 Employee Count
33001	WE-Production	**-**	-		-	-	**-**
33002	WE-Network	**5**	-		-	(1)	**4**
33003	WE-Customer Relations	**-**	-		-	-	**-**
33004	WE-Tech Services	**2**	-		-	(2)	**-**
33005	WE-Administration	**3**	-		-	-	**3**
33006	WE-Service Delivery	**1**	-		-	-	**1**
33007	WE-Finance	**14**	(1)		1	(1)	**13**
33011	WE-Environmental Management	**1**	-		1	-	**2**
33014	WE-Engineering	**-**	-		-	-	**-**
33015	WE-Legal	**6**	-		1	-	**7**
33016	WE-Maintenance	**3**	-		-	-	**3**
33018	WE-Human Resources	**5**	-		1	-	**6**
33019	WE-Operational Risk	**3**	-		-	-	**3**
33020	WE-Business Development	**5**	1		1	(1)	**6**
33025	WE-External Affairs	**2**	-		2	-	**4**
33028	WE-Asset Planning	**4**	-		-	(2)	**2**
		54	-	-	7	(7)	**54**
51001	CAL-Corp	**2**	-	-	1	-	**3**
51005	CAL-Corp	**11**	(3)	-	1	-	**9**
51006	CAL-Corp	**3**	-	-	-	-	**3**
51012	CAL-Corp	**7**	1	-	-	-	**8**
51014	CAL-Corp	**2**	2	-	3	-	**7**
51016	CAL-Corp	**-**	2	-	-	-	**2**
51026	CAL-Corp	**8**	-	-	-	-	**8**
51027	CAL-Corp	**4**	(2)	-	-	(2)	**-**
		37	-	-	5	(2)	**40**

Sources: Responses to OC-7 and OC-92.

Cal Corp
2006 - 2009
Detail by Account

Account	Actual 2006	Actual 2007	Budget 2008	Budget 2009	
Salaries	1,045,068	2,484,846	5,007,409	5,210,411	
Payroll Taxes - FICA	64,939	75,974	323,064	331,744	
Payroll Taxes - FUTA & SUTA	8,014	8,108	19,478	19,870	
Group Insurance	-	-	635,846	699,924	(B)
Oper Admin & Gen	84,553	-	-	-	
Employee Awards	1,226	100	-	-	
Employee Physical Exam	399	710	-	-	
Tuition Aid	1,264	183	-	-	
Training AG	(32,902)	25,194	-	-	
Temp Employee Oper Admin & Gen-AG	10,224	1,254	-	-	
Bill Inserts Admin & Gen	10,163	3,059	-	-	
Brochures and Handouts	1,691	225	-	-	
Office & Admin Supplies	40,793	38,809	42,361	43,420	
Contr Svc - Accounting	88,573	153,232	86,924	89,097	
Contr Svc - Legal	111,780	184,958	20,000	20,500	
Contr Svc Other-WT	-	-	-	-	
Contr Svc Other-AG	80,947	184,405	82,472	84,534	
Temp Employee Oper Admin & Gen-SS	-	-	-	-	
Rents - Real Property AG	3,428	2,952	336,220	348,410	(A)
Transportation	(99,929)	(101,933)	(359,831)	(375,664)	
Trans Oper Admin & Gen Lease Cost	180	80	-	-	
Trans Oper Admin & Gen Lease Fuel	1,246	378	-	-	
Trans Oper Admin & Gen Lease Main	16,693	1,179	-	-	
Ins Vehicle Oper AG	87,270	97,634	107,004	118,000	
Miscellaneous Operating Exp	23,143	42,068	-	-	
Misc Oper AG	90,289	(1,786)	-	-	
Misc General Office	-	-	-	-	
Advertising	18,099	24,745	-	-	
Bank Service Charges	171,745	218,860	179,509	183,997	
Bank Service Charges	6,407	(6,199)	-	-	
Bill Inserts	-	-	-	-	
Collections Agencies	22,132	22,397	26,826	27,503	
Condemnation Costs	(50,000)	-	-	-	
Conservation Exp	15,107	(6,600)	-	-	
Credit Line Fee	68,942	91,061	88,791	86,625	
Directors Fees	12,000	13,531	12,000	12,000	
Directors Exp	1,804	295	2,000	2,000	
Dues / Membership Deduct	1,536	3,857	12,108	7,508	
Employee Travel Exp Admin & Gen	15,168	173,307	197,218	202,148	
Empl Exp Conf / Registration	1,653	12,875	15,000	21,400	
Meals	1,982	12,676	-	-	
Meals & Travel Non Deduct	1,688	12,206	-	-	
Forms	150,656	178,402	161,130	165,164	
Forms AG	569	786	-	-	
Lobbying Expenses	-	-	-	-	
Merger Transaction Costs	10,735	-	-	-	
Office & Admin Supplies	7,499	4,507	1,200	1,200	

Cal Corp
2006 - 2009
Detail by Account #

Account	Actual 2006	Actual 2007	Budget 2008	Budget 2009
Overnight Shipping Admin & General	12,864	3,550	1,200	1,200
Penalties Non Deduct	1,283	-	-	-
Research Develop Exp	25,565	26,205	26,863	27,535
Security Services AG	-	-	-	-
Software Licenses & Supp	44,210	97,419	47,441	48,627
Telephone Admin & Gen	4,749	18,307	2,400	2,400
Cell Phone Admin & Gen	59,313	32,367	18,696	19,163
Wireless Service	68,140	62,335	49,643	50,885
Trash Removal Admin & Gen	87	-	-	-
Mat & Sup Admin & General	(1,018)	322	-	-
Contract Services Other	-	-	-	-
Miscellaneous Maint Exp	110,121	88,294	105,739	106,526
Amort Def Maint TD	-	-	-	-
Depreciation	937,279	405,792	487,476	487,476
	3,359,368	4,692,926	7,736,187	8,043,603
CAP EX	(799,678)	(1,121,407)	(2,968,129)	(3,089,108)
O&M (TOTAL LESS CAP EX)	2,559,690	3,571,519	4,768,058	4,954,495

(A) Due to the "restructuring" of personnel, CalAm chose to treat Chula Vista office lease costs and rental and maintenance on equipement as Cal Corp costs rather than as a cost of the LSC (Rate case filing, Discussion of Exhibit B - Chapter 6 - Section 1).

(B) CalAm inadvertently excluded Group insurance for 2006 and 2007 from its application (Exhbit B - Chapter 6 - Section 1 - Table 1A). Its disclosure of Group Insurance in Table 1C was also not comparable to its projections as historical amounts included costs for all CalAm employees, not just those of CalCorp (see response to OC-124). 2008 and 2009 budgets only include costs for Cal Corp employees. For purposes of this schedule, details supporting historical costs associated with Table 1A were presented.

6. RWE Acquisition and Spin-off of Interest in American Water; Analysis of Synergy Savings from Citizens Acquisition

In this Chapter, Overland provides an analysis of CalAm or American Water compliance, where possible, with "Conditions" imposed by the Commission; initially with regard to the acquisition of American Water by RWE, and more recently of the divestiture of the RWE interest in the company.

This Chapter also addresses ongoing requirements imposed by the Commission associated with: the CalAm acquisition of water assets previously owned by Citizens Utilities; specifically the analysis of synergy benefits imputed due to the operation of these properties by CalAm in relation to the acquisition premium allowed in rates to date.

Finally, potential implications of the recent sale of the Felton assets on the amount of acquisition premium recoverable from CalAm customers is addressed.

Transfer of Control of Stock Ownership from RWE to American Water

Control of American Water Works Company, Inc. ("American Water") was transferred to RWE Aktiengesellschaft ("RWE")[1] in 2003.[2] At that time, RWE provided water and wastewater services to about 43 million people worldwide. The American Water acquisition was intended to expand RWE operations to the U.S.[3]

The transfer of control to RWE was expected to produce economic benefits to ratepayers, including: sharing of best practices; lowering CalAm's cost of debt; deferring a rate increase; implementing two public assistance programs; and adopting affiliate transaction rules.[4]

In Decision 06-11-050 dated November 30, 2006, the Commission addressed RWE savings recognized in setting rates for the Monterey and Felton districts. The CalAm estimate of savings due to the RWE acquisition was $1,023,204 for 2006. This estimate was accepted as part of the settlement of the GRC proceeding. The underlying record in GRC proceeding provided the actual basis for the RWE savings estimate. The primary factors were: the impact of improved procurement practices and expected savings from changes in IT systems.

[1] Thames Water Aqua Holdings GmbH is the intermediate holding company for most of the water and wastewater operations of RWE, which holds the investment in American Water.
[2] The Commission actually approved the transfer in D.02-12-068 on December 19, 2002.
[3] CPUC Decision 07-05-031, dated May 3, 2007, page 7.
[4] CPUC Decision 02-12-068, dated December 19, 2002, page 13.

The impact of any improvements in procurement practices is now embedded in the historical data relied upon to forecast costs. This is also true for costs associated with the changes made in IT systems utilized.[5] For these reasons, as well as the fact that RWE is in the process of divesting its interest in American Water, there is no basis at this time to assume that any RWE related benefits can be expected beyond the levels embedded in historic costs.

In D.07-05-031, the Commission approved the transfer of indirect control of CalAm from RWE to American Water through the sale of up to 100% of the shares of common stock through an IPO and subsequent offerings. At the time of the CPUC Order in May 2007, CalAm represented less than 5% of the American Water regulated operations.[6]

The position of Applicants in requesting approval for the spin-off from RWE is summarized by the Commission at page 10 of D.07-05-031 as follows:

> Applicants contend that their proposed transaction meets the requirements of § 854 (a) because it will result in a company with sound financial structure focusing on the water and wastewater business in the United States that will be ***well managed and will provide benefits to ratepayers. Although applicants cannot quantify the benefits from the proposed transaction, they identify them as significant.*** Those ratepayer benefits include a solid capital structure; ability to raise capital on a going forward basis; becoming a United States publicly traded company; ***local control***; enhancement of employee relations; and ***transparency to CalAm's ratepayers.*** (emphasis added)

In its Decision to approve the transfer of ownership, the Commission imposed the following conditions, among others:

1. The authority granted by Ordering Paragraph 1 is subject to complying with the 11 conditions set forth in Appendix A to this Order.
2. None of the acquisition conditions from Decision 02-12-068 should be removed until RWE (or its subsidiaries or affiliates) has sold more than 90% of its interest in American Water… (page 39)

The acquisition conditions in Decision 02-12-068 were attached as Appendix C. Both Appendix A and Appendix C are attached herein as Attachments 1 and 2, respectively.

CalAm represents that it has addressed its compliance with the conditions imposed by Decision 02-12-068 by its submission of Exhibit E, Chapter 1, Section 1.[7] Similarly, CalAm represents that it complied with applicable conditions imposed in Decision 07-05-031 by virtue of its submission of Exhibit E, Chapter 1, Section 10.[8]

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[5] Actual results in changes to IT systems failed to produce the expected cost reductions estimated in the last GRC case (per Dave Stephenson August 27, 2008).
[6] CPUC Decision 07-05-031, dated May 3, 2007, page 6.
[7] Response to OC-96, page 2.
[8] Ibid, pages 1-2.

A review of Exhibit E, Chapter 1, Sections 1 and 10 reveal that CalAm's idea of compliance is generally met by one sentence statements that may be characterized as: a) an unsupported representation that the condition has been met or that CalAm is in compliance; b) that compliance with certain conditions will be demonstrated in future GRC applications; c) a general qualitative statement, absent any empirical support; or d) a reference to some other document or documents not contained in the filing itself or in the accompanying workpapers[9].

Referring specifically to Exhibit E, Section 10, page 3 of 3, CalAm identifies that "Condition 11" of Decision 07-05-031 provides for the continued requirement to provide a showing of compliance with the conditions originally set forth by the Commission in approving the acquisition of American Water in the first instance.[10] There were numerous conditions imposed by the Commission; many of which remain applicable today. Relevant conditions that continue at this time include:

- Condition 2 – Adequate capital required to fulfill service obligations.
- Condition 6 – No adverse impact on customer service.
- Condition 15 – CalAm's equity to capital ratio must be at least 35%.
- Condition 16 – Notification of downgrading of bonds by rating agencies.
- Condition 19 – Cost of new debt will not increase due to RWE ownership.
- Condition 22 – Track costs and benefits associated with implementation of "best practices".
- Condition 23 – Commit funds to support low-income assistance programs.
- Condition 24 – Commit funds to support a "Small System Technical Advisory Team".
- Condition 26 – Notification of dividends to parent in excess of 75%.
- Condition 29 – Expected savings associated with implementation of "advanced project delivery" methods.

The following represents the CalAm evidence of compliance filed in its application, as well as in its response to Overland discovery.[11]

> **Compliance Action –** California American Water will demonstrate compliance with this condition in future GRC applications.

Overland assumes that the Commission imposed conditions in previous proceedings for good cause, and with the intent to exercise its regulatory oversight responsibilities in protecting regulated water utility customers against potential harm arising from unintended circumstances subsequent to its approval of transactions associated with the

[9] Supplemental Response to OC-34. This amended response provides various references to what is apparently an August 20, 2007 draft version of American Water's S-1 filing actually made on August 27, 2007. The excerpts referenced were not produced in the response, nor is the document otherwise produced in discovery. The references are inconsistent with the August 27, 2007 S-1 filed with the Securities and Exchange Commission. In any event, the S-1 generally addresses American Water consolidated operations and its major business unit or subsidiary operations. There is no discussion of RWE and American Water compliance with CPUC conditions imposed in D.07-05-031.

[10] CPUC Decision 02-12-068, dated December 19, 2002, Appendix C.

[11] Response to OC-34; see also Application Exhibit E, Chapter 1, Section 10.

RWE acquisition, and subsequent spin-off its investment in American Water. We believe that the submission of evidence by CalAm with regard to the conditions required by these previous proceedings is insufficient for the Commission to exercise its intended review and authority over the potential or intended effects of its RWE authorizations previously referenced.

The potential concerns of the Commission in monitoring CalAm and American Water operations, as reflected by the conditions imposed in the proceedings referenced above, are further justified by a number of specific factors now known, which include:

- Credit ratings lowered for American Water Capital Corp. by Moody's on October 12, 2007, and by S&P on June 19, 2008.
- Write-down of goodwill through December 31, 2007 of $1.1 billion; with an additional asset impairment through June 30, 2008 of $750 million.[12]
- Internal cash flows from operations will not be sufficient to fund forecasted capital expenditures, thus requiring significant capital from new debt and equity offerings.[13]
- The current equity ratio is approximately 47%. However, there is a risk of erosion due recognition of further asset impairments in the goodwill of $1.7 billion that remains on American Water's balance sheet at June 30, 2008.[14]

Overland requested data to support and verify compliance with the conditions required by the RWE decisions previously identified. Aside from its references to Exhibit E, it also provided references to an August 20, 2007 draft version of an S-1 filing for Conditions 1-6, while stating that "Compliance will be demonstrated in future general rate case applications" for Conditions 8-12.[15] In a follow-up request, Overland made the following statement.[16]

> …Overland again requests the production of actual documentation of compliance with applicable conditions. Overland does not believe that it is its responsibility to define "the specific information required for a specific condition" [17], as it believes that CalAm should make a good faith effort to address and document compliance consistent with the intent of the CPUC Orders approving this matter…

CalAm did not produce any documents, empirical evidence, quantitative analysis or documentary support in response to OC-96. However, to the extent that Overland was

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[12] American Water S-1/A dated April 1, 2008, page 45; and June 30, 2008 10-Q, page 5. Recognition of these impairments commenced in 2005, and generally relate to the goodwill recognized due to the RWE acquisition of American Water in 2003.

[13] Forecasted capital expenditures are at approximately $1.1 billion per year in 2008 to 2012. New debt and equity funding is expected to be approximately $3.0 billion over that period. Response to OC-99, Goldman Sachs research report dated June 2, 2008, page 19. S&P (at page 3 of its June 19 Research Update) puts the expected capital expenditures at $4 to $4.5 billion over the next five years; somewhat lower than the Goldman Sachs forecast. Response to Discovery OC-98.

[14] American Water June 30, 2008 10-Q, pages 3 and 4.

[15] Response to OC-34; Supplemental Response relating to D.07-05-031 conditions.

[16] Discovery Request OC-96.

[17] Response to OC-34.

able to gain information relevant the conditions established in the RWE decisions, the following discussion and analysis is provided.[18]

Water Quality. CalAm has no management level reporting of water quality statistics that provide summary analysis or comparative data. It apparently relies solely on its Consumer Confidence Reports ("CCRs") for information about water quality.[19] These reports are developed annually, by district, and distributed to customers.

Attachment 3 includes data derived from CalAm's Consumer Confidence Reports for the Monterey district published for the years 2003-2007. We have compiled the data in this attachment for comparative purposes. The attachment shows the Maximum Contaminant Level (MCL) allowed for certain substances as determined by the State of California and the U.S. EPA and the average amount detected as reported in that year.[20] No violations were reported for any of the reported substances.

Low Income Assistance Programs. Commencing in February 2007, and through the period to April 2008, CalAm had spent approximately $99,000 of a $250,000 commitment for low income assistance programs (CPUC Condition 23) it has recorded as a liability in its financial statements. The following is a detail of these expenditures by district:[21]

Table 6-1
California American Water

District	Amount
Sacramento	$69,338
Larkfield	4,211
Felton	7,307
Los Angeles	18,321
Total	**$99,177**

"Small System Technical Advisory Team" Program. The actual and planned expenditures for this program are as follows.[22]

[18] Overland did not have the time or resources to continue through multiple rounds of discovery to attempt to induce CalAm to provide relevant information to support its filing requirements in the face of its position that the information contained in its application had already met its burden of proof.

[19] Response to OC-97.

[20] As stated in the reports, while most monitoring was conducted during the year reported, certain substances are monitored less than once per year as levels do not change frequently. Based upon the reports, these substances include Gross Alpha Particle Activity, Combined Radium, Copper and Lead. The CCRs for 2003-2005 included sample results for those substances from 2003. Sample results from 2005 for Arsenic, Fluoride, and Selenium were included in both the 2005 and 2006 CCRs. 2005 sample results were included in the 2007 report for Gross Alpha Particle Activity, Combined Radium, Uranium, Copper and Lead, while testing had been performed and reported in 2006.

[21] Response to OC-45.

[22] Response to OC-46.

Table 6-2 California American Water		
Description	Year	Amount
Ponderosa Sky Ranch Water System	2004	$ 10,000.
Ponderosa Sky Ranch Water System	2005	20,000.
Live Oaks Springs Water Company	2006	12,010.
Matt Dillon Water Company	2006	55,750.
San Jerado Water System	2006	37,000.
Ramona Water Company	2007	27,636.
Actual Expenditures through 2007		$162,396.
Ramona Water Company (planned)	2008	49,900.
Total Program Expenditures		**$212,296.**

CPUC Condition 24 required a commitment of $50,000 per year for five years from the closing of the RWE transaction.

Accounting Controls and Financial Reporting. Goldman Sachs initiated coverage of AWW in a June 2, 2008 research report. The report addressed accounting controls and financial reporting as follows.

> **Material accounting control weaknesses**
> American Water has reported material weaknesses in internal accounting controls. While we believe the company has adequately increased controls and accounting staff, these weaknesses may have not been fully addressed which would negatively impact the company's ability to report its financial statements in an accurate and timely basis. Costs related to comply with Sarbanes-Oxley could also be higher than expected.[23]

Merrill Lynch also identified the "material weaknesses" in the AWW accounting controls that existed as of December 31, 2006, including:

- Inadequate internal staffing and skills
- Inadequate controls over financial reporting processes
- Inadequate controls over month-end closing processes, including account reconciliations
- Inadequate controls over maintenance of contracts and agreements
- Inadequate controls over segregation of duties and restriction of access to key accounting applications
- Inadequate controls over tax accounting and accruals[24]

Capital Expenditures. A detail of capital expenditures is contained in Attachment 4, covering the period 2003-2007.

Dividend Payout; Capital Contributions. For the period 2002-2007, CalAm paid out essentially 100% of its net income in dividends. The CalAm policy is to pay out 75% of net income as a common dividend. When measured against prior year income, dividends

[23] Response to OC-99. Goldman Sachs research report dated June 2, 2008, page.12.

[24] According to the report, AWW intends to be in full compliance with regulatory standards by December 31, 2009. Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 29.

for 2003-2007 were about 73%.[25] During this same period, CalAm received $25 million in capital contributions.[26]

The IPO. Based on its IPO presentation materials dated April 2008, American Water expected to sell up to 64 million shares of common stock at $24 to $26 per share, with 160 million total shares outstanding post-offering.[27] The presentation documents reflect the American Water financial policies which include:

- Target dividend policy of 50-70% of net income
- Solid investment grade rating and targeted long-term debt of 50-55%[28]

While the initial offering was expected to produce a value of $24 to $26 per share, the actual price realized was $21.50, a discount in the range of 10-20%.[29] As a result of the April 22 IPO, and a partial exercise of the greenshoe option on May 27, RWE currently holds about 60% of the AWW common stock. RWE realized approximately $1.36 billion in proceeds from the offering.[30] Many of the regulatory approvals permitting the sale of AWW shares are valid for 24 months from the time of the IPO, and as such, it is likely that RWE will further reduce its holdings during this timeframe.[31]

Financial Condition/Bond Ratings. While American Water and CalAm have represented that the divestiture of the RWE equity holding will be positive for the company and its customers, the rating agencies do not agree. In October 2007, Moody's downgraded its rating for American Water Capital Corp, making the following comments:[32]

> American Water is a parent holding company with no direct debt obligations. Its primary financing vehicle is American Water Capital Corp. ("Capital"), a finance subsidiary. American Water also incurs debt at the regulated subsidiary level.
>
> On October 12, 2007, Moody's downgraded to Baa2 from Baa1 the senior unsecured issuer rating of Capital…
>
> The downgrade of Capital's long-term rating was prompted by RWE AG's planned divestiture of the company, via initial public offering. The initial sale of RWE's interest in American Water is expected to happen in late-2007; however, preceding that transaction, Capital is expected to issue $1.5 billion of senior unsecured notes in order to substantially repay

[25] See Attachment 5, which provides a detail of dividends and relevant income for the 2002-2007 period.
[26] Response to OC-40 Revised. 2006 -- $10 million; 2007 -- $15 million.
[27] Response to OC-31, "Final Roadshow Presentation", p.2.
[28] In its June 6, 2008 research report at page 28, Merrill Lynch noted that AWW "is targeting an A- credit rating over the long term." It also stated that its expected equity ratio would be in the 40-45% range over its forecast period through 2011. Response to Discovery OC-99.
[29] Response to OC-94. The Company was unable to identify the factors contributing to the price discount relative to expectations.
[30] Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 15.
[31] Response to OC-99. Goldman Sachs research report dated June 2, 2008, page 16.
[32] Response to OC-42; Moody's Credit Opinion dated October 17, 2007, pages 1-2.

> approximately $2.0 billion of inter-company debt currently owed to RWE. These notes are expected to be issued in October 2007. It is Moody's understanding that the company will also issue $500 million of "equity units" concurrent with the IPO that will fund out the balance of inter-company debt owed to RWE.
>
> The one-notch downgrade of Capital's senior unsecured issuer rating, and the assignment of a Baa2 issuer rating to its parent, American Water, reflects the loss of implied support from RWE following the IPO, historically weak consolidated credit metrics, and the increase in financial and operating risk going forward as a publicly traded, stand-alone company. Moody's has also taken this opportunity to equalize the new rating for American Water, a holding company, with its finance subsidiary, Capital, due to the existence of a "support agreement" between the two entities that effectively backstops Capital's timely payment of principal and interest, as needed.

While S&P did not downgrade the American Water credit ratings in October 2007 as Moody's had done, it did put the securities on CreditWatch negative. In a January 2008 Research Update, S&P stated that:[33]

> We still believe the postponement of the IPO distracts AWW's management and could stall necessary improvements to the company's financial profile, which depends on the successful execution of a number of rate cases across several states…
>
> AWW's financial metrics are weak for the rating and partly result from agreements with some state regulators not to file rate cases for up to three years. This was a condition of RWE's acquisition of AWW. As evidenced by the filing of 11 rate cases in 2007, we expect AWW to actively pursue additional rate cases as determined by its rising operating costs, capital-spending plans, and pension and other postretirement obligations…Another reason for the weak performance is AWW's significant goodwill impairments over the past three years. The impairments, which have totaled more than $1 billion, were based on slower-than-expected growth in RWE's North American water segment, privatization of water utilities in North America, and valuation of its nonregulated businesses. Based on indicative market values, an impairment of up to $300 million could be reported in fourth-quarter 2007.
>
> …Capital expenditures are projected at $4 billion to $4.5 billion during the next five years for infrastructure replacements, new facility construction, maintenance of water-quality and environmental standards, and system reliability.

[33] Response to OC-42; S&P RatingsDirect, January 29, 2008, pages 2-3.

> With cash from operations for the past 12 months of only $390 million, AWW's cash flow generation is insufficient to meet its ongoing operating and capital needs, and will require additional access to the capital markets over the intermediate term.

In order to meet its commitment to regulators for the IPO, RWE agreed to maintain a minimum equity ratio of 45% at the time of the IPO. RWE had to contribute approximately $250 million to AWW to comply with this condition.[34] A major factor contributing to the erosion in the equity ratio, has been the substantial write-downs of recorded goodwill.

> At the time of the acquisition RWE recorded goodwill of approximately $3.4B representing the acquisition premium for AWK as well as the acquisition premium for E'Town Corporation, which had been bought by Thames Water in 2001 and was subsequently folded into AWK. Between 2004 and the first quarter of 2008, AWK recorded goodwill impairments totaling approximately $1.9B; remaining goodwill is now $1.7B.[35]

A write-off of the remaining goodwill would cause the equity ratio to decline to approximately 34% from its June 2008 level of about 47%.

The American Water Capital Corp. bond ratings for the period 2003 to 2007 were as follows:

Table 6-3
American Water Capital Corp.
End of Year
Long-Term Debt Ratings

Year	Standard & Poor's	Moody's
2003	A	Baa1
2004	A	Baa1
2005	A-	Baa1
2006	A-	Baa1
2007	A-	Baa2

Source: Response to OC-44 (supplement dated May 11, 2008).

On June 19, 2008, S&P lowered its corporate credit ratings for AWW to BBB+ from A-, citing a lack of cash flow improvement as the primary factor. The American Water Capital Corp. corporate credit debt securities were also downgraded to BBB+ at this time.[36] This marks the second downgrading of the company's securities by S&P in the last five years.

Sarbanes-Oxley; Divestiture Costs. The following is a summary of certain costs incurred due to the IPO, and AWW's return to being a public company.[37]

[34] Response to OC-98. S&P Research Report Dated May 20, 2008, page 3.
[35] Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 21.
[36] Response to OC-98. S&P Research Report Dated June 19, 2008, page 2-3.
[37] Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 22.

Table 6-4 American Water Works Company (millions)			
	2006	2007	2008
Sarbox	$15.4	$32.0	$11.2
Divestiture	7.4	8.1	7.8
Total	**$22.8**	**$40.1**	**$19.0**

Findings and Conclusions. While CalAm is required to provide the Commission with information sufficient to assure compliance with conditions imposed in both the RWE acquisition and spin-off decisions, the actual filing of relevant support is highly superficial, if not nonexistent. CalAm has represented that its customers will benefit from the spin-off. However, given the substantial pressure imposed by a capital program that exceeds cash flows available from operations, and the significant goodwill that remains on the company's books, it appears evident that the recent downgradings by S&P and Moody's indicate an erosion in financial position; not an enhancement. Regulated utilities, in the face of such conditions, generally attempt to either raise customer rates, cut costs, or both. Overland assumes that, in imposing conditions reflected in previous decisions, it did so as a basis to: evaluate the delivery of benefits represented by CalAm; and to assess, and where possible, safeguard against any potential harm to ratepayers.

The following is an illustrative review of information that the Commission may wish to require of CalAm in complying with the Conditions on Transfer of Indirect Control:

1. CalAm will be provided with adequate capital from American Water to fulfill all of its service obligations.
    - Analysis of cash flow requirements, including expected capital expenditures, dividend payments, debt refunding, etc. Representation of sources of funds aside from internally generated from operations.
    - Statement of policy regarding parent company funding, including specific financing plans necessary to meet capital requirements.
2. The transaction will not result in adverse changes in CalAm policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations.
    - Comparative analysis of number of employees by major functional categories over five-year historical period, and forecasted over three years.
    - Comparative analysis of capitalization over five-year historical period, with five-year forecast of capital structure.
    - Five-year history of changes in customer rates by district.
    - Five-year history of effective depreciation rates for jurisdictional property, including disclosure of any changes in approved rates during the period.
    - Disclosure of any changes in maintenance programs or policies over the last three years, or expected over the next three years.
3. No adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction.

- Comparative analysis of service quality, service reliability and customer satisfaction over five-year historical period.
- Comparative analysis of key measures of water quality over five-year historical period.
- Summary of all water quality violations with state or federal standards, and remediation measures taken.

4. Maintain business headquarters in California.
   - Disclosure of any offices closed, any basis for closure over three-year historical period. Indication of any closures expected over next three years.
5. No adverse impact on CalAm employees; no changes to collective bargaining agreements.
   - Statement of any adverse changes to employee compensation or benefits that conflict with employee policies and practices prior to the spin-off.
6. No changes to staffing that would result in service degradation.
7. 30 day notification of rating agency downgrades.
   - Provide five-year history of credit ratings by major rating agencies.
   - Provide detail of basis for changes in ratings.
8. No recovery of RWE spin-off transaction costs.
9. Minimum 45% equity ratio for American Water at time of IPO.
10. Affiliate agreement to remain in effect.
11. D.02-12-068 conditions to remain until RWE has sold more than 90% of its interest in American Water.

The above listing is not meant to be exhaustive, but rather an indication of the nature and extent of data that the Commission may reasonably have expected of the Company when it chose to impose these conditions.

Citizens Acquisition Premium and Synergy Savings

In D. 01-09-057, dated September 20, 2001, CalAm was authorized to acquire Citizens Water assets in California for $161.32 million, which included an acquisition premium of $64.6 million.[38] At the time of the acquisition, no independent study was performed to identify and allocate the premium with the Citizens assets acquired.[39] This premium was to be recovered in customer rates based upon a 40-year amortization, predicated, at least in part, upon a showing of synergy savings that were expected to exceed the premium. While the discussion in the decision reflects that CalAm was confident that the synergy savings estimates would be realized, the Commission recognized that there was a potential risk for overestimation.

> There are at least three ways synergies savings could be overestimated: errors in predictions of what can or will be achieved through economies of scale in operations and capital structure and/or how much value they will produce; errors in estimating the escalation, inflation and discount

[38] These amounts were subject to adjustments anticipated at the time of closing.
[39] Response to OC-101.

> methods used to extrapolate future benefits and sum them to a present value; and the possibility of long-term, significant changes that defy prediction today.[40]
>
> CalAm repeatedly acknowledged that it would have to carry the burden in future proceedings to demonstrate what synergies have been realized. CalAm also acknowledged that the Commission would be free in the future to examine whether synergies initially realized may have for whatever reason declined with the passage of time to below those initially projected. The stipulation proposal, while not permitted to extend to substantive issues which may come before the Commission in other or future proceedings, may prove a valuable reference to establish the level of synergies achieved. However, we decline in this proceeding to foreclose parties from proposing and supporting other methods and figures in a future proceeding.[41]
>
> …CalAm would bear the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer growth) in future years were not erosions of earlier-estimated synergies.[42]

In its May 6, 2004 Sacramento District GRC Decision, the Commission found that the methodology for, and quantification of, the synergy savings was appropriate.[43] It concluded the following, based on the synergy analysis in the record.

> …Most of the synergies savings accrue from cost of capital savings, cost of investment savings, and allocation of general office costs to Arizona; savings from other sources are small by comparison. Cost of capital savings are a primary contributor, and those arise in large part from CalAm's much lower equity ratio…We are convinced those savings do exist and came about due to CalAm's acquisition of the Citizens assets. (at page 25)

Based upon the discussion in this decision, it is clear that the Commission intended to verify and ensure that ratepayers benefited from the synergies arising from the Citizens acquisition.

> …However, we still intend to ensure that ratepayers receive their share of the post-2004 Citizens acquisition synergies as D.01-09-057 anticipated, even if CalAm's request is granted and there is no TY2005 GRC for one or more of these districts. To accomplish that, for any Citizens districts for which there is no TY2005 GRC, revenues for service rendered on and after January 1, 2005 that are associated with the Citizens acquisition synergies savings in those districts will be made subject to refund pending

[40] D. 01-09-057; page 43.
[41] Ibid; pages 47-48.
[42] Ibid; page 48. This is also addressed in Finding h. at page 68.
[43] D. 04-05-023; pages 24-25.

a determination of what portion of the synergies savings are to be shared with customers.[44]

In its Monterey District application, CalAm has submitted an analysis estimating synergy savings associated with the purchase and operation of the Citizens' water assets located in California. The analysis of the net benefits (after consideration of the acquisition premium costs approved for rate recovery to date by the Commission) is found in the testimony and exhibits of CalAm witness David P. Stephenson.[45] The testimony and related attachments assert that CalAm operations continue to produce synergy savings at or above levels estimated in previous proceedings, based upon a previously agreed upon methodology. Based upon these representations, CalAm has requested the elimination of any further showing of the existence of merger benefits arising from the acquisition of the Citizens properties.

Review and Application of Methodology. The methodology used by CalAm to quantify both its acquisition premium and the synergy savings associated with the former Citizens' properties has been subject to prior Commission review and been accepted by the ORA.[46] Therefore, the focus of our review is to confirm that the methodology continues to be followed and that the results support CalAm's claims that the synergy savings exceed the amortization of the premium paid for the Citizens' properties.

The company's current calculation of the revenue requirement of the premium and synergy savings is summarized in the following table:

Table 6-5
California American Water
Summary of Revenue Requirement of the Premium and Synergy Savings
(as filed in the Application to Increase Rates in the Monterey District)

Year	Net Premium to Citizens Properties	Cost of Capital Savings	Cost of Investment Savings	Other Synergy Savings	Premium in Excess (Less Than) Synergy Savings
2005	$2,639,000	$1,454,697	$1,147,000	$474,933	($437,630)
2006	2,566,000	1,660,457	1,714,000	604,410	(1,412,867)
2007	2,609,500	2,492,757	2,593,000	869,568	(3,345,825)
2008	2,077,880	2,757,034	3,209,000	1,006,828	(4,894,982)
2009	2,014,740	2,965,997	3,815,000	1,299,091	(6,065,348)
2010	1,952,830	3,197,467	4,394,000	1,480,266	(7,118,903)

Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.

Consistent with its 2004 filing, the company computed an annual revenue requirement for the acquisition premium associated with the Citizens' properties of $2.6 million in 2005. This was the only year that overlapped with previously-filed data. In subsequent years, the revenue requirement decreased to $2.0 million (for the year 2010) which was due to a decrease in the total premium (net of amortization) partially offset by a reduction in the percentage allocated to the former Citizens' districts from 50% to 41%.[47] Although

[44] D. 04-05-023; page 28.
[45] Stephenson testimony, pages 28-30.
[46] CPUC Decision 04-05-023, pp. 24-26.
[47] Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District.

significant, it should be noted that amounts allocated to the former CalAm districts were not incorporated in the following synergy savings analysis prepared by the company.[48]

The synergy savings calculated by the company were driven largely by two components – the cost of capital savings and the cost of investment savings. These two were previously identified by the Commission in its decision approving the recovery of synergies (D.04-05-023).[49] Although the total synergy savings also incorporate expected differences in the levels of costs associated with a CalAm-managed company versus a Citizens-run company, these savings are relatively insignificant.

The company's calculated cost of capital savings are a function of expected differences between the weighted average cost of capital (WACC) of CalAm and Citizens.[50] These expected differences in WACC are multiplied by rate base to derive the savings. Without regard to income tax impacts, WACC is calculated as follows:

WACC = (% of Debt Financing x Cost of Debt) + (% of Preferred Stock Financing x Cost of Preferred Stock) + (% of Common Equity Financing x Cost of Common Equity)

The WACC inputs assumed by the company for this calculation are summarized in the following table:

Table 6-6
California American Water
Range of Weighted Average Cost of Capital Inputs
Used in Synergy Savings Calculations
(2005-2010)

Description	Citizens	CalAm
% of Debt Financing	46.25% - 49.39%	65.00%
Cost of Debt	7.07% - 7.75%	5.17% - 6.25%
% of Preferred Stock Financing	2.36% - 5.50%	0,00%
Cost of Preferred Stock	5.31%	N.A.
% of Common Equity Financing	48.25%	35.00%
Cost of Common Equity	9.95% - 10.00%	9.95% - 10.00%
Pre-Tax Gross Up Factor	1.79	1.79

Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.

Primarily because CalAm projected that it would employ more debt financing than Citizens at a significantly more attractive rate than Citizens could obtain, the pre-tax WACC savings estimated by CalAm were as follows:

[48] The primary drivers of synergy benefits in the Citizens' districts, namely improved productivity in construction practices and saving in the cost of capital, would not be applicable in an assessment of benefits in the CalAm districts.

[49] CPUC Decision 04-05-023, p. 25 (dated May 6, 2004).

[50] The Citizens authorized rate of return prior to the American Water acquisition was 8.18%, which included an embedded cost of debt of 7.07%. Response to OC-47; CPUC Decision 98-10-056, dated October 22,1998.

Table 6-7 California American Water Company Computations of WACC Savings			
Year	Citizens	CalAm	WACC Savings Under CalAm
2005	12.39%	9.81%	2.58%
2006	12.38%	9.72%	2.66%
2007	12.36%	9.94%	2.42%
2008	12.42%	9.97%	2.45%
2009	12.40%	9.97%	2.43%
2010	12.41%	9.98%	2.43%
Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.			

The other primary driver of synergy savings is the cost of investment savings. This is derived by the company by comparing the presumed construction expenditures under both Citizens and CalAm management, multiplied by the pre-merger Citizens' WACC.

Underlying this synergy savings component is an assumption by CalAm that it is able to complete a capital project more efficiently than Citizens. For instance, CalAm projects that it can do the Conversion of Flat Rate to Metered Service Connections (Investment Item No. 056002-09) less expensively than Citizens by nearly $12.3 million over a 6-year period (2005-2010). This equates to an approximate 43% discount before overhead loadings when compared to Citizens' projected costs.[51]

The most significant investment savings were derived from the following projects:

Table 6-8 California American Water Projected Capital Expenditure Savings by Project				
Year	Conversion of Flat Rate to Metered Service Connections (056002-09)	Construct Distribution Service Improvements (Suburban Area) (056002-02)	Small Main Replacement Program – Shenandoah (056002-15)	Arsenic Treatment
2005	$1,991,641	$563	$567,938	$104,695
2006	2,154,963	9,017	602,119	266,659
2007	2,336,451	798,830	610,312	495,944
2008	1,953,750	550,000	575,000	--
2009	1,905,000	625,000	577,500	--
2010	1,929,375	587,500	576,250	--
Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application, some summing required.				

Additionally, CalAm assumes that Citizens' overheads to be applied to capital projects are approximately 8% more than its own. This assumption results in an additional $11.2 million of capital costs "saved" by CalAm over the 2005-2010 timeframe.[52]

[51] Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application, some summing required.
[52] Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application, some summing required.

To test the sensitivity of these key assumptions on projected synergy savings, Overland recalculated the results with more conservative assumptions, including cost of capital savings and cost of investment savings that ranged from one-fourth to one-half of the spreads assumed by the company. Recalculations of the savings were each run independently of one another and are summarized along with the company's original calculation in the table below:

Table 6-9
California American Water
Revenue Requirement of the Acquisition Premium in Excess (Less Than) Synergy Savings

Year	Company Calculation	50% of Cost of Capital Savings	25% of Cost of Capital Savings	50% of Cost of Investment Savings	25% of Cost of Investment Savings
2005	($437,630)	$289,719	$650,574	$292,917	$657,290
2006	(1,412,867)	(582,639)	(170,645)	(333,139)	207,325
2007	(3,345,825)	(2,099,447)	(1,481,408)	(1,735,632)	(929,435)
2008	(4,894,982)	(3,522,092)	(2,824,393)	(2,879,669)	(1,872,412)
2009	(6,065,348)	(4,588,453)	(3,843,902)	(3,664,356)	(2,464,760)
2010	(7,118,903)	(5,526,749)	(4,724,092)	(4,345,372)	(2,958,006)

Note: Company calculation obtained from Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.

Even with more conservative assumptions, the calculated synergy savings over the 6-year period from 2005 to 2010 exceed the revenue requirement of the acquisition premium using the methodology previously reviewed by the Commission.

Finally, Overland considered the effect of the Commission's implicit requirement that CalAm maintain a minimum 45% equity ratio.[53] In deriving its imputed benefits for the Citizen's districts, CalAm has continued to use a 35% equity ratio. While substitution of a 45% equity ratio does reduce the implied synergy savings, it does not eliminate them.

Comparative Analysis. Attachment 6 provides a comparative income statement for CalAm. Operation and maintenance expenses have risen by approximately 38% over the five-year period 2003-2007, while inflation during this period was approximately 13% and 16%, as measured by the CPI and PPI price indices, respectively.

Table 6-10
California American Water
O&M Expense per Customer

Year	O&M Expense (A)	Number of Customers (B)	O&M Expense per Customer (C)
2003	$67,374,280	167,834	$401
2004	72,859,724	170,195	428
2005	88,863,117	169,358	525
2006	85,318,015	169,475	503
2007	93,013,029	169,196	550

Sources: Column (A) – Response to OC-35, Column (B) – 2003-2006 obtained from Exhibit B: Chapter 9: Section 1: Table 6 of the CalAm General Office Application and 2007 was obtained from the response to OC-90, Column (C) = Column (A) divided by Column (B).

[53] Decision 07-05-031 dated May 3, 2007, Appendix A, Condition 9. CalAm is required to maintain a 45-55% equity ratio.

During this period, customer rates were modified as follows:

Table 6-11 California American Water Rate Modifications Monterey					
Date Filed	Effective Date	General Rate Case Amount	General Rate Case Percent	Riders Amount	Subject Matter
2/1/2003	2/23/2003	$2,642,100	10.36%		GRC Rates
3/14/2003	6/10/2003			$849,314	Recovery of WRAM Balancing Account
6/25/2003				$1,122,653	Recovery of Conservation Balancing Account
4/27/2004	11/24/2004			-$458,383	WRAM Balancing Account - Refund over collection
11/10/2004	1/6/2005	$948,400	3.3%		Step Rate Increase
5/11/2005		$710,302	2.44%		Recovery of Plan B - Surcharge
4/4/2006	5/5/2006			-$3,429,045	Refund over collection in WRAM account
12/20/2006	1/1/2007			$2,993,260	Surcharge - Coastal Water Project
3/2/2007	4/6/2007			$3,023,971	True up interim rates per D.06-11-050 --Surcharge
11/16/2007	1/1/2008	$752,700	2.30%		Step Rate Increase - 2008
5/15/2008	5/8/2008			-$3,116,173	WRAM Balancing Account - Refund over collection
Source: Response to OC-157					

Sale of Felton Properties

CalAm has entered into an agreement to sell the Felton water properties to the San Lorenzo Valley Water District for $10.5 million in cash, and assume $2.9 million in debt for the Kirby Street water treatment plant secured by state loans. As part of the transaction, CalAm will also donate 250 acres of forested watershed land.[54] In order to address matters of potential relevance to the Commission associated with this transaction, Overland issued discovery to gain more detailed information than contained in the Settlement Agreement itself.[55] However, given the refusal of CalAm to produce information needed to provide the Commission with an analysis necessary to consider the potential implications of the sale on CalAm customer rates, we must confine the discussion to the application of Commission policy, supplemented with hypothetical estimates.

CPUC Policy Regarding the Treatment of Gains from the Sale of Utility Assets. The Commission has addressed its policy regarding the treatment of gains or losses from the sale of property in a number of cases. The following is a brief summary of these decisions, and their applicability to the specific facts associated with the sale of the Felton assets.

In R.04-09-003, the Commission Order dated September 2, 2004, established guidelines for recognition and allocation of gains on the sale of public utility property. It considered these guidelines based on various objectives including:[56]

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[54] Response to OC-149; Settlement Agreement (After Mediation) dated May 27, 2008.
[55] CalAm refused to provide detailed information regarding the property valuation, or accounting and tax implications of the sale of the Felton properties as contained in : OC-151, 152, and 155, issued July 15, 2008.
[56] R.04-09-003, pages 4-5.

- These guidelines should apply to the allocation of both gains and losses upon the sale of a capital asset.
- The allocation should vary directly, holding everything else constant, with the assumption of the financial risk of the investment.
- While it is important to ensure that ratepayers are not harmed by the sale of the asset, or that they are compensated if they are, it is equally important to recognize who has borne the burden of the financial risk of the investment.
- For the majority of cases, ratepayers have borne most of the financial risk and have paid for the asset. Thus it will be typical for most of the gain to be allocated to the ratepayer. The burden of the financial risk should be a primary consideration whenever the gain is allocated between ratepayer and shareholder.
- The allocation of the gain on sale standards should provide an incentive to encourage prudent management of utility assets.

The Rulemaking references provisions of the Utility Code specific to the treatment of gains of water utility assets.[57]

> In 1995, Pub. Util. Code §§ 789 *et seq.* was enacted, which provides that a water corporation shall invest the "net proceeds" of the sale of real property in water system infrastructure that is necessary or useful for utility service. This rule effectively allocates the entire gain from the sale of an asset to shareholders if it is reinvested toward a public purpose. The gain is added to the utility's ratebase on which the shareholders earn a rate of return through rates paid by the ratepayers.

The Rulemaking also references decisions regarding the sale of a portion of a distribution system to a municipality – specifically, a segment of the PG&E distribution properties to the City of Redding. In D.85-11-018, the Commission originally found that the gain from sale of the distribution assets were assignable to ratepayers based upon recognition of relative risk. However, this policy was reversed in a subsequent Decision that has come to be referred to as "Redding II", summarized by the Commission in the Rulemaking as follows.[58]

> The result obtained in D.85-011-018 was essentially reversed in D.89-07-016. We used two standards to allocate the gain: 1) whether the ratepayers were harmed by the transaction leading to the gain, and 2) whether ratepayers had contributed capital to the acquisition of the asset. We stressed that these standards applied to the particular circumstances of this sale only.(9) We concluded that, under these standards, the gain should be allocated to the shareholders. ***If either of these standards had not been met, the gain could have been used to mitigate the harm to ratepayers or repay their contributed capital...*** (emphasis added)

[57] Ibid; page 7.

[58] R.04-09-003, page 21. Within the above quote, the referenced footnote stated: "sale of part of a public utility distribution system to a public entity which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system."

The Rulemaking recognized potential implications of the Water Utility Infrastructure Improvement Act of 1995, Public Utilities Code §§ 789 *et seq.*, including consideration of the sale of property no longer used or useful in providing water utility service. The Code provided for the potential retention of such gains, with a requirement for utility reinvestment in utility property. The Commission was concerned with the potential applicability of Code §§ 789 and § 790, stating various reasons, including the following.[59] [60]

> We also believe the statute may require further interpretation regarding water utility assets originally obtained from sources other than the utility shareholders.

Aside from the specific conditions referenced above for sales of distributions systems and Code guidelines for water property sales, the Commission addressed general guidelines for the allocation of gains that included.[61]

- The Allocation should vary directly, holding everything else constant, with the assumption of the financial risk of the investment.
- While it is important to ensure that ratepayers are not harmed by the sale of the asset, or that they are compensated if they are, it is equally important to recognize who has borne the burden of the financial risk of the investment.
- For the majority of cases, ratepayers have borne most of the financial risk and have paid for the asset. Thus it will be typical for most of the gain to be allocated to the ratepayer. The burden of the financial risk should be a primary consideration whenever the gain is allocated between ratepayer and shareholder.

In an effort to provide a general standard for the treatment of utility gains and losses, the Commission issued Decision 06-05-041, dated May 25, 2006. The general rules provided by this Decision are to apply if the sale price is $50 million or less and the after-tax gain or loss is $10 million or less. The Commission found that, unless there was an exception from the general rule established in the Decision, that ratepayers should receive 100% of gains from the sale of depreciable property.[62] This Decision continued to uphold its Redding II ratepayer harm test, stating:[63]

[59] Ibid; pages 26-31. See also Finding 39 at page 51.

[60] In D.07-09-021, dated September 6, 2007, Opinion Regarding Gains on Sale of Utility Assets (Phase Two) – Issues Not Resolved in Decision 06-05-041, the Commission clarified its position on certain matters previously left open. Among other things, it addressed the treatment of gains due to the condemnation of water utility assets, wherein it concluded that such transactions are no different in character than other sales of property that are no longer used or useful under Section 790 (pages 24-27).

[61] Ibid; pages 39-40.

[62] D.06-05-041, pages 2-3. At page 96, the Commission found that ratepayers should receive 50% of gains or losses on the sale of non-depreciable utility assets. This was subsequently modified in D.06-12-043 (page 16), to provide for an allocation of 67% of gains to ratepayers for non-depreciable assets.

[63] Ibid; page 32. The Commission's position on Redding II was reaffirmed in D-06-043, dated December 14, 2006, page 15.

> We will continue to apply the *Redding II* principles in the narrow circumstances to which they were designed to apply. Thus, where (1) a public utility sells a distribution system to a governmental entity, (2) the distribution system consists of part or all of the utility operating system located within a geographically defined area, (3) the components of the system are or have been included in the rate base of the utility, and (4) the sale of the system is concurrent with the utility being relieved of, and the governmental entity assuming, the public utility obligations to the customers within the area served by the system, then the gains or losses from the sale of the system should be allocated to utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and remaining ratepayers are not adversely affected by the transfer of the system. We have not been presented with an adequate record to justify broadening or narrowing *Redding II's* scope.

While the general application of the current Commission policy for the allocation of gains from the sale of a utility operating system would indicate an allocation to shareholders, we believe that the specific facts and circumstances of the Felton transaction, upon its review, should lead the Commission to consider otherwise. These properties were a component of the assets acquired by CalAm in 2002. As previously addressed, the CPUC granted the recovery in customer rates of a $64.5 million premium associated with the Citizens assets, including the Felton district. No independent study or internal analysis was performed to identify the fair value of the Citizens properties acquired, or the specific values of particular districts.[64] For ratemaking purposes, CalAm has allocated the acquisition premium to Citizens districts on the basis of customers. This implicitly assumes that the relationship of fair value (the purchase price of the Citizens properties) to the underlying book value is uniform among the districts acquired. However, there is no reason to believe that this would be the case. Further, present market conditions have eroded relative to the timeframe in which the Citizens acquisition occurred. Thus, the market value of the Felton properties can reasonably be assumed to have been higher at the time they were acquired by CalAm than is indicated by the recent transaction.

Consistent with existing precedent, Felton customers are likely to pay rates that reflect the acquisition costs of the water assets acquired. However, unless the Commission reduces the Citizens acquisition premium by the gain on the sale of the Felton properties, the unintended consequence will be the ongoing recovery of most of the fair value over book value of the Felton properties in the CalAm customer rates.

Findings and Conclusions. In its Monterey filing now pending, CalAm witness David Stephenson addresses the company's request to cease any future requirement to support the level of synergy savings relative to acquisition costs in rates.[65] The analysis performed by CalAm generally conforms to the methodology agreed upon and approved in previous proceedings. Overland has tested the CalAm results filed in the current Monterey application, and has found that positive results are realized, even under much

[64] Response to OC-101.
[65] Direct Testimony of David P. Stephenson, pages 28-30.

more conservative assumptions. As more time elapses from the time of the CalAm acquisition of these properties, the application of any methodology becomes more difficult to use as a reliable estimate, as such estimates must be based upon a hypothetical case that assumes a theoretical conditions under a continued Citizens ownership and operation of the properties. For these reasons, we concur that CalAm need not be required to impute synergy benefits to support its acquisition premium in future cases.

With regard to the gain from the sale of the Felton properties, we believe that the facts and circumstances associated with this transaction, in light of the acquisition premium in current CalAm rates that are potentially attributable to these properties, now warrants further Commission scrutiny. We believe that the gain on these properties may be in the range of $5-6 million.[66] It is clear that the Commission reserves the right of review for the disposition of utility property; particularly in case-specific circumstances where its general policy may not apply. Given our previous discussion on this subject, it may be appropriate to reduce the current acquisition premium by the gain realized in the Felton transaction. However, without more detailed information, we cannot make any final recommendations at this time.

[66] The Company has refused to produce specific information that would provide details regarding to actual gain on the Felton transaction. General market indicators support a market-to-book ratio of about 2x. However, actual transaction data may vary materially from this general assumption.

APPENDIX A

ADOPTED
CALIFORNIA-AMERICAN WATER COMPANY
CONDITIONS ON TRANSFER OF INDIRECT CONTROL

1. California-American Water Company (Cal-Am) will be provided with adequate capital from American Water Works Company, Inc. (American Water) to fulfill all of its service obligations prescribed by the Commission and Cal-Am.

2. American Water and Cal-Am shall ensure the transaction will not result in any adverse changes in Cal-Am policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations.

3. American Water and Cal-Am will ensure that there is no adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction.

4. Cal-Am will continue to maintain its business headquarters in California together with field offices as appropriate to maintain the quality of service. Cal-Am will not close any of its local offices as a result of his transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transactions or which would have occurred absent the transaction.

5. The transaction will have no adverse impact on Cal-Am employees and there will be no changes in any existing union agreements as a result of the transaction. All collective bargaining agreements will continue to be honored.

6. Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction.

7. American Water and American Water Capital Corporation (AWCC) will notify the Commission in writing within 30 days of public notification to American Water or AWCC of any downgrading to the bonds of American Water or AWCC and will include with such notice the complete report from the issuing bonding rating agency.

8. American Water will make no attempt to recover through Cal-Am's rates any of the transaction costs arising from the divestiture by RWE Aktiengesellschaft (RWE) and Thames Water Aqua Holdings GmbH (Thames GmbH) of American Water, including the Securities and Exchange registration fee, the National Association of Securities Dealer filing fee, the stock exchange listing fee, legal fees and costs of the proposed transaction, accounting fees and expenses of the proposed transaction, printing and engraving fees and expenses for the registration statement, Blue Sky fees and expenses, transfer agent fees and expenses, legal fees for the state regulatory approval process, and the costs of implementing the initial process and controls for compliance with the Sarbanes-Oxley Act of 2002. Cal-Am will not at any time seek to recover from its ratepayers costs directly incurred as a result of the proposed transaction from ratepayers of Cal-Am; however, Cal-Am may seek recovery of legitimate ongoing, non-startup costs of being a publicly traded company in future general rate proceedings.

9. RWE will provide an equity investment to American Water at the time of the proposed initial public offering to ensure that American Water has a capital structure in the range of 45% to 55%, with a minimum of 45% common equity.

10. All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. Additionally, the Affiliate Transaction Rules that were agreed to as part of the Settlement Conditions in Decision

(D.) 02-12-068 will continue. The references to RWE and RWE Group will be removed once RWE no longer has a 10% controlling interest in American Water.

11. None of the acquisition conditions from D.02-12-068 should be removed until RWE (or its subsidiaries or affiliates) has sold more than 90% of its interest in American Water. Where RWE and its affiliates cumulatively have more than 10% but less than 50% interest in American Water and find themselves in a minority position and unable to comply with any of the conditions set forth in Appendix C, Cal-Am should file an application explaining why RWE or its subsidiaries cannot comply with the condition and request an exemption from the condition.

(END OF APPENDIX A)

APPENDIX C

APPLICATION NO: A.06-05-025

JOINT APPLICANTS: RWE AKTIENGESELLSCHAFT, THAMES WATER AQUA HOLDINGS GMBH, AMERICAN WATER WORKS COMPANY, INC., CALIFORNIA-AMERICAN WATER COMPANY

LATE-FILED EXHIBIT __

CONDITIONS IMPOSED IN D.02-12-068

Number[1]	CONDITION IMPOSED IN D. 02-12-068 PURSUANT TO SETTLEMENT AGREEMENT	JOINT APPLICANTS' PROPOSED REMOVAL OF OR MODIFICATION TO CONDITION	ANALOGOUS CONDITION PROPOSED BY DRA IN THIS PROCEEDING
1	Cal-Am agrees to the following: Monterey: defer filing the authorized 2004 step rate increase that would have been filed in 2003 to November 2004 to be effective January 2005. Sacramento, Felton, Montara and Larkfield: defer filing the authorized 2004 step rate increase that would have been filed in 2003 to November 2004 to be effective January 2005. Los Angeles (San Marino, Duarte and Baldwin Hills): file general rate case as scheduled in 2003 but set forth in the application that Cal-Am will defer filing the tariffs authorizing rate increases from January 1, 2004 to January 1, 2005. This deferral will not apply to any step rates. Village & Coronado: file	Fully executed; not applicable going forward. See endnote.	Proposed Condition No. 15.

[1] The number of each condition refers to each condition as numbered in Appendix B to D. 02-12-068 entitled "Settlement Agreement With Conditions."

	general rate case as scheduled in 2004 but set forth in the application that Cal-Am will defer filing the tariffs authorizing rate increases from January 1, 2005 to January 1, 2006. This deferral will not apply to any step rates. Any such deferred rates will be placed into effect at the same time as the next scheduled step rate for each such district.		
2	Cal-Am will be provided with adequate capital to fulfill all of its service obligations prescribed by the Commission and Cal-Am will comply with all applicable California and federal statutes, laws and administrative regulations.	Cal-Am will be provided with adequate capital from American Water to fulfill all of its service obligations prescribed by the Commission and Cal-Am. (Condition No. 1)	Proposed Condition No. 1
3	The Commission will retain jurisdiction over the rates and services provided by Cal-Am. RWE, Thames, American and Cal-Am will not assert in any Commission proceeding that Commission review of the reasonableness of any cost has been or is preempted by a United Kingdom, Federal Republic of Germany, European Community or other foreign regulator.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
4	Cal-Am will continue to maintain its books and records in accordance with all Commission rules. Cal-Am's books and records will be maintained and housed in California.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
5	The transaction will not result in any adverse changes in Cal-Am policies with respect to service to customers, employees, operations,	American Water and Cal-Am shall ensure the transaction will not result in any adverse changes in Cal-Am policies with respect to	Proposed Condition No. 2

	financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest or utility operations.	service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations. (Condition No. 2)	
6	There will no adverse impact on customer service as a result of the transaction. RWE and Thames will maintain American's and Cal-Am's levels of commitment to high quality utility service and will fully support maintaining Cal-Am's record for service quality.	American Water and Cal-Am will ensure that there is no adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction. (Condition No. 3)	Proposed Condition No. 3.
7	Cal-Am shall continue to maintain its business headquarters in California together with fully operational field offices as appropriate to maintain the quality of its service. Cal-Am will not close any of its local offices as a result of this transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transactions.	Cal-Am will continue to maintain its business headquarters in California together with full operational field offices as appropriate to maintain the quality of its service. Cal-Am will not close any of its local offices as a result of this transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transaction **or which would have occurred absent the transaction.** (Condition No. 4)	Proposed Condition No. 4.
8	The transaction will not result in changes to the existing management and officers of Cal-Am.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
9	Operational control of Cal-Am will not change as a result of the transaction.	Covered by Condition No. 4. No longer warranted; condition should be removed.	Not addressed in DRA Report.
10	The transaction will have no adverse impact	The transaction will have no adverse impact on	Proposed Condition No. 5.

	on Cal-Am employees. Thames has committed to no layoffs until March 31, 2004 or one year after the transaction closes, whichever is later. There will be no changes in compensation and the value of employee benefits will not diminish as a result of the transaction.	Cal-Am employees and there will be no changes in any existing union agreements as a result of the transaction. All collective bargaining agreements will continue to be honored. (Condition No. 5)	
11	There will be no changes in any existing union agreement as a result of the transaction. All collective bargaining agreements will be honored.	Covered by Condition No. 5.	Proposed Condition No. 5.
12	Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction.	Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction. (Condition No. 6)	Proposed Condition No. 6.
13	There will not be an additional layer of management overhead allocated to Cal-Am as a result of the transaction. Cal-Am may, however, demonstrate in a rate proceeding that specific management overheads provide a benefit to Cal-Am or its customers and should be recoverable in rates.	No longer warranted; condition should be removed. See endnote.	Not addressed in DRA Report.
14	None of the outstanding debt, owed and recorded as liabilities on the books of Cal-Am, will be affected by the proposed transaction. There will be no changes in the income statement, balance sheet or financial position of Cal-Am as a result of the transaction.	No longer warranted; condition should be removed. See endnote.	Not addressed in DRA Report.

15	Cal-Am's equity to capital ratio shall be maintained at or about 35 percent. If Cal-Am's common equity falls below 35 percent of total capital, Cal-Am shall within 30 days of such event provide a detailed written plan of action to return Cal-Am's equity capital to a minimum of 35 percent. In general rate cases the Commission has historically authorized a capital structure for Cal-Am composed of approximately 55-60% debt and 40-45% equity. Cal-Am shall not be prohibited from requesting that the foregoing equity percentage be modified based on changes in capital markets or other conditions that make it prudent to alter Cal-Am's capital structure.	No longer warranted; condition should be removed. See endnote.	Not addressed in DRA Report.
16	RWE and American Water Capital Corporation (AWCC) will notify the Commission in writing within 30 days of any downgrading to the bonds of RWE or AWCC and will include with such notice the complete report of the issuing bonding rating agency.	American Water and American Water Capital Corporation will notify the Commission in writing within 30 days <u>**of public notification to American Water or AWCC**</u> of any downgrading to the bonds of American Water or AWCC and will include with such notice the complete report of the issuing bonding rating agency. (Condition No. 7)	Proposed Condition No. 7.
17	Neither Cal-Am nor its ratepayers, directly or indirectly, will incur any transaction costs or other liabilities or obligations arising from Thames' and RWE's acquisition of American. All costs of the transaction will be absorbed by the shareholders with no attempt to seek recovery from ratepayers at any time. Cal-Am will not incur any additional indebtedness, issue any additional securities, or pledge any	<u>**American Water will make no attempt to recover through California American Water's rates any of the transaction costs arising from the divestiture by RWE and Thames GmbH of American Water, including the SEC registration fee, the NASD filing fee, the stock exchange listing fee, legal fees and costs of the Proposed Transaction, accounting fees and expenses of the Proposed**</u>	Proposed Condition No. 8.

	assets to finance any part of the purchase price paid by Thames for American stock.	**Transaction, printing and engraving fees and expenses for the registration statement, Blue Sky fees and expenses, transfer agent fees and expenses, legal fees for the state regulatory approval process, and the costs of implementing the initial processes and controls for compliance with the Sarbanes-Oxley Act of 2002. California American Water will not at any time seek to recover from its ratepayers costs directly incurred as a result of the Proposed Transaction from ratepayers of California American Water; however, California American Water may seek recovery of legitimate ongoing, non-startup costs of being a publicly-traded company in future general rate cases.** (Condition No. 8)	
18	The premium Thames pays for American stock, as well as all transaction-related costs, including external advisors, early termination costs, change in control payments, or retention bonuses paid to Cal-Am or American employees as a result of the proposed transaction, will not be "pushed down" to Cal-Am, and there will be no attempt to recover such costs in any future rate proceeding.	Covered by Condition No. 8, as modified by Joint Applicants.	Proposed Condition No. 8.
19	For a period of five years following the close of the transaction Cal-Am will not seek a cost of new debt greater than it would have sought if American had remained an independent entity. For the purposes of this provision, Cal-Am agrees that at present its cost of new debt	No longer warranted; condition should be removed. See endnote.	Proposed Condition No. 9.

	is based on AWCC's current Standard and Poor's credit rating of A- for secured debt and current Moody's credit rating of Baal, for senior unsecured debt.		
20	For a period sufficient to cover a single full rate cycle for each of Cal-Am's four sets of filing districts, not to exceed four years from the date of closing, RWE, Thames, American and Cal-Am will implement a mechanism to track the savings and costs resulting from the proposed merger and a methodology to allocate all net savings and will submit to the Commission in writing a detailed description of that methodology in connection with future Cal-Am general rate case filings.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
21	Cal-Am will provide the Commission with English-language versions of the RWE annual reports, RWE quarterly shareholder reports and the annual audit reports of RWE, Thames, American and Cal-Am, as applicable, either in printed media or through access to electronic versions. In addition, the income statement, balance sheet, and statement of cash flows will be converted to U.S. dollars at the exchange rates existing at the end of the time period for such excerpts or financial reports.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
22	Cal-Am will match in its future rate proceedings the cost of any "best practices" that are implemented with a reasonable estimate of the savings or increased revenues that will result from the implementation of such practices and will not implement the	No longer warranted; condition should be removed.	Not addressed in DRA Report.

	practices if the increased revenues or decreased expenses do not justifiably exceed the cost of such practices. When implementing best practices, RWE, Thames, American and Cal-Am will take into full consideration the related impacts on the levels of customer service and customer satisfaction, including any negative impacts resulting from any future work force reductions.		
23	Thames will commit shareholder funds up to $50,000 annually for a five-year period from the close of the transaction to develop, promote or otherwise get a low-income assistance program underway in cooperation with the Commission. Cal-Am will not seek recovery of those contributions to a low-income assistance program from ratepayers. Applicants shall spend the fully allocated annual sum for this program even if the funds are not expended during the five-year period.	No longer warranted; California American Water will honor its existing commitment.	Proposed Condition No. 16.
24	Thames will commit shareholder funds up to $50,000 annually for a five-year period from the close of the transaction to establish in cooperation with the Commission a Small System Technical Advisory Team (SSTAT) by Cal-Am within six months of the close of the transaction. Cal-Am will not seek recovery of those contributions for a SSTAT from ratepayers. Applicants shall spend the fully allocated annual sum for this program even if the funds are not expended during the five-year period.	No longer warranted; California American Water will honor its existing commitment.	Proposed Condition No. 17.

25	The Commission has approved Cal-Am's agreements with affiliates American Water Works Service Company and American Water Capital Corp. All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. The Affiliated Transaction Rules attached as Appendix A shall apply to Cal-Am affiliated transactions not now covered by existing Commission-approved affiliated transactions.	All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. Additionally, the Affiliated Transaction Rules that were agreed to as part of the Settlement Conditions in D.02-12-068 will continue. The reference<u>s</u> to RWE and RWE Group will be removed once RWE no longer has **<u>a</u>** controlling interest in American Water. (Condition No. 12)	Proposed Condition No. 12.
26	Historically, Cal-Am has transferred on a quarterly basis approximately 75% of its net income to its parent, American Water Works Company, Inc., as a dividend. If Cal-Am's payment of any dividend or transfer of any funds to American represents more than the historical percentage of Cal-Am's annual net income, then Cal-Am will notify the Commission of that fact.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
27	Cal-Am's parent and affiliates will not acquire Cal-Am assets at any price if such transfer of assets would impair the utility's ability to fulfill its obligation to serve or to operate in a prudent and efficient manner.	No longer warranted; condition should be removed. Also covered by Condition No. 12, as modified by Joint Applicants.	Not addressed in DRA Report.
28	The creation of Thames Water Aqua U.S. Holdings, Inc., by RWE will have no adverse impact on Cal-Am from an operating, financial or management perspective.	No longer warranted; part of a complete agreement between parties to a different proceeding; condition should be removed.	Not addressed in DRA Report.
29	Cal-Am will seek to employ Thames' advanced project delivery experience to compliment American's capability. Based on	No longer warranted; part of a complete agreement between parties to a different proceeding; condition should be removed.	Not addressed in DRA Report.

	Cal-Am's forecasted capital expenditures for a full rate cycle for Cal-Am's filing districts, Applicants believe such savings would reduce its capital expenditure requirements by about $2.2 million.		

ENDNOTE: The continuation of Condition Nos. 1, 13, 14, 15 raise issues that are more appropriately addressed in general rate case proceedings and would assure a financially weakened American Water and California American Water, directly contrary to the public interest.

(END OF APPENDIX C)

Water Quality Results 2003-2007
California American Water Company
Monterey

Substance:	Gross Alpha Par icle Activity (pCi/L)		Combined Radium (pCi/L)		Uranium (pCi/L) (1)		Arsenic (ppb)		Fluoride (ppm)		Nitrate as NO3 (ppm)		Selenium (ppb)	
Reporting year	MCL	Average Amount Detected	MCL	Average Amount Detected	MCL	Average Amount Detected	MCL (2)	Average Amount Detected	MCL	Average Amount Detected	MCL (3)	Average Amount Detected	MCL	Average Amount Detected
2003	15	3.44	5	1.53	NR	NR	50	ND	2	0 22	45	17	50	7
2004	15	3.44	5	1.53	NR	NR	50	ND	2	0 23	45	4.8	50	5
2005	15	3.44	5	1.53	NR	NR	50	ND	2	0 20	45	2.04	50	ND
2006	15	1.18	5	ND	20	ND	10	ND	2	0 20	45	21.4	50	ND
2007	15	0.95	5	<1.0	20	0.79	50	10	2	0 26	45	16	50	20

	Total Trihalomethanes (TTHM) (ppb)		Halocetic Acids (ppb)		Chlorine (ppm)		Copper (ppm)		Lead (ppb)		Total Coliform Bacteria	
	MCL (5)	Results	MCL	Results	MRDL as Cl2	Results	Action Level	Amount Detected at 90th %ile	Action Level	Amount Detected at 90th %ile	MCL	Highest Percentage Detected
2003	80	36.5	60	18.1	4.0	1.58	1.3	0.364	15	2	NR	NR
2004	100	31.5	60	14.4	4.0	1.45	1.3	0.364	15	0.002	NR	NR
2005	100	33	60	18.7	4.0	1.37	1.3	0.364	15	0.002	(4)	0.57
2006	100	36.6	60	16.4	4.0	1.18	1.3	0.618	15	5	(4)	0.57
2007	100	34	60	14	4.0	1.09	1.3	0.364	15	0.002	(4)	0.57

MCL = Maximum contaminant level, unless otherwise noted, is based on U.S. Envrionmental Protection Agency standards

MRDL = Maximum residual disinfectant level. The level of disinfectant added for water treatment that may not be exceeded at the consumer's tap.

NR = Not included in report for hat year

ND = Not detected

pCi/L (picocuries per liter) Measurement of the natural rate of disintegration of radioac ive contaminants in water (also beta particles).

ppb = parts per billion

ppm = parts per million

1 - In California the MCL for Uranium is reported as pCi/L. MCL per the U.S. EPA is 30 mcg/L (micrograms/liter). The conversion factor used is 0.67pCi/mcg

2 - Effective 1/23/06 the U.S. EPA MCL for Arsenic is 0.010mg/L (10 ppb.) At the time of reporting, the state of California MCL remained at 0.050mg/L (50 ppb), and he new standard had not yet been adopted.

3 - Reported MCL standard of 45 milligrams per liter (mg/L) for nitrate as NO3 is equivalent to U.S. EPA standard of 10 mg/L for nitrate as N.

4 - MCL for Total Coliform Bacteria (systems that collect 40 or more samples/month) more than 5%of mon hly samples are posi ive; (systems that collect less han 40 samples/month), no more than 1 positive monthly sample.

5 - Standard MCL for TTHM is 80ppb for both California as of 6/17/06 and he U.S. EPA as of 1/1/02. 100ppb is listed on reports.

California American Water Company
Capital Expenditures

	2003	2004	2005	2006	2007	Cumulative
Los Angeles (LA)	3,293,847	3,227,836	4,844,127	2,546,565	4,513,360	18,425,735
Coronado (COR)	198,778	407,746	1,310,109	849,092	1,362,768	4,128,493
Corporate (CORP)	340,971	802,269	724,485	91,552	139,151	2,098,428
Felton (FEL)	347,740	576,679	159,438	179,850	(36,314)	1,227,393
Ventura (VEN)	348,147	2,530,619	4,083,831	(103,665)	6,136,376	12,995,307
Larkfield	742,379	1,490,984	697,638	1,507,734	1,002,470	5,441,205
Monterey	11,002,394	19,941,978	14,108,026	16,262,275	(6,646,826)	54,667,846
Monterey Wastewater	-	-	-	-	303,913	303,913
Sacramento	7,298,391	10,676,884	14,964,630	20,071,493	21,285,386	74,296,785
Total	23,572,647	39,654,994	40,892,283	41,404,896	28,060,283	173,585,104

Source: Annual district amounts obtained from response to OC-33

California American Water Company
Dividend Pay-Out Percentage

	2002	2003	2004	2005	2006	2007	Cumulative
Current Year Dividends Paid	3,135,000	2,223,000	2,712,000	124,000	-	1,295,000	9,489,000
Current Year Net Income	2,990,000	5,037,000	2,287,000	(2,948,000)	1,300,000	467,000	9,133,000
Calculated Dividend Pay-Out Percentage	104.85%	44.13%	118.58%	-4.21%	0.00%	277.30%	103.90%
Current Year Dividends Paid		2,223,000	2,712,000	124,000	-	1,295,000	6,354,000
Prior Year Net Income		2,990,000	5,037,000	2,287,000	(2,948,000)	1,300,000	8,666,000
Calculated Dividend Pay-Out Percentage		74.35%	53.84%	5.42%	0.00%	99.62%	73.32%

Source: OC-41 (Statement of Cash Flows)
Note: Per response to OC-41, the target dividend is 75% of net income (based on the 12-month period ending September 30).

California American Water Company
Total Company (USGAAP)

	2003	2004	2005	2006	2007
Operating Revenues:					
Water	$ 97,898,064	$ 105,940,003	$ 105,033,354	$ 111,951,155	$ 120,249,411
Sewer	707,729	1,057,829	1,349,671	1,503,249	1,497,278
O her	918,999	(918,171)	4,878,976	1,248,823	2,609,553
Management	-	-	-	-	-
Total Operating Revenues	99,524,792	106,079,661	111,262,001	114,703,227	124,356,242
Operations & Maintenance Expense:					
Labor	10,589,142	10,760,963	11,671,181	12,137,754	14,098,643
Purchased Water	21,605,540	23,510,403	26,509,958	25,071,352	28,968,935
Fuel & Power	7,431,125	7,165,316	6,616,676	7,126,701	7,099,617
Chemicals	512,963	601,823	879,088	981,409	1,035,911
Waste Disposal	105,360	117,721	112,259	196,473	122,983
Management Fees	7,494,011	10,766,933	10,992,827	12,684,501	13,474,583
Group Insurance	2,278,341	2,327,026	2,634,070	2,646,494	2,632,620
Pensions	580,607	296,440	553,702	1,639,979	1,485,299
Regulatory Expense	1,448,085	1,875,379	3,880,168	2,807,756	2,718,457
Insurance O her Than Group	2,413,041	2,370,882	1,551,546	1,591,407	1,850,367
Customer Accounting	1,202,537	1,036,228	1,179,627	1,490,587	1,690,133
Rents	941,414	965,869	977,591	1,053,652	1,137,661
General Office Expense	816,371	971,367	1,717,503	1,337,970	1,309,152
Miscellaneous	7,141,874	7,239,503	14,067,436	8,828,366	8,378,523
O her Maintenance	2,813,869	2,853,871	5,519,485	5,723,614	7,010,145
Total Operations & Maintenance Exp	67,374,280	72,859,724	88,863,117	85,318,015	93,013,029
Depreciation	12,155,971	13,723,178	12,878,721	12,741,664	12,995,245
Amortiza ion	554,787	1,275,715	343,666	881,091	335,667
General Taxes	3,667,976	3,982,197	4,018,651	4,300,432	4,653,621
State Income Taxes	517,067	393,204	(271,755)	(260,856)	(2,457,146)
Federal Income Taxes	1,878,116	1,211,398	(2,437,605)	(174,096)	(7,166,115)
Tax Savings Acquisition Adjustment	7,560	7,560	-	-	-
Total Operating Expenses	86,155,757	93,452,976	103,394,795	102,806,250	101,374,301
Utility Opera ing Income	13,369,035	12,626,685	7,867,206	11,896,977	22,981,941
Other Income & Deductions:					
Non-Operating Rental Income	162,368	119,925	172,740	202,713	244,073
Dividend Income - Common	-	-	-	-	-
Dividend Income - Preferred	-	-	-	-	-
Interest Income	175,933	117,609	364,570	251,790	1,947,363
AFUDC Equity	228,989	101,453	-	295,885	-
M&J Miscellaneous Income	1,522,131	138,391	696,012	8,788	(125,288)
Gain (Loss) on Disposition	2,123,991	1,644,988	416,871	369,479	-
Total Other Income	4,213,412	2,122,366	1,650,193	1,128,655	2,066,148
Miscellaneous Amortization	159,376	122,331	32,408	13,708	13,708
Tax Savings Acqusition Adjustment	(7,560)	(7,560)	-	-	-
Misc Other Deductions	191,768	343,027	890,625	(1,739,677)	258,130
General Taxes	7,830	-	-	-	-
State Income Taxes	318,409	121,519	93,365	233,732	2,444,576
Federal Income Taxes	840,875	481,127	369,656	925,409	6,973,622
Total Other Deductions	1,510,698	1,060,444	1,386,054	(566,828)	9,690,036
Total Other Income	2,702,714	1,061,922	264,139	1,695,483	(7,623,888)
Income Before Interest Charges	16,071,749	13,688,607	8,131,345	13,592,460	15,358,053
Interest Charges:					
Interest on Long-Term Debt	11,144,696	10,228,946	10,225,230	10,379,147	12,814,321
Amortiza ion and Debt Expense	83,276	59,142	59,734	94,619	78,106
Interest - Short Term Bank Debt	30,810	3,732	595,690	1,597,206	1,625,398
Other Interest Expense	(10,752)	15,358	210,817	310,042	368,433
AFUDC - Debt	(212,889)	57,707	(12,613)	(87,482)	4,987
Total Interest Charges	11,035,141	10,364,885	11,078,858	12,293,532	14,891,245
NET INCOME	$ 5,036,608	$ 3,323,722	$ (2,947,513)	$ 1,298,928	$ 466,808

Source: OC-36

7. Rate Case Expense

CalAm's requested rate case expense is separate from the General Office revenue requirement, and discussed by DRA in its testimony of August 21, 2008. Overland Consulting provides additional analysis of rate case expense in this chapter. Rate case expense includes CalAm's request to recover the expenses associated with the General Office and district-level filings in the current General Rate Case (GRC) cycle.

CalAm estimates it will incur $3,197,747 of costs to prepare, file, and prosecute these present rate case applications. A portion of this total is "applicable to California American Water's other districts." The company proposes to defer these particular costs ($460,720) until such time as these districts file their rate cases.[1] The remainder, $2,737,028, is the amount CalAm proposes to recover for its Monterey and General Office rate filing. CalAm proposes to amortize the costs over a 3-year period, resulting in an annual amortization of $912,343.

Overland calculated several key metrics concerning rate case expense that are summarized in Table 7-1.

Included in this analysis are two recent California proceedings, the Los Angeles rate case (A.06-01-005) and the Coronado, Village, Sacramento, and Larkfield rate cases (A.07-01-036). According to the company, it has incurred to date $1,065,027 and $1,165,821, respectively, on these two cases.[2]

Table 7-1
California American Water
Rate Case Expense Metrics from Recent Filings

Description	No. of Cases w/ Available Info (A)	Average	Weighted Average	Median	Average Excluding Largest Customer Bases (B)
Rate Case Expense Requested per Customer	33 (27)	$11.20	$4.10	$7.59	$13.11
Rate Case Expense Approved per Customer	20 (16)	$9.39	$3.43	$6.15	$11.22
Rate Case Expense Requested as a % of Revenue	31 (26)	1.73%	0.65%	1.15%	1.97%
Rate Case Expense Approved as a % of Revenue	20 (16)	1.54%	0.54%	1.23%	1.83%

Sources: Derived from responses to OC-105 and OC-121.

(A) The first number presented in this column is the total number of cases used to calculate the Average, Weighted Average, and Median. The second number in parentheses is the total number of cases used to calculate the Average Excluding Largest Customer Bases.

(B) Customer bases in excess of 280,000 customers were excluded.

[1] Supplemental Direct Testimony of David P. Stephenson, p. 1.

[2] Responses to OC-54 and OC-57. CalAm cut off its analysis as of October 2007. Additional costs may have been incurred subsequently.

Based on a conservative application of the average of each of these metrics (excluding the cases with customer bases over 280,000) to CalAm's request for the Monterey proceeding, it becomes clear that the company's request of $2,737,028 is excessive:

Table 7-2
California American Water
Rate Case Expense Alternatives

Description	Average	CalAm Monterey Customers	CalAm Revenues Requested	Calculated Rate Case Expense
Rate Case Expense Requested per Customer	$13.11	42,308	N.A.	$554,658
Rate Case Expense Approved per Customer	$11.22	42,308	N.A.	$474,696
Rate Case Expense Requested as a % of Revenue	1.97%	N.A.	$58,551,000	$1,153,455
Rate Case Expense Approved as a % of Revenue	1.83%	N.A.	$58,551,000	$1,071,483

Note 1: The number of CalAm customers includes the Monterey and Monterey Wastewater districts (40,060 + 2,248) obtained from the response to OC-90).

Note 2: The CalAm revenues requested includes the cumulative amounts requested for Monterey and Monterey Wastewater districts ($55,501,000 + $3,050,000).

To put matters in perspective, CalAm has included nearly $1 million of legal fees in its current request (including the pro-rated costs associated with the cost of capital proceeding). Although legal fees are only a portion (35%) of the entire request in this case, they are nearly equivalent to the total costs incurred for each of the two California cases mentioned previously.

Employee Costs Assigned to Rate Case Expense

$298,768 of the total rate case expense of $2,737,028 requested by the company is associated with labor and related employee costs (e.g., travel). These employees work in the Cal Corp, LSC, and NSC organizations.

Because the rate case expense estimate for these costs was based on the number of hours multiplied by an hourly rate, Overland was able to determine what percentage of time CalAm had assumed each employee was going to spend on the rate case over a one-year period. The following table summarizes this information assuming a 2,080-hour year for the Cal Corp and LSC employees:

Table 7-3 California American Water Rate Case Expense Data Underlying Company Computation of "Company Labor" Component		
Employee	Total Hours	% of Year
Jordan	281	13.5%
Fulter	799	38.4%
Chew	642	30.9%
Halterman (A)	569	27.4%
Pressey	781	37.5%
Pilz	1,224	58.8%
Patacsil	201	9.7%
McCaleb	442	21.3%

Source: Response to OC-54.

Note: Includes the hours attributed to the cost of capital proceeding.

(A) Identified in OC-54 as "Suzette". Based on the other employees identified, it was determined that this was likely Suzette Halterman.

With the exception of Jordan, all of these employees are included in Cal Corp's charges to CalAm that are part of the General Office costs. Jordan is included in the LSC allocations to CalAm. According to CalAm's filing, Cal Corp labor costs are assigned to one of two categories – O&M (operating expense) or Capital Projects / Rate Cases.[3] A review of the support for the allocations between the two categories reveals the following:

Table 7-4 California American Water Selected Cal Corp Employee Allocations		
Employee	Operating Exp	Capital Exp / Rate Case
Jordan	10.0%	90.0%
Fulter	90.0%	10.0%
Chew	90.0%	10.0%
Halterman	90.0%	10.0%
Pressey	80.0%	20.0%
Pilz	0.0%	100.0%
Patacsil	89.0%	11.0%
McCaleb	80.0%	20.0%

Source: Derived from responses to OC-141, OC-142 and OC-166 and Workpapers GO-124 and GO-125.

[3] CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1C.

Chapter 7

When the information from these two tables is combined, it suggests that the time (and associated labor costs) of some Cal Corp employees was included more than once in CalAm's rate application. None of these salaried employees should have more than 100% of their time assigned.

Table 7-5
California American Water
Selected Cal Corp Employee Allocations

Employee	Rate Case Expense	Operating Expense	Total
Jordan	13.5%	10.0%	23.5%
Fulter	38.4%	90.0%	128.4%
Chew	30.9%	90.0%	120.9%
Halterman (A)	27.4%	90.0%	117.4%
Pressey	37.5%	80.0%	117.5%
Pilz	58.8%	0.0%	58.8%
Patacsil	9.7%	89.0%	98.7%
McCaleb	21.3%	80.0%	101.3%
Source: Two previous tables.			

It is possible that these employees may work on rate cases in other jurisdictions.[4] If that is the case, the preceding calculations understate the amount that may be captured more than once in company's current California rate filing and filings in other jurisdictions.

CalAm also identifies a group of Rate Department personnel from the National Service Company whose labor costs are included in deferred rate case expense. One of the employees, Rod Nevirauskas, works in a department (Business Unit 32505) which attributes none of its time to rate cases or any other non-management fee category. Even though management has budgeted an allocation of all of Mr. Nevirauskas' time to various jurisdictions, it believes that it is appropriate to charge another 405 hours to deferred rate case expense in California. Just as with the four Cal Corp employees, his labor costs ($48,309) are being requested more than once in CalAm's rate application.

In its analysis of the Cal Corp charges to CalAm, Overland has proposed an adjustment to correct the company's request for over-recovery of labor costs of its operating expenses. While the same could have been done for the National Service Company employee, Overland chose not to propose an adjustment because the resulting effect on allocations to CalAm would have been relatively insignificant. However, the company's decision to include this redundant cost lends

[4] According to CalAm, only one employee at the LSC currently spends a significant amount of time on other rate cases. In the past, other employees did also (response to OC-215). This is CalAm's explanation for its witness' statement that "direct charges to a case is the most reasonable approach, particularly when we process cases for more than one state." (Supplemental Direct Testimony of David P. Stephenson, p. 7)

credence to the Overland's finding that rate case expenses requested by the company were excessive.

Conclusion

Our analysis of CalAm's regulatory expense demonstrate that CalAm's rate case expense exceeds every one of the alternative (based on American Water filings in other jurisdictions) calculated by Overland – in some cases by over 150 percent. It is our understanding that DRA has also evaluated rate case expense and made a recommendation concerning cost recovery. Our analysis indicates that CalAm's rate case expense is excessive. We defer to DRA concerning a cost recovery recommendation.

8. District Allocation of the General Office Revenue Requirement

In the prior rate case CalAm used a customer-based allocator to distribute its National Service Company and Local Service Company expenses to the district level. In this rate filing CalAm has proposed a "four-factor" allocator based on operations and maintenance expense, plant, payroll and "connections" (an analog for customers). In direct testimony CalAm described the factors included in the four-factor allocator as "those most common cost components and cost drivers of the operating districts."[1] For the reasons below, we recommend General Office costs be allocated to California districts using a customer-based allocation, as was done in the last General Office rate filing, to distribute CalAm's General Office cost among district operations.

There is nothing unusual about a four-factor allocator. However, it is important to define what the allocator represents. Contrary to what CalAm's testimony implies, increases or decreases in Monterey O&M, plant and payroll do not "drive" equivalent changes in AW's common (allocable) service company costs.[2] The four-factor allocator is an "unattributable" allocator. Unattributable allocators distribute joint costs (costs that exist because the corporate entity exists and that cannot be assigned based on causation) using one or more measures of size. We believe CalAm's four-factor allocator is inferior to a simple customer-based allocator, which is already being used by American Water (AW) to distribute the national and some of the regional General Office costs to the state level.

Recommended District Allocation of General Office Expense

Of the asserted "cost drivers" in CalAm's four-factor allocator, the three financial components (payroll, O&M and plant) are themselves related to, and ultimately exist because of, the fourth component (customers, or connections). Although most General Office costs do not vary directly with changes in customers, at a more fundamental level *all* costs (payroll, O&M, plant, etc.) at every level (district, regional and corporate) are incurred because of customers, without which *no* costs would be incurred.

AW uses customers to allocate a majority of regulated General Office costs, including all regulated NSC costs, from the service companies to California. In requesting a four-factor method to allocate this expense to the districts, CalAm is proposing that the Commission approve one allocator (customers) to move service company costs to the California state border, and a different allocator (four-factor) to further distribute the *same* costs within the state, based on an argument that corporate and regional costs are "driven by" plant, O&M and payroll, as well as by customers. If allocable service company costs were "driven by" district-level plant, payroll and O&M, any such link between the costs and their "drivers" would be dissolved, prior to district allocation, by the customer-based allocator used to distribute them to the state level.

Overland does not believe it makes sense to distribute costs geographically to the state border using a customer-based allocator and further distribute costs to the district level using a different

[1] Testimony of Gary Paquette, p.6, lines 10-12.

[2] When Monterey causes the New Jersey-based NSC to incur a specific costs, it is (or should be) directly charged to CalAm.

allocator. CalAm was correct to use customers to allocate General Office expense to the state *and* district levels in the prior rate case, and we recommend the Commission require CalAm to use the same customer-based method for the complete (state and district) allocation in this rate filing. Our recommended district allocation factors, based on year-ending 2007 customer levels without the Felton district, are summarized below.

Table 8-1
California American Water
Overland-Recommended
District Allocation Factors
Based On 12/31/2007 District Customers

District	Customers	Allocation Pct.
Coronado	20,791	12.22%
Los Angeles (1)	27,733	16.30%
Village	21,012	12.35%
Monterey Water (2)	40,060	23.55%
Monterey Wastewater	2,248	1.32%
Felton (2)	-	0.00%
Sacramento	55,917	32.88%
Larkfield	2,353	1.38%
Total	**170,114**	**100.00%**

Source: OC-90

(1) OC-90 data does not show customers for Los Angeles. OC-90 shows customers for Baldwin Hills, Duarte & San Marion. Based on an analysis of district numbers in OC-90, these "055" districts were assumed to combine to be equivalent to Los Angeles as shown by CalAm in its rate filing.

(2) OC-90 does not show customers for Toro, Bishop, Chualar, Ralph Lane or Ambler Park. It was assumed that these combined in OC-90 under the category Monterey.

(3) 1,330 Felton customers as of 12/31/07 are removed on a pro-forma basis because of CalAm's plans to sell before the test year.

Overland's Recommended District-Level General Office Revenue Requirement

Using customer-based factors as shown above, Overland's recommended General Office revenue requirement compares with CalAm's and spreads to district operations as follows.

Table 8-2
California American Water
Test Year 2009 General Office Revenue Requirement Allocation to District Operations
Rate Base and O&M Expense

	Per CalAm		Per Overland		Overland Adjustment to CalAm
CalAm District	Pcts	Amount	Pcts	Amount	
Coronado	10.80%	1,835,857	12.22%	1,633,384	(202,472)
Los Angeles (1)	13.54%	2,301,621	16.30%	2,178,737	(122,884)
Village	13.39%	2,276,123	12.35%	1,650,761	(625,362)
Monterey Water (2)	31.81%	5,407,279	23.55%	3,147,807	(2,259,471)
Monterey Wastewater	2.28%	387,570	1.32%	176,438	(211,132)
Felton (2)	1.54%	261,780	0.00%	-	(261,780)
Sacramento	24.75%	4,207,172	32.88%	4,394,900	187,728
Larkfield	1.89%	321,275	1.38%	184,457	(136,817)
Totals	**100.00%**	**16,998,675**	**100.00%**	**13,366,485**	**(3,632,190)**

Sources: Customer Allocation Factors, Table 8-1, Total 2008 & 2009 Revenue Requirements, Table 1-1

Overland
Consulting

Audit of Affiliate Relationships and Transactions Between Atlantic City Electric and Pepco Holdings Inc. and Subsidiaries

Management Audit of Atlantic City Electric Co.

Submitted to:

New Jersey Board of Public Utilities

Submitted by:

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February 2010

Public Version – Confidential Materials Redacted

Exhibit 7-5

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Chapter 2. Overview of Affiliate Relationships and Transactions

This chapter contains an overview of PHI's organizational structure and the relationships and transactions between Atlantic City Electric Company (ACE) and its affiliates. This chapter discusses the relationship and transactions between ACE and Atlantic Southern Properties, Inc. (ASP), which owns and leases a building (Mays Landing) that houses some of ACE's administration and operations employees. This chapter also addresses the New Jersey activities of Pepco Energy Services, Inc. and ACE's overall compliance with EDECA standards.

Audit Scope and Objectives

The scope of Phase I of our audit included significant relationships and transactions between ACE and affiliates during the years 2005 through 2007 (the audit period). Among the key audit objectives were:

- Determine that internal controls and accounting procedures were sufficient to prevent significant opportunities for cross-subsidization between ACE and affiliates.
- Determine compliance with applicable portions of the Electric Discount and Energy Competition Act (EDECA).
- Determine the disposition of recommendations from the prior EDECA audit.

We focused a significant amount of effort on PHI Service Company (PHISCO) because it is where the greatest opportunities for affiliate cross-subsidization exist. Direct and allocated PHISCO charges accounted for a significant percentage of ACE's operating expenses. PHISCO is discussed in chapter 3. We also performed a review of the relationships and power supply transactions between ACE and its merchant affiliates Conectiv Energy Supply, Inc. (CESI) and Pepco Energy Services, Inc. (PES). The merchant affiliates engage in a wide variety of transactions in the PJM regional power and transmission markets. Merchant affiliate relationships are discussed in chapter 4. We reviewed the relationship between ACE and Millennium Account Services, LLC (MAS), which performs joint meter reading services on behalf of ACE and South Jersey Gas Company. MAS is discussed in chapter 5. We reviewed inter-company tax transactions and between ACE and PHI; in particular, compliance with the NJBPU's consolidated tax savings policy and the allocation of tax liabilities by PHI to ACE and other subsidiaries. This is discussed in chapter 6. We examined the relationship and transactions between ACE and Atlantic Southern Properties (ASP), which owns the Mays Landing utility operations building occupied by ACE. The lease arrangement between ACE and ASP is discussed in this chapter. We examined PES's limited participation in the New Jersey retail electricity and energy-related service markets, which is also discussed in this chapter.

Summary of Findings

Atlantic Southern Properties

1. The calculation of rent for ACE's use of space in the Mays Landing building owned by ASP is vaguely defined and insufficiently documented in both the building lease and the Cost Allocation Manual (CAM) Neither the lease between ACE and ASP nor ACE's CAM contain an adequate description of ACE's rent for Mays Landing or how it is calculated. The amount of space leased to ACE (currently approximately 160,000 square feet) is also not documented. Instead, the lease simply states that the "rental amount [is to be] developed in accordance with the CAM." When we asked where the basis for the rental amount was discussed in the CAM, ACE pointed us to Section I, page 4 of the CAM, which states that "the underlying [principle] of PHI's costing approach is the use of a fully distributed cost alignment methodology (full costing)".

2. The amount ACE paid per square foot for *finished* space at Mays Landing was comparable to what was charged to third party tenants. However, because ACE's lease cost for the space depended on an arbitrary allocation of total building cost between the finished and unfinished space categories, comparison of ACE's finished space cost to what non-affiliated tenants paid, without accounting for unfinished space, is not meaningful. Based on building cost allocated to finished space, ACE was charged $14.89 per square foot in 2006 in Mays Landing. The Federal Aviation Administration (F.A.A.), by far the most significant third party tenant, was charged $14.63 for finished space in 2006.[1] At first glance, ACE's cost-based price appears reasonable: ACE was charged only a little more than what an unaffiliated tenant paid for a significant amount of space in the same building. However, under the procedure in place during the audit period, ACE's price depended on an arbitrary allocation of total building cost between the unfinished and finished space categories. As discussed below, less than half of ACE's total lease cost was attributable to finished space. ACE was the only significant tenant occupying and paying for unfinished space (77.55% of the usable unfinished space in the building was assigned to ACE), and unfinished space, based on the cost allocation noted above, was charged to ACE at nearly three-fourths the price of finished space. Because ACE's finished space price was dependent on several variables and accounted for less than half of ACE's total lease cost, we believe a market comparison to what third parties paid for finished space only is not meaningful.

3. ACE paid 54% more per square foot for unfinished space than the price paid by third party tenant the F.A.A. Unfinished space accounted for more than half of ACE's total audit period lease cost in Mays Landing.[2] Neither the amount of unfinished space assigned to ACE, nor the basis for allocating building cost to the unfinished category, was documented in ACE's

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[1] Response to Discovery, OC-729 and OC-908-b. $14.63 is an average of $16.64 per s.f. for 32,564 s.f. of finished office space and $7.30 per s.f. for 8,920 s.f. of space used as a gym.

[2] According to data provided in response to Discovery, OC-729, ACE's total lease cost for Mays Landing broke between finished and unfinished categories as follows: 2006 – 44.7% finished / 55.3% unfinished; 2007 – 43.3% / 56.7%; 2008 – 41.9% / 58.1%.

lease. ACE was assigned an average of more than 100,000 square feet of unfinished space during the audit period. ACE was charged an average of $11.28 per square foot for the space. Third party tenant the F.A.A. was charged $7.30 per square foot for 5,000 square feet of unfinished warehouse space, 35% less than the price paid by ACE. Much of the space assigned to ACE consisted of vehicle repair and materials and supplies storage, consistent with ACE's utility operating needs.[3] However, a significant amount was assigned for "furniture storage", and smaller amounts were designated as "training" and "evidence storage."[4] By 2008, ACE was the only tenant using unfinished space in Mays Landing, occupying 83% of the available space, with the remainder retained (unleased) by ASP. In 2008, ACE was charged almost $280,000 annually for storage space that ACE indicated was used primarily for surplus furniture.[5] Neither the amount of space nor the price were documented in ACE's lease.

4. Taking finished and unfinished space together, ACE annually paid approximately $460,000 more than the market price for the space it occupied at Mays Landing, as evidenced by the lease terms given to third-party tenant the F.A.A. - As noted above, ACE's price for finished and unfinished square feet in Mays Landing depended on an arbitrary allocation of building cost between the two space categories. The allocation of cost to finished space produced a cost-based price per square foot close to the prices paid by third party tenants. However, the flip side of this allocation – the cost allocated to unfinished space – resulted in a cost-based price for unfinished space that was 54% higher than the price paid by the F.A.A., which leased both finished and unfinished space in the building. Unfinished space accounted for more than half of ACE's total lease cost during the audit period, and by 2008, ACE was assigned more than 80% of the unfinished space available in the building. Taking finished and unfinished space together, ACE paid about $460,000 more each year during the audit period than it would have paid had it been charged the same prices per square foot paid by the F.A.A.

5. ACE and PHISCO were unable to provide workpapers showing the calculation of ACE's Mays Landing lease cost for 2005. – We did not review the costs charged by ASP to ACE under the Mays Landing lease for 2005 because the Company indicated it could not provide supporting workpapers. ACE was charged $1,945,401 in 2005 (net of amounts charged by ACE to ASP for building maintenance). This compares to net charges of $1,565,387 in 2006 and $1,713,199 in 2007.[6] As a result of the unavailability of lease cost documentation for 2005, the audit period for transactions between ACE and ASP was adjusted forward by one year, to include the years 2006-2008.

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[3] Response to Discovery, OC-910

[4] Id.

[5] Based on response to Discovery, OC-729, in 2008 ACE used 23,512 square feet of unfinished space in cost center 109 (furniture storage). Based on Discovery, OC-910, ACE used 619 square feet in cost center 851 (evidence storage). Combined, ACE used 24,131 square feet for of unfinished space for furniture and evidence storage. At a cost of $11.58 per square foot, this is $279,442 annually.

[6] Response to Discovery, OC-4, 7 & 8

Compliance with EDECA Standards

1. Based on the nature of ACE affiliates and their businesses, there were limited opportunities for ACE to run afoul of EDECA rules addressing non-discrimination, cross-marketing and information disclosure to affiliates providing competitive services in New Jersey. During the audit period ACE had three affiliates operating in New Jersey that were classified as “related competitive business segments”: PES, MAS, and ASP.[7]

   - PES had a very limited presence in New Jersey, selling about $3 million annually in competitive electricity to a few large commercial and industrial customers. It did not market to residential or small commercial customers and New Jersey accounts represented a very small share of its business. We found nothing to indicate that PES gained an advantage in selling services in New Jersey based on its relationship with ACE. PES’ website is not linked to ACE and does not mention ACE.

   - MAS provided meter reading to two customers under a single trilateral agreement involving MAS, ACE and South Jersey Gas. Overland found no evidence that MAS affected broader New Jersey markets for energy or related services, although, as discussed below and in chapter 5 and noted below, MAS’ transfer pricing to ACE was not in compliance with EDECA transfer pricing rules. Most of the competitive market concerns that EDECA is designed to address are not applicable to MAS.

   - ASP, a real estate affiliate, owned the Mays Landing building, which it leased to ACE and to third parties (notably, the Federal Aviation Administration) during the audit period. EDECA rules require that ACE pay the lower of cost or market for the space it leased in Mays Landing. As explained below, ACE paid more than the market price for this space and was not compliant with EDECA transfer pricing requirements. However, we found no evidence that ACE promoted ASP in the commercial real estate marketplace. Mays Landing was ASP’s only investment during the audit period, and it was leased mainly to ACE and PHISCO. It is therefore reasonable to conclude that ASP did not have a significant effect on the overall local market for commercial office space.

2. ACE was compliant with significant EDECA provisions addressing the separation of utility management and utility accounting from competitive affiliates, and the sharing of corporate support services. Overland found that ACE maintained the proper separation of its books and management from those of its affiliates. As discussed in more detail below, ACE shared certain utility services with DPL. Most of these services were conducted jointly through PHISCO, the service company. Most of the affiliates served by PHISCO are not classified as “related competitive segments” under EDECA. Nevertheless, the nature of the services provided by PHISCO, and the related procedures for distribution of costs among

[7] Previous EDECA audits have determined that affiliates that provide a product or service to end users (i.e., a product or service that is not resold) are subject to EDECA’s competition rules.

affiliates, were appropriate under the EDECA standards. In terms of risk to ACE, the services provided by PHISCO and related distributions of cost were ACE's most significant overall relationship during the audit period. The relationship with PHISCO was analyzed in detail and is discussed at length in a separate chapter.

3. <u>ACE and ASP were not in compliance with EDECA transfer pricing rules that required ACE's pay no more than the market price for space leased in Mays Landing.</u> Per EDECA Section 14:4-5.5(u)(2), utility asset transfers, including leases, from an RCBS "shall be recorded at the lesser of book value or fair market value." EDECA Section 14:4-5.5(t)(2) states that services offered for sale on the open market shall be priced at "no more than fair market value." ASP offered and rented commercial space on the open market, making it subject to this EDECA rule. As discussed above, the price ACE paid for finished space was slightly higher than the price paid by the F.A.A., the only third party tenant leasing a substantial amount of space. However, ACE paid substantially more per square foot than the price paid by the F.A.A. for unfinished space. As such, ACE and ASP were not compliant with EDECA transfer pricing requirements. As discussed in more detail below, we calculated ACE's over-payment (relative to EDECA requirements) to be about $460,000 annually, or about $1.4 million for the three-year audit period.

4. <u>MAS did not comply with EDECA rules that required transfer pricing for "services not produced . . . for sale on the open market" be priced at the lower of fully allocated cost or fair market value</u>. MAS' classification as an RCBS was established in two prior audits. EDECA section 14:4-5.5(t)(6) requires that an RCBS that sells a service to a utility that is *not* sold on the open market provide the service at the lower of fully allocated cost or fair market value. As explained in detail in the chapter documenting transactions with MAS, MAS did not provide service on the open market during the audit period and no market value was established. MAS audit period pricing was also not based on fully distributed (allocated) cost; in fact, there was no cost basis for the meter reading prices MAS charged to ACE and South Jersey Gas. Instead, MAS pricing was set by fiat by its owners, which are holding companies for ACE and South Jersey Gas. MAS pricing appears to have been set to achieve a target level of operating margin.

Recommendations

Recommendations concerning PHISCO, power supply transactions and MAS are discussed in the applicable chapters.

Atlantic Southern Properties

1. <u>Fully document the pricing basis and space leased by ACE in the lease. Require ACE to approve all changes in the price per square foot and space leased before they are made. Document all changes in lease amendments signed by both parties.</u> As discussed above, the lease and the CAM currently contains no information other than "fully distributed cost" to describe the rent that ACE pays to ASP for its use of the Mays Landing building. The rent

varies from year to year, as expenses and space usage change. Overland recommends ACE's rent calculation, including the charges per square foot of finished and unfinished space, and the amount of space leased, be fully documented in the ASP / ACE lease. In addition to full documentation in the lease, to the extent lease prices are based on cost, changes in: 1) the cost basis (cost methodology, cost elements or allocation to space categories); 2) the market price basis (including market survey data supporting the market price; or 3) the *amount* of space leased should be approved in advance and incorporated into the lease by way of an amendment, dated and signed by both ASP and ACE. While it will not turn the lease into an arms-length contract, implementing this recommendation will bring ACE into compliance with standard business practice for documenting commercial lease transactions.

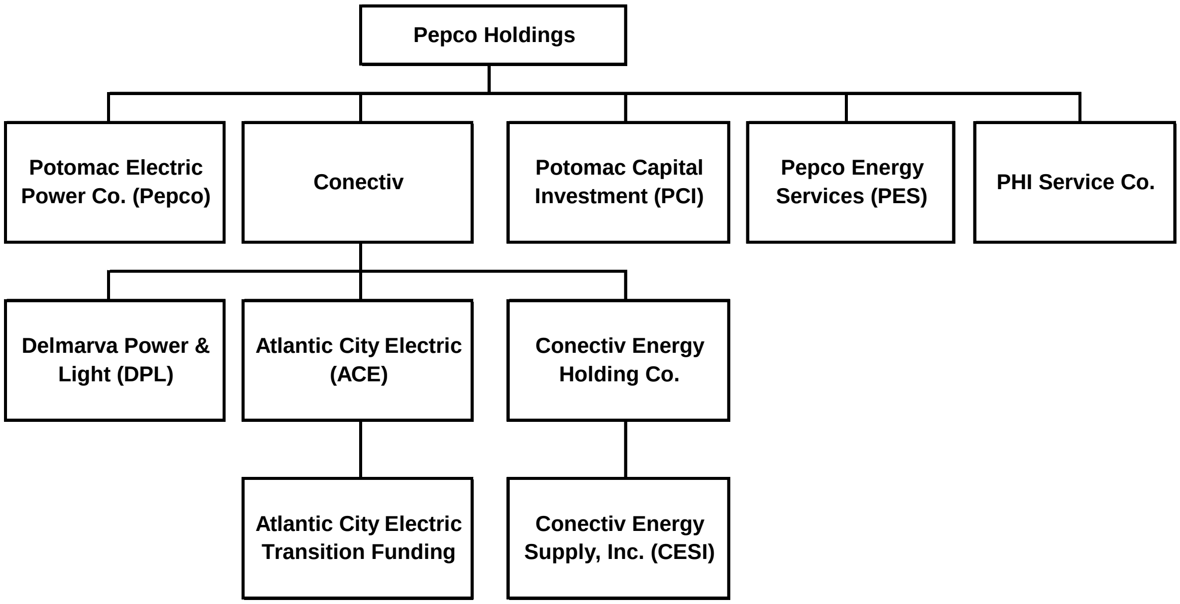
2. <u>Conduct an annual survey of market prices for finished and unfinished commercial space in market area surrounding Mays Landing. Ensure the price charged to ACE for finished and unfinished space is no more than the lower of fully allocated cost or the market price for equivalent finished and unfinished commercial space in the local market area</u>. As discussed above, EDECA transfer pricing rules require that ASP's lease to ACE be priced at "no more than fair market value." ACE's Mays Landing lease did not comply with this provision. As a result, we estimate that ACE paid approximately $1.4 million ($460,000 per year for three years) over the market value for space leased at Mays Landing during the audit period. Overland recommends ACE annually obtain, by survey, the necessary market data to determine that its Mays Landing lease price per square foot does not exceed the market price for equivalent finished or unfinished commercial space in the Mays Landing market area. To the extent ACE is charged more than the market price for either finished or unfinished space (i.e., if ACE is charged "fully distributed cost" that exceeds the market price in either space category), ACE should record the excess of cost over market below-the-line so that it is not passed on to ratepayers. The prior audit recommended that the lease be brought into compliance with EDECA's "lower of cost or market" pricing rules.[8] Despite the prior auditor's report notation that a new lease document (which the auditor had not reviewed) was to be executed, compliance with transfer pricing rules was *not* implemented. Therefore, in this audit, we recommend the NJBPU require ACE to provide documented proof of compliance (consisting of the new lease document and annual market survey results).

<u>PHI's Organizational Structure</u>

The flowchart below summarizes the structure of PHI and ACE's place in that structure.

[8] Liberty Consulting, <u>Audit of the Competitive Service Offerings of Atlantic City Electric</u>, March 31, 2003, recommendation 28, p. 117.

Chart 2-1
Pepco Holdings Inc. Organization



For financial reporting purposes, PHI is divided into the following operating segments:

Power Delivery – The Power Delivery segment consists of the transmission and delivery of electricity and natural gas service by PHI's three regulated utility subsidiaries: Potomac Electric Power Company (Pepco) (approximately 750,000 customers), Delmarva Power and Light Company (DPL) (approximately 525,000 customers) and Atlantic City Electric Company (ACE) (approximately 540,000 customers). On a combined basis, the utilities operate in the District of Columbia and the states of Delaware, Maryland and New Jersey. ACE provides only electric service and operates exclusively in New Jersey.

Competitive Energy - This segment generates, markets and supplies energy through a number of unregulated subsidiaries organized under two umbrellas:

- Conectiv Energy Holding Company (CEH), through its subsidiaries, provides electric power, power capacity and "ancillary services" using its own generating facilities. The CEH subsidiaries provide power only in the wholesale markets. They do not deliver power to retail customers. At the end of 2007, CESI's generating capacity consisted of approximately 3,700 MW.[9] CEH controls an additional 480 MW of capacity through tolling agreements, and is constructing a plant which will add another 545 MW of capacity to its generating portfolio in 2011. CEH's primary operating subsidiaries during the audit period include:

[9] PHI 2007 S.E.C. Form 10-K, p. 10.

- Conectiv Energy Supply, Inc. (CESI) is CEH's primary operating subsidiary during the audit period. It conducted energy procurement, transportation, energy trading and wholesale energy sales.
- Conectiv Bethlehem, LLC (CBL) owns and operates a 1,100 MW generating plant in Pennsylvania.
- Conectiv Mid-Merit, LLC (CMM) is currently constructing a 545 MW generating plant in Pennsylvania.
- Conectiv Delmarva Generation, LLC (CDG) owns and operates generating plants formerly owned by DPL.
- Conectiv Atlantic Generation, LLC (CAG). CAG owns and operates generating plants formerly owned by ACE.
- PHI Operating Services Company (POSC) - operates and maintains Conectiv generating plants.
- Delaware Operating Services Company (DOSC) - operated and maintained Conectiv generating plants in 2005. By the end of the audit period it no longer conducted any business.

- Pepco Energy Services, Inc. (PES) is PHI's competitive retail energy supplier. PES and its subsidiaries sell electricity to commercial, industrial and government customers in the mid-Atlantic and northeastern regions and the Chicago, IL area. PES sells competitive natural gas supply services in the mid-Atlantic area. PES subsidiaries also own two older, oil-fired generating plants in the District of Columbia. These plants sell power on a wholesale basis into the PJM market area. PHI plans to fully deactivate both plants by 2012. PES did not sell retail electricity to residential or small commercial customers in New Jersey during the audit period, but it did sell power to a few larger customers. Based on remittances by ACE (which bills customers on PES' behalf), PES' sales to New Jersey customers averaged between $3 million and $4 million annually during the audit period. PES' primary operating subsidiaries include:

  - Pepco Energy Services (PES) sells wholesale and retail energy commodity and related services, including electricity and natural gas. It also provides energy efficiency contracting services primarily to government customers. PES had 106 employees at the end of 2006 and 128 employees at the end of 2007.[10]
  - Conectiv Thermal Systems, Inc. develops, owns and operates systems that provide heating and cooling. These systems currently serve customers in Wilmington, DE and in the casino district of Atlantic City, NJ.
  - Potomac Power Resources, LLC owns the District of Columbia power plants discussed above.
  - Pepco Building Services, Inc. owns businesses that provided heating, ventilation, air conditions, electrical testing and building automation. **[BEGIN CONFIDENTIAL]**

[10] Response to Discovery, OC-377. ACE did not provide employee statistics for PES for 2005.

[END CONFIDENTIAL] were sold in 2006 for approximately $21 million.[11]

PHI Investments - This segment consists primarily of Potomac Capital Investment Corporation (PCI). It also includes Conectiv Properties and Investments, Inc. (CPI), Atlantic Southern Properties, Inc. (ASP) and Conectiv Communications (CCI), Inc.

- Potomac Capital Investment Corporation (PCI) - PCI, owned by Pepco Holdings, Inc., is the primary company in the PHI Investments business segment. Financial statements describe PCI as the owner of a "portfolio of financial investments which are principally energy leveraged leases."[12] Basically, PCI purchases energy industry assets, including electric generating plants and gas transmission and distribution pipe, and leases them back to the sellers. During the audit period, PCI's portfolio consisted of an equity investment of approximately $1.3 billion. Approximately two-thirds was invested in electric power plant leases, with the remainder invested in gas transmission and distribution leases. The underlying assets are located in The Netherlands, Austria and Australia. PCI had no employees during the audit period. PCI is a participant in the PHI money pool. During most of the audit period, PCI also operated with a **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** loan from PHI. In November, 2007, PCI repaid half of the loan.

- Atlantic Southern Properties (ASP) - ASP is owned by Conectiv. It owns the Mays Landing building, leased to ACE and PHISCO.

- Conectiv Communications (CCI) - This affiliate is owned by Conectiv. Prior to 2007, CCI provided the use of a fiber optic loop to affiliates. It was no longer operating in 2007, but continued to pay preferred dividends approximately equal to its annual revenue in prior years.

- Conectiv Properties and Investments, Inc (CPI) - This subsidiary, owned by Conectiv, owns an office building leased to PHISCO. Total revenue from these leases is approximately **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** annually.[13]

Summary of Transactions Between ACE and Affiliates

Significant transactions between ACE and its affiliates during the audit period included the following:[14]

- Power and Transmission Transactions - ACE bought power and transmission services from Conectiv Energy Supply, Inc. (CESI). Power and transmission purchases from CESI

[11] PHI 2007 S.E.C. Form 10-K, p. 12.
[12] Response to Discovery, OC-5, PCI 2006 & 2007 financial statements.
[13] Response to Discovery, OC-47.
[14] Response to Discovery, OC-4, OC-7 and OC-8.

constituted ACE's largest affiliate relationship in dollar terms **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**. The relationship between ACE and CESI is discussed in chapter 4.

- Service Company Transactions - ACE received a significant amount of service during the audit period from PHI Service Company (PHISCO). PHISCO provided corporate and shared utility and competitive energy operating services to most of PHI's operating subsidiaries. PHISCO's employees, including PHI's corporate executives, also managed PHI's non-operating (investment) subsidiaries. In addition to providing services, PHISCO also assigned employee benefit costs to ACE that PHISCO paid on behalf of ACE employees. PHISCO services to ACE totaled approximately $82 million in 2005, $79 million in 2006 and $81 million in 2007. PHISCO assigned ACE employee benefits expenses of $6.7 million in 2005, $6.7 million in 2006 and $5.7 million in 2007. Services provided by PHISCO to ACE are discussed in chapter 3.

- Meter Reading Services - ACE purchases meter reading services from Millennium Account Services (MAS), an affiliate jointly owned by Conectiv Solutions LLC (a subsidiary of Conectiv) and South Jersey Industries, the holding company for South Jersey Gas. MAS exists to perform meter reading services for the utilities of its two holding company owners. Meter reading charges to ACE were **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**. ACE's relationship and transactions with MAS are discussed chapter 5.

- Intercompany Tax Allocation – Pepco Holdings, Inc. is the entity that pays corporate income tax on the income earned by ACE and other PHI subsidiaries. PHI allocates tax liabilities to subsidiaries based on income or losses. Tax allocations to ACE were $56 million in 2005, $108 million in 2006 and $27 million in 2007. Intercompany tax allocations are discussed in chapter 6.

- Dividends to the Parent - ACE pays dividends to the Pepco Holdings, Inc. ACE's dividends to the parent were $96 million in 2005, $109 million in 2006, $50 million in 2007. Issues involving finance, including dividends paid to the parent company, are covered in Phase II of the report in chapter 11.

- Building Lease - ACE's Mays Landing building is owned by affiliate ASP. ACE leases space from ASP and supplies some building services to ASP. Lease payments were **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** ACE's relationship with ASP and the Mays Landing lease are discussed below in this chapter.

- Remittances to Pepco Energy Services (PES) - PHI's competitive retail energy affiliate PES sells power to certain large customers in ACE's territory. ACE performs consolidated billing for these customers and remits the amounts collected to PES. ACE remitted **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]**. The ACE / PES relationship is discussed below in this chapter and in chapter 7.

- Other Transactions - During the audit period, ACE sold electricity at tariffed rates to affiliate Thermal Energy Limited Partnership I **[BEGIN CONFIDENTIAL] [END CONFIDENTIAL]**. ACE provided and received minor amounts of direct labor, materials and the use of vehicles to and from Pepco, DPL, Conectiv Bethlehem, Conectiv Delmarva Generation and Conectiv Atlantic Generation, resulting in small net transfers to and from ACE of less than $1 million per year.

ACE's Lease With Atlantic Southern Properties

ASP is described by ACE as a company "formed to own and manage certain investments in real estate including a commercial office and warehouse facility in southern New Jersey."[15] It owns the Mays Landing building, which serves as operating and administrative office space for ACE. ACE has rented space in the building from ASP since 1999. Mays Landing was ASP's only real estate investment during the audit period.[16] In addition to ACE, several tenants not affiliated with PHI or ACE rented space in the building during the audit period:

- The Federal Aviation Administration (F.A.A.) (vacated in 2007)
- A building maintenance company (vacated in 2005)
- A company running a day care facility
- An alarm company

On a combined basis, third party tenants not affiliated with PHI or ACE occupied approximately 77,300 of Mays Landing's 282,000 square feet in 2006, and 16,900 square feet after the F.A.A. vacated in 2007. The amount occupied in 2005 is unknown.[17]

The lease between ACE and ASP for Mays Landing contains the following provisions:

- The lease is on a "year to year" basis unless terminated.
- Rent price is defined only as an amount "developed in accordance with the CAM."
- Utilities are "developed and charged in accordance with the CAM."

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[15] Response to Discovery, OC-3.
[16] Phone interview, Kathy White and Karen McKenna, February 18, 2009.
[17] Square footage statistics per rental calculations provided in response to Discovery, OC-729. ACE was unable to locate 2005 rental calculation workpapers.

- There is a 5 percent late charge if rent is not paid by the 15th of each month, which ACE indicates it did not pay during the audit period.[18]

Affiliate Transfer Pricing - The terms of the Mays Landing lease are vague and non-specific. There is nothing in the lease that specifies the basis upon which rents are calculated or how much space is to be leased. Although it references the Cost Allocation Manual (CAM), there is nothing in the CAM referencing ASP or the lease. When we asked ACE to identify the portion of the CAM governing the rent calculation, the Company responded as follows:

> Section I, page 4 of the MD 2008 CAM filed with the Company's response to OC 40, governs the calculation of the rental amounts. This section describes the underlying principal (sic) of PHI's costing approach as the use of fully distributed cost. Additional information describing fully distributed cost has been provided under item B above.[19]

The referenced section of the CAM describes fully distributed cost in theoretical terms, as "a philosophy . . . based on the premise that both direct and indirect costs are identified for products and services." No description of the Mays Landing rent calculation is included or referenced. The additional information "provided under item B" (Response to Discovery, OC-729) is similarly vague:

> B. The rental amounts were developed based on PHI's cost approach of using a fully distributed cost alignment methodology (full costing) to charge for services provided by one PHI affiliate to another affiliate. As stated in the company's 2008 Cost Allocation Manual (CAM), PHI's full costing philosophy is based on the premise that both direct and indirect costs are identified for products and services and that the costs of products and services include all costs that would be incurred on a stand alone basis . . . [20]

This description, like that in the CAM, is vague and uninformative and contains nothing to describe how ASP's rent is calculated; specifically, it contains nothing explaining how rent is "developed in accordance with the CAM."

Analysis of Mays Landing Rents Charged to ACE - We asked for a detailed calculation of the fully distributed rental cost calculation developed in accordance with the CAM.[21] ACE provided rent calculations for 2006 and 2007, but indicated that 2005 was unavailable.[22] Below is a summary of the 2007 calculation, which shows the ACE rental for Mays Landing was **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**.

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[18] Response to Discovery, OC-729, item E
[19] Response to Discovery, OC-729, Item C
[20] Response to Discovery, OC-729, Item B
[21] Response to Discovery, OC-729
[22] Response to Discovery, Per OC-7, **[BEGIN CONFIDENTIAL]**

[END CONFIDENTIAL]

[BEGIN CONFIDENTIAL]

Table 2-1
Atlantic Southern Properties
2007 Calculation of Atlantic City Electric's Lease Payment Amounts ($000s)

Item	Unfinished Pct	Unfinished Space Allocation	Finished Space Allocation	Total

[END CONFIDENTIAL]

<u>Audit Testing of ACE's Rent for Mays Landing</u> – We tested ASP's cost-based rent calculation, which is calculated by PHISCO. We also examined the reasonableness of the amount charged.

<u>ACE's Rent Calculation</u> - We attempted to trace the amounts in the table above to ASP's trial balance for 2007.[23] We traced the total amount charged to ACE – **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]** - directly to intercompany revenue on the ASP trial balance. Some of the amounts used to compute total rent (depreciation, utilities, property taxes) tied directly to the trial balance. Tracing O&M from the rent calculation above required a reconciliation that we requested from ACE.[24]

The response to our request for the detailed rent calculation contained no explanation of how interest was calculated. We determined through discussion with PHISCO's Assistant Controller that interest expense is based on a commercial paper (short term debt) rate applied to net

[23] Response to Discovery, OC-47, Conectiv Consolidating Workpapers, Company 3520, ASP.
[24] Response to Discovery, OC-909

borrowings by ASP from the money pool.[25] The resulting interest expense charged to ACE during the audit period was equivalent to an approximate 10 percent rate of return on ASP's net property, plant and equipment, which consists entirely of Mays Landing.

Reasonableness of the Rent Charged to ACE – Tables 5 and 6 below are comparisons of finished and unfinished space lease rates per square foot for ACE and several third party tenants. Based on an arbitrary allocation of building costs to ACE's finished and unfinished space rates, the comparisons show that ACE's cost-based rate per square foot for *finished* space appears reasonable in comparison to several third-party tenants; most notably, the F.A.A., which leased a substantial amount of space over a five-year period from 2002 to 2007. However, ACE paid 54% more per square foot for *unfinished* space than the F.A.A., even though ACE was assigned 20 times as much unfinished space as leased by the F.A.A. In addition, it appears that about 600 square feet of unfinished space was provided at no charge (over the lease rate for finished space) to tenant American Building Maintenance (ABM).[26] Taking finished and unfinished space together, and using the prices paid by the F.A.A. as a market proxy, we calculated that ACE paid approximately $460,000 annually ($1.4 million for the audit period) *more* than the market price for the space assigned to it in Mays Landing.[27]

It is possible for the amounts charged to ACE to be "managed" (for example, by allocating the amount necessary to keep finished space near or below the price charged to third party tenants). This is a consequence of affiliate relationship between ACE and ASP. However, it is *facilitated* by the lack of documentation in the lease as to how ACE's rent is to be calculated, how building cost is to allocated between space categories, how much space ACE occupies from "year to year", and market price comparisons for equivalent commercial space. Regardless of how ACE's lease cost was calculated and documented (or not documented) in the lease, ACE and ASP were not in compliance with EDECA because there was no information to demonstrate that ACE's *overall* cost-based price during the audit period was not higher than market.

Building Cost Charged to ACE - ACE's cost-based price to lease Mays Landing during the audit period depended on the following variables:

- Total incurred building cost for Mays Landing – Total building cost and related audit testing is discussed above.

- The allocation of building cost between finished and unfinished space - The total incurred cost of Mays Landing includes operating costs (maintenance, utilities, etc.), depreciation and interest on ASP's borrowings from the PHI money pool. ACE's share of this cost depends in part on an arbitrary allocation of 60% of expense to the "finished

[25] Phone interview, Kathy White and Karen McKenna, February 18, 2009.
[26] Response to Discovery, OC-935, Attachment
[27] Referencing the prices and space figures in Table 5 and Table 6, [(15.32 – 14.63) x 59,195 finished s.f. + (11.28 – 7.30) x 105,604 unfinished s.f.] = $461,149.

space" category and 40% to unfinished.[28] Allocations by cost category are shown in the following table. There was no practical way to test these arbitrary allocations. EDECA rules require that the building space in Mays Landing be priced to ACE at no more than market price. As discussed above, we recommend that ACE survey the market for equivalent finished and unfinished commercial space in the Mays Landing area to determine the proper price per square foot for each space category in its lease.

Table 2-2
Atlantic Southern Properties
Allocation of Building Cost to Finished and Unfinished Space

Cost Category	Cost Allocation to Finished	Cost Allocation to Unfinished
Operations & Maint Exp.	60%	40%
Depreciation	60%	40%
Utilities	70%	30%
Property Tax	60%	40%
Facilities Svc Admin	50%	50%
Allocations & Assessments	60%	40%
Property Insurance	60%	40%
Interest on Money Pool Loan	60%	40%
Overall Building Cost Allocation (1)	60%	40%
Relative Building Space (2)	53%	47%

Source: Response to Discovery, OC-729
1. For 2007, based on total cost in each category and the factors shown above.
2. Based on 281,943 total square feet; 133,293 of which was designated "unfinished" as of 12/31/07.

- The amount of finished space rented and the allocation of unfinished space between ACE and ASP. - ACE's total cost also depended on the amount of finished and unfinished space assigned to ACE. The cost of space not assigned to ACE is assigned to ASP. To test the reasonableness of the space charged to ACE:

  - We computed the number of square feet of finished space per employee. During the audit period, finished space (including finished common space) averaged about 300 square feet per PHI employee.[29] We consider this to be a relatively high, but not extremely high, amount per employee.[30]

  - We assessed the usage of unfinished space to determine why ACE was charged for more than 100,000 square feet of unfinished space. ASP's allocation of unfinished space to affiliated and non-affiliated tenants, and to itself, is summarized in the table below. In 2006 and 2007, ACE was assigned 77% of

[28] "Arbitrary", does not mean "unreasonable." Rather, it means that an allocation of 60% to finished space represents a number chosen by PHISCO and / or ASP.
[29] Response to Discovery, OC-908-a and OC-729. This includes space occupied by ACE and PHISCO employees.
[30] It was our observation while working at Mays Landing that a significant amount of finished space was lightly used.

this space. In 2008, ACE's share of unfinished space rose to 82%. When the largest third party tenant (the F.A.A.) vacated the building, the unfinished space assigned to third party tenants appears to have shifted, first to ASP in 2007, and then to ACE in 2008. In 2008, at the rate of $11.58 per square foot, ACE's annual bill for unfinished space, approximately $1,265,000, accounted for nearly two-thirds of its Mays Landing rent.

Table 2-3
Atlantic Southern Properties
Unfinished Space Assignments
Square Feet

Assigned To	2006	2007	2008
ACE	102,950	102,745	109,256
ASP (Retained, not Leased)	22,748	29,335	22,678
PHISCO	621	619	619
3rd Party Tenants	7,240	594	594
Total	**133,559**	**133,293**	**133,147**

Source: Response to Discovery, OC-729

We also asked an accounting of the use of unfinished space assigned to ACE. This is summarized in the table below.

Table 2-4
Atlantic Southern Properties
Usage of Unfinished Space - 2007
ACE and PHISCO (Square Feet)

Used For	Amount
Furniture Storage	18,600
Garage (Vehicle Repair)	15,232
Warehousing (Stores, Maint.)	64,232
Training Area	4,682
Evidence Storage	619
Total	**103,365**

Source: Response to Discovery, OC-910

- The total, 103,365 square feet, is the sum of the unfinished space assigned to ACE and PHISCO in 2007. ACE paid for an additional 6,500 square feet of unfinished space in 2008. The additional amount can probably be added to either the furniture or evidence storage, since garage and stores areas should be confined to finite spaces specifically designed for the purposes indicated. Thus, in 2008, it appears that ACE paid as much as $280,000 for storage mainly of furniture.[31] In fact, it is possible that ACE's annual cost for Mays Landing furniture storage exceeds the market value of the furniture. This highlights one of the problems with the lease as it is currently structured: Any amount of space deemed necessary can be assigned to ACE, without signed approval on the part of ACE, and without written evidence in the

[31] Using amounts per response to Discovery, OC-729 and 910: (18,600 s.f. furniture storage + 620 s.f. evidence storage + 6,500 additional unfinished square feet assigned to ACE in 2008) X $11.58 cost per unfinished square foot = $297,838. The amount paid for furniture storage in 2007 was $215,760.

lease as to ACE's need for or use of the space in the form of a lease amendment.[32] It also appears likely, based on the fluid nature of the space assigned to ACE from year-to-year, that ACE bears, directly or indirectly, the cost consequences of space leased to or vacated by third party tenants.

We also found that ACE was charged not only for space assigned to its own employees, but also for approximately 19,000 square feet assigned to PHISCO employees. We reviewed the cost center detail for the space assigned to PHISCO and determined that the cost center titles were primarily consistent with those of utility operations, rather than corporate administration.[33] However, there is nothing in ACE's lease documenting the fact that ACE will pay for space occupied by PHISCO employees, or why it is reasonable for ACE to do so.

Comparison of ACE and Third-Party Rental Prices per Square Foot – **Finished** Space - ACE's cost per square foot for finished space during the audit period compared to third party tenants (tenants unaffiliated with ACE, ASP or PHI) as shown below.

[BEGIN CONFIDENTIAL]

Table 2-5
Atlantic Southern Properties
Comparison of ACE and Third Party Lease Prices per Square Foot – *Finished* Space

Lease Date	Lessee	Terms	Square Feet	Annual Rent	Price / Sq.Ft.

[END CONFIDENTIAL]

Finished space leased by the Federal Aviation Administration (F.A.A.) was priced at an average of $14.63 (for office and gymnasium space combined) during its lease term.[34] By comparison,

[32] This is not to suggest that the existence of lease amendments alone would solve the problem, given that the underlying issue is that the relationship between ACE and ASP is not arms-length. However, a lease that specifically defined the space to be rented to ACE, together with amendments describing changes in the amount of space leased, would at least serve to provide documentation of the factors affecting ACE's rental expense under the lease, and serve as a basis for determining whether the amounts should be funded by ratepayers.

[33] To the extent these employees are fully dedicated to ACE, it is unclear why they should be PHISCO employees, rather than ACE employees. However, PHISCO employees can charge time to multiple utilities (in this case most likely DPL). To the extent they directly charge their time, the fully distributed "Activity Type Price" rates used by PHISCO are designed to capture a portion of overheads such as billing costs and distribute them to the affiliate benefiting from the assigned employee time.

[34] Using the amounts shown in Table 5: **[BEGIN CONFIDENTIAL]**

ACE's $14.89 charge per finished square foot in 2006, the last complete year of the F.A.A. lease, was only slightly higher. However, as discussed above, ACE's price per finished square foot essentially depends on an arbitrary allocation of total building cost to finished space. Furthermore, ACE's total rental charge for Mays Landing also depends significantly on the amount of unfinished space assigned to ACE. For example, as noted above, by 2008 ACE was spending $280,000 annually just for storage (mainly furniture). As such, a price-per-square foot comparison between ACE and third parties for a space category by itself is not meaningful – both categories must be considered together.

Comparison of ACE and Third-Party Rental Prices per Square Foot – **Unfinished** Space

The F.A.A. and American Building Maintenance (ABM) were the only third-party tenants leasing unfinished space at Mays Landing during the audit period. ABM vacated its space in 2005 and the F.A.A. vacated in 2007. A comparison of the prices paid by ABM, the F.A.A. and ACE for unfinished space is shown below.[35]

[BEGIN CONFIDENTIAL]

Table 2-6
Atlantic Southern Properties
Comparison of ACE and Third Party Lease Prices per Square Foot - *Unfinished* Space

Lease Date	Lessee	Terms	Square Feet	Used for	Annual Rent	Price / Sq.Ft.

[END CONFIDENTIAL]

Based on the building cost allocation to unfinished space, ACE paid an average of 54 percent more per square foot for the space than the F.A.A. even though it occupied more than 20 times as much space. In its data response ACE noted that the unfinished space is "not listed in the ABM lease."[36] We presume this means that it was provided at no cost. Conversely, ACE paid almost 75% as much per square foot for unfinished space as it paid for finished space, even though ACE rented more than 90% of the unfinished space leased by ASP during the audit

[END CONFIDENTIAL] It is also important to note that ACE's allocated cost and the F.A.A.'s lease price both were inclusive of utilities and building maintenance.

[35] Response to Discovery, OC-908-2 Supplemental. The amendment showing the F.A.A.'s lease for unfinished space was omitted from the initial data response. It was provided only after Overland found some of the unfinished space that was leased could not be accounted for, and asked ACE to explain it.

[36] Response to Discovery, OC-935. In addition, OC-935 shows that the F.A.A. occupied 6,645 s.f. of unfinished space, while the lease covers only 5,000. We do not know what to make of the difference; it may be that the F.A.A. was given 6,645 s.f., but paid for only 5,000.

period. As with the finished space, comparison of the price paid by ACE is dependent on an arbitrary allocation of building cost to unfinished space, and is therefore not meaningful by itself. However, if the allocation of building costs to finished and unfinished space categories is considered to be “attributable” rather than arbitrary, the unfinished space provided to the F.A.A. was provided at a rate significantly below cost ($7.30 vs. a cost of $11.28). The unfinished space provided to ABM was significantly below cost by any measure, since it was free.

Pepco Energy Services

Pepco Energy Services (PES) provides competitive retail energy, including electricity from renewable sources. It also provides various energy-related services, including energy assessment and consulting, internet-based energy information systems, heating, ventilation and cooling systems, lighting, project financing, and energy operations and maintenance services.[37] Marketing materials and the PES website indicate that its primary customers are classified in the commercial, industrial and government categories.[38] PES is a subsidiary of Pepco Holdings, Inc., but it is not part of Conectiv. According to marketing materials, PES’ primary area of operation includes the Mid-Atlantic states and states in the eastern half of the Midwest (from Illinois east and from North Carolina north to New Jersey).

PES appears quite large when viewed in terms of revenue. However, because most of its revenues reflect a pass-through of energy and fuel purchase costs, net income is small by comparison. PES’ net income in 2007 was **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**[39] Assets at the end of the audit period totaled **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**, but these consisted primarily of accounts receivable. Total non-utility plant investment was approximately **[BEGIN CONFIDENTIAL]** **[END CONFIDENTIAL]**. From the end of 2006 to mid-2008, PES’ employee level grew from 107 to 160.

Transactions Involving ACE - PES operates as a third-party retail electricity provider in New Jersey. It sells retail electric service to approximately 20 larger commercial and industrial customers in ACE’s territory.[40] It is currently one of approximately 15 companies supplying competitive retail electricity to approximately 400 mainly commercial and industrial customers in ACE’s service territory.[41] With one minor exception, PES did not sell retail service to New Jersey residential customers during the audit period.[42] New Jersey commercial, government and other non-residential customers who select PES as a supplier are metered and billed by ACE under the terms of standard Third Party Supplier and Customer Account Services

[37] Pepco Energy Services website.
[38] Response to Discovery, OC-14.
[39] Response to Discovery, OC-47, consolidating worksheets for 2007.
[40] Telephone interview with Scott Razze, Manager, Supplier Relations, March 5, 2009.
[41] Id.
[42] According to the response to Discovery, OC-928, “PES provided generation and transmission service to 13 residential accounts located within the Atlantic City Electric service territory during all of 2005 and through May of 2006. No residential accounts were served after May 2006 or during 2007. The accounts consisted of twelve cabins at a state park and a state forest, as well as one account at a public college.”

agreements. These agreements are products of the NJBPU and are identical for all retail electricity providers supplying electricity within ACE's and other utilities' service territories in New Jersey. In addition to metering and billing and the transfer of associated data, ACE purchases the receivables of PES and other third party suppliers and remits funds collected back to the suppliers, resulting in the amounts that appear as affiliate transactions between PES and ACE. The audit period amounts collected and remitted to PES by ACE were as follows:[43]

[BEGIN CONFIDENTIAL]

[END CONFIDENTIAL]

These transactions reflect amounts remitted to PES by its New Jersey customers for which ACE acts as an intermediary. Among the New Jersey customers of PES listed in a "2004 Annual Report" (marketing brochure) were the State of New Jersey, Rutgers University and the Tropicana Casino and Resort. However, it is not clear from the 2004 report whether these customers purchased retail electricity or one or more of the many other services provided by PES. New Jersey retail electricity sales accounted for less than 1 percent of PES' revenue during the audit period.[44]

Costs Associated with Metering, Billing, Coordination and Receivables Factoring on behalf of Third Party Suppliers – The services ACE provides to PES and other third party suppliers have costs, such as the salary of ACE's Manager, Supplier Relations, incremental paper and postage costs for bills, and meter reading. These costs are not directly charged to the third party suppliers; therefore, there are no affiliate transactions associated with the services provided by ACE to PES. Instead, as a result of regulatory decisions evolving over the years since retail competition was introduced, the costs of facilitating retail competition, which were initially tracked and deferred by ACE, have been effectively included in ACE's revenue requirements and recovered from its entire customer base.[45]

PES Marketing in New Jersey – To test compliance with EDECA rules in the area of marketing and promotion, we requested marketing materials used by PES during the audit period and reviewed PES' and ACE's websites to determine whether either used ACE in any way to promote PES' services[46] We did not find any reference to ACE in any of the materials. Similarly, we found no mention of PES or its services on ACE's website. With respect to PES, PHI appears to have complied with EDECA rules concerning marketing and promotion during the audit period.

[43] Response to Discovery, OC-8.
[44] For example, in 2007 PES' New Jersey billings of $3.8 million accounted for less than 2/10ths of 1% of operating revenue of $2.3 billion.
[45] Razze interview, March 5, 2009; information provided by Charlie Morgan, interview moderator.
[46] Marketing materials were provided in response to Discovery, OC-14.

Management and Accounting Separation – PES' management and accounting are both completely separate from ACE. There were no employee transfers between ACE and PES during the audit period.[47]

Compliance with EDECA Standards

In 2000 New Jersey implemented the Electric Discount and Energy Competition Act (EDECA). EDECA includes rules governing affiliate relations, competition, accounting and reporting for utilities that provide retail services in competitive markets. The rules regulate certain aspects of the relationship between New Jersey utilities and their affiliates that provide competitive non-regulated retail services (services to end users). EDECA was crafted to ensure that affiliates providing non-regulated retail products or services are not given cost, resource or marketing advantages by virtue of their affiliation with the utility. More specifically, EDECA serves to ensure that non-regulated affiliates do not obtain an unfair advantage in New Jersey markets by selling at an artificially low price due to subsidy by the utility or its holding company; by gaining access to utility resources, such as customer lists, that are not available to competitors; or by creating an impression that what they sell are utility products or services, thereby trading on the utility's name and reputation.

ACE does not currently have relationships with affiliates that have a significant presence in New Jersey retail markets, nor did it have such relationships during the audit period. PHI's competitive retail electric and gas provider, PES, did not market services to New Jersey residential or small commercial customers during the audit period, and had only a limited presence in the large commercial and industrial retail electricity market. We found no evidence that it benefited in any way from its association with ACE. Other ACE energy affiliates, discussed above, most of which market energy through CESI, were not subject to EDECA's competition rules. It was determined in a prior audit that Millennium Account Services (MAS) was a related competitive business segment (RCBS) of Conectiv, and therefore subject to EDECA. A discussion of MAS' compliance with EDECA is included in chapter 5. It was also determined that ASP, which leases space to ACE in the Mays Landing building, is an RCBS of Conectiv, and therefore subject to EDECA. ASP owns a utility operations building (Mays Landing) and rents some of the building's space to unaffiliated tenants. Given the fact that only a portion of one building was involved, Overland believes ASP was of relatively little significance to the local market for commercial office space, a market that bears almost no relationship to the market for utility or utility-related services. However, as an RCBS offering a service to both a utility and on the open market, we found that ASP's pricing to ACE violated the transfer pricing rule set forth in EDECA 14:4-5.5.

As a result of the nature or the business conducted and / or their limited presence in New Jersey retail markets many of EDECA's competition rules were not applicable to ACE's affiliates

[47] Response to Discovery, OC-32 and OC-33.

during the audit period. However, Overland conducted this audit under the assumption that the EDECA's rules relating to affiliate pricing, cost allocation and internal accounting control applied to all affiliates, regardless of their status as an RCBS. Below is a general discussion of ACE's overall compliance with EDECA rules in key areas.

- Non-Discrimination – EDECA requires that ACE refrain from discriminating against a competitor in favor of an affiliate. The only ACE affiliate providing a potential for discrimination is PES, which has a limited presence in New Jersey selling retail power to a few large commercial and industrial customers. We found nothing in the relationship between ACE and PES to indicate that any form of discrimination in favor of PES over other third-party electricity suppliers occurred during the audit period.

- Information Disclosure – ACE did not provide customer or other proprietary information to affiliates in violation of EDECA standards. However, in order to conduct its business, MAS requires certain customer information to be able to read meters, and, in fact, MAS' service (meter reading) produces customer information. There is no evidence that MAS' use or provision of ACE's customer information disadvantaged or otherwise affected any unaffiliated business operating in New Jersey.

- Accounting Separation – All PHI subsidiaries, including ACE, and all affiliates that maintained a business relationship with ACE, maintained books separate from ACE (and each other) during the audit period.

- Management Separation – Management responsibility for ACE, and for many other PHI subsidiaries, was either 1) divided between the subsidiary and PHISCO (PHI's service company), or 2) handled entirely by PHISCO. Subsidiaries that were effectively managed by PHISCO were generally those with limited or no ongoing operations (e.g. investment subsidiaries such as PCI). Overland found that the management of ACE's day-to-day operations was effectively separated from the operations of affiliates conducting non-utility businesses. EDECA section 14:4-5.5(i) specifically permits ACE to share corporate support services, including corporate oversight, governance, support systems and personnel. In addition to corporate services, the management and operation of some of ACE's significant utility operations (transmission and distribution engineering and planning and customer service are two examples) was shared during the audit period with DPL and Pepco. In these cases, the sharing took advantage of economies of scope and scale, and Overland believes that the efficiencies and cost savings created by joint utility services offset, by a significant margin, what amounts to a minor risk of a diversion of the management attention from ACE due to shared utility management.

- Affiliate Pricing – Within EDECA's separation standards are rules covering pricing.[48] Although ACE was in compliance with EDECA covering the most substantial transfers from affiliates (PHISCO services and power and transmission purchases), it was not compliant with transfer pricing requirements in the following areas:

  - Space Rented by ACE from ASP at Mays Landing – ASP was determined to be an RCBS (subject to EDECA rules) in the prior audit. Because it offered commercial space to the marketplace, ASP was required by EDECA rules to lease to ACE at the lower of fully allocated cost or the market value of the commercial building space it provided.[49] ASP's lease price to ACE was determined on the basis of building cost. ACE did not receive the market price for space in ASP. Specifically, ACE paid slightly more than market (as measure by what unaffiliated tenant the F.A.A. paid) for finished space, and substantially more (over 50% more than the F.A.A. paid) for unfinished space. The *amount* of unfinished space leased to ACE, which included approximately $250,000 annually for surplus furniture storage (perhaps more than the value of the furniture), was also questionable.

  - Meter Reading Services Provided to ACE by MAS – MAS has also been found to be an RCBS in at least two prior audits. EDECA requires that the provision of services by an RCBS to a utility that are "not produced . . . for sale on the open market" be priced at the lower of cost or market.[50] As discussed more fully in the chapter discussing MAS, MAS' services were not priced at the "lower of fully allocated (fully distributed) cost or market," making the pricing non-compliant with EDECA. The prior audit recommended establishing a market price based on a competitive bidding process. A Request for Proposals was sent to coincide with the end of MAS' contract, but no unaffiliated companies submitted proposals. As a result, MAS continues to charge ACE substantially more than what would be charged under a standard regulatory definition of fully distributed cost, and a market price for MAS meter reading service remains undetermined.

- Access to ACE Information Systems – ACE shares certain information system assets with PHISCO. PHISCO uses a number of information systems for the shared benefit of either multiple utilities and the utility and non-utility subsidiaries. As noted above, assets shared are used for the provision of corporate and shared utility support services, and are therefore compliant with EDECA 14:4-5.5(i). Overland found the costs associated with these shared systems are appropriately distributed by PHISCO to benefiting subsidiaries based on usage. Overland found no evidence indicating that designated retail affiliates PES or MAS used ACE information systems; however, ACE did bill the energy services provided by PES to PES' customers.

[48] EDECA Section 14:4-5.5(t) & (u)
[49] EDECA Section 14:4-5.5(u)(2)
[50] EDECA Section 14:4-5.5(t)(6)

- Marketing and Promotion – The only audit period affiliate relationship that presents a potential for violation of EDECA restrictions on the cross-marketing and promotion was the relationship with PES. PES had a limited presence in New Jersey markets, selling approximately $4 million annually electric power to large commercial and industrial customers. We reviewed PES' website and requested copies of marketing materials used during the audit period. We did not find references or links to ACE or any of its services on the website or in the marketing materials. New Jersey accounts for a small percentage of PES' service. As noted in a separate chapter, the operations of ACE's other retail affiliate, MAS did not indicate the MAS and ACE were engaged in joint marketing. ACE and South Jersey Gas are MAS' only customers, and the nature of MAS' services are such that additional New Jersey customers are unlikely. As such, violation of EDECA marketing and promotion standards by MAS is very unlikely.

- Provision of Competitive Services by ACE – EDECA rules regulate and restrict the provision of competitive services by a utility. During the audit period, ACE did not provide competitive services, nor did it provide such services through a subsidiary or affiliate.

Followup on Prior Audit Recommendations

Overland reviewed the status of ACE's implementation for the recommendations made in the prior audit, as documented in ACE's Compliance Summary.[51] Implementation of prior audit recommendations is discussed below. It should be noted that compliance letters sent to the NJBPU Staff make it clear that some of the prior audit's recommendations were no longer applicable by the time implementation was being discussed in 2006. Recommendations found to be no longer applicable by 2006 are not discussed here.[52]

- Prior audit recommendations to update the Compliance Plan, the CAM and internal policies and procedures – Many of the recommendations in the prior audit report discussed the addition of language to the Compliance Plan or the CAM addressing concerns about internal controls, EDECA restrictions on transactions or communications between ACE and affiliates, or the status of affiliates as EDECA competitive business segments. Our review of ACE's responses in correspondence with the NJBPU Staff indicated that the recommended changes in language and affiliate status had been made to the Staff's satisfaction.[53] Given that the updates to the Compliance Plan and company procedures completed the implementation of these recommendations, they are not individually addressed in this discussion.

[51] Response to Discovery, OC-1.
[52] Includes recommendations 20, 21, 22, 23 and 29
[53] Response to Discovery, OC-1, Letter to NJBPU Audit Staff, February 17, 2006. Uncontested recommendations 1, 4, 5, 6, 7, 8, 9, 10 12, & 14

- Solicit bids for meter reading services provided by MAS and change contractors if another contractor provides and acceptable lowest-cost bid.[54] In 2006 ACE and SJG jointly issued an RFP for meter reading services for a three-year period. The RFP was sent to five vendors, including MAS. Several of the vendors not affiliated with ACE operated from a significant distance (Georgia and Texas). No vendor other than MAS had existing business in New Jersey; the closest was located in Pennsylvania. Of the five vendors that received the RFP, only MAS responded with a bid, offering essentially the same pricing and terms under which services were being provided at the time. Thus, although the recommendation was implemented, it did not produce lower meter reading costs for ACE or SJG, nor did it establish a market price comparison for the services provided by MAS.

- Charge for all work done by MAS - Following this recommendation, beginning in 2006, MAS was billed for executive committee (governance) efforts. As discussed in the chapter on MAS, it does not appear that the amount billed in 2007, $1,470, was sufficient to account for corporate governance efforts, which we estimate, based on a statement made by ACE in a Compliance memo to the BPU staff following the prior audit, to be at least 20 hours per year. However, the amounts involved are not material.

- Formulate detailed procedures for pricing transactions under Section 14-4:5.5(t) and implement a training program for their use. ACE noted that this recommendation dealt with MAS. In its Compliance Summary document, ACE stated "procedures for such pricing transactions will be addressed."[55] Overland concurs with the prior audit's recommendation, but notes that it has not been addressed or implemented. There is no evidence that the pricing used by MAS to charge ACE for meter reading services is either cost or market-based, not to mention the lower of cost or market, as required by EDECA. This issue is discussed in chapter 5. Given that a market price for MAS' services does not exist, Overland recommends that any charges to ACE that exceed MAS' fully distributed cost of meter reading services, determined in accordance with normal cost-based regulatory costing principles (O&M + rate of return on rate base + income tax), be recorded below-the-line by ACE. This will prevent ratepayers from cross-subsidizing PHI through excess profits earned by MAS from ACE.[56]

- Reduce dependence on general allocators by implementing a greater degree of direct charging. The Company's response to this recommendation, which appears to have satisfied the NJBPU Staff, was to note that "costs shall be directly charged whenever practicable and possible and [the] goal shall be to increase direct billings to ACE."[57] As

[54] Uncontested recommendation #2
[55] Compliance Summary, recommendation 27
[56] In Overland's 2003 Audit of the Competitive Service Offerings of South Jersey Gas, we made a similar recommendation concerning MAS. Based on the current review, it does not appear to have been implemented.
[57] Response to Discovery, OC-1, Letter to NJBPU Audit Staff, February 17, 2006, uncontested

discussed in chapter 3, it is not currently possible to determine the overall percentage of PHISCO's cost that is directly charged, because PHISCO cannot currently produce a report that shows how the costs in each of its 400-plus cost pools are distributed. However, Overland's review of PHISCO's allocation process, which included analysis of more than 60 cost pools, did not find that so-called "general allocators", such as "total cost", O&M and assets, produced inappropriate cost allocations. We found that although arbitrary by nature, PHISCO's size-based "general" allocators were appropriately used in the cases included in our sample to distribute "unattributable," higher-level corporate costs.[58] Perhaps because of the emphasis placed by regulators on direct charging, we also found that PHISCO described certain usage-based cost allocations it made as "direct charges".[59] Direct charging *should* be used when it will provide a more accurate link to cost-causing subsidiaries than an allocator, but this is not usually the case when dealing with higher-level corporate functions, for which each dollar spent usually benefits multiple cost objectives (subsidiaries).

- Develop an A&G loader to be included in the activity type prices (ATPs) used for direct charges. Develop a method for capturing the indirect A&G costs in each cost center so that remaining costs allocated reflect the fully loaded cost of that activity. Reconcile for differences between budgeted and actual activity type prices.[60] - ACE addressed these recommendations in its Compliance Summary by noting that it had added pension and OPEB costs to ATPs. It also added language to the CAM addressing the overhead costs to be included in ATPs. Overland found that, in general, ATPs and the costs collected in allocable PHISCO cost centers contained the appropriate types of indirect and overhead costs that attach to each activity. There were a few exceptions in which indirect costs could, with some refinement, be attached to service company activities rather than separately allocated. One example is incentive pay for PHI's corporate executives, which was separately allocated rather than charged to executive cost centers for distribution with salaries. However, we did not find that further refinement would have had a significant effect on the distribution of PHISCO costs to ACE or to the Power Delivery (regulated) segment of PHI. Below is an example showing the PHISCO ATP for Legal Services. It contains the appropriate types of indirect and overhead costs and is, therefore, a fully distributed cost-based rate.[61] We also reviewed PHISCO's

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recommendation 16

[58] However, this should not be interpreted to mean that there are problems with the use of general allocators as applied to cost pools not included in our sample. As noted, we were prevented from conducted an overall high-level analysis of the process of linking costs to cost objectives by PHISCO's inability to produce, with a reasonable amount of effort, a report showing how each of several hundred cost pools were distributed.

[59] For instance, pools the labor, materials, outside services and other costs to maintain personal computers and related equipment and distributes them based on the number of workstations in each subsidiary. PHISCO considers this a direct charge, we would call it unattributable (usage based) allocation. Regardless of what it is called, PHISCO's procedure is appropriate given the costs and the benefiting subsidiaries involved.

[60] Response to Discovery, OC-1 Compliance Summary, recommendations 17, 18 & 19

[61] One noteworthy cost missing from the Legal Services ATP is professional services (outside counsel, experts, etc.). These costs can usually be directly assigned themselves to benefiting subsidiaries based on the nature of the project for which the outside services are employed. As such it would not be appropriate, at least in the case of legal services, to attach professional services to a loaded labor rate used by PHI's Legal Services employees.

process for true-up between actual and budgeted costs. Variations between standard ATP rates and actual costs are trued up at least annually, and sometimes more frequently. It is also important to note that most PHISCO costs are allocated, not distributed using standard ATP rates. Overall, we found the true-up process provided a reasonable matching between the incurred costs and benefiting subsidiaries during the 2005-2007 audit period.

Table 2-7
PHI Service Company Legal Services Cost Center 882
Activity Type Price (ATP) Standard Cost Breakout
2006

Cost Category	OH Rate	Total Std Costs
S&W Regular		$4,561,335
S&W Overtime		105,637
S&W Meal Allowance		7,000
Incentives		729,785
Benefits	0.33	1,505,241
Pension	0.07	319,293
OPEBS	0.13	592,974
Total Salaries and Wages	**0.53**	**$ 7,821,265**
Employee Service Costs	$2,220	$ 90,132
Occupancy - Finished Space		1,339,169
Edison Place Park		37,800
Common Support IT Workstation	2,940	173,460
Common Support IT Network	4,440	173,160
Common Support IT Phone	900	61,200
Common Support IT SAP	6,600	270,600
Training		15,000
Travel		55,000
Office, Misc, Materials		972,000
Total Indirect & Overhead Costs		3,187,521
Total ATP Costs		**$11,008,786**

Source: Response to Discovery, OC-461

- Formalize a lease agreement between ACE and ASP for the Mays Landing office building, with the charges to ACE based on the lower of book value or demonstrated market value. This recommendation was not implemented. ACE's Compliance Summary response stated that there was an updated lease agreement (dated March 27, 2003).[62] Liberty Consulting, the prior auditor, indicated it had not reviewed the updated lease.[63] The lease provided in response to Overland's request was dated May 1, 1999, not March 27, 2003, and contained no provisions that would indicate ACE is to be charged the lower of cost or market value, or "no more than market value" (as we interpret the rule).[64] Notwithstanding the question of whether the lease Overland

[62] Compliance Summary, recommendation 28
[63] Audit of the Competitive Service Offerings of Atlantic City Electric, March 31, 2003, p.117
[64] Response to Discovery, OC-557

reviewed is the most current lease, we found its provisions to be vague and non-specific. As discussed above, we recommend that the lease terms be made more specific by fully documenting the rental price basis and square footage rented by ACE in the lease and documenting all changes in lease amendments.

- Reposition the duties of employees serving as directors of officers for both ACE and related competitive business segments.[65] The prior audit found that there were instances in which individuals served as directors and / or officers for both ACE and a competitive business segment. The prior audit concluded that this violated EDECA Section 14:4-5.5(q). As it applies to ACE, this EDECA rule states that a holding company officer or board member may serve on the holding company and with the utility and a competitive business segment, but not both. During the prior audit period, and into the current audit period, ACE had several board members and officers that served both ACE and ASP, which is a competitive business segment under EDECA. These same individuals also serve as officers and board members for other affiliates, such as Conectiv Energy Supply, which are technically not subject to EDECA because they do not provide "retail" services to customers in New Jersey.

  ACE did not implement this recommendation. In its Compliance Summary discussion of the recommendation, ACE stated that the prior auditor misinterpreted EDECA Section 14:4-5.5(q). ACE did not elaborate on how or why it believes the finding is a misinterpretation of EDECA.[66] ACE also stated that cross-affiliate alignment of officer and board responsibilities was essential for the proper governance and oversight of the affiliates. Because the NJBPU was considering a change in a different section of its administrative rules that would require that utilities with more than one board member to maintain "significant ties to New Jersey," three of ACE's four board members resigned from the Board in 2007.[67] However, it is Overland's understanding that none of the other officer changes covered by the prior audit recommendation have been or will be made.

  We address issues involving affiliate governance, including officer and board membership, in chapter 8 of this report. We do not reiterate the prior audit's recommendation that ACE separate its officers and board members from affiliate oversight. However, the fact that officers and board members continue to oversee both ACE and the affiliates with which it does business highlights the need to improve and tighten the contracts and pricing provisions between the utility and the affiliates. In particular, it highlights the need to ensure that meter reading services and office space

[65] Compliance Summary recommendation 25
[66] In its initial comments to Overland's draft report, ACE stated that it met with the BPU Staff on May 8, 2006 and reached agreement with Staff that ACE was in compliance with EDECA concerning its officer/director structure. ACE further stated that "[t]his was confirmed in ACE's May 19, 2006 submittal of a final compliance summary and confirmed by the BPU Staff in its September 19, 2006 letter, in which Staff states 'It is the understanding of this Division that the intent of all recommendations (with the exception of #31 [which related to the money pool – not officers or directors] that were submitted by Liberty Consulting Group in their report has been completed'".
[67] Response to Discovery, OC-677.

sold to ACE by MAS and ASP are either priced based on the traditional regulatory standard of "lower of cost or market", or that charges to ACE that exceed amounts determined under this standard are recorded below-the-line, as recommended elsewhere in this report.

- Demonstrate the adequacy of steps to protect the utility from the negative effects of affiliation with unregulated businesses, and place restrictions on ACE investments in the money pool. These recommendations were implemented by placing restrictions on ACE's interaction with the PHI money pool. Based on a letter to Mark Beyer, Chief Economist for the NJBPU, ACE agreed to the following:

  - Not to petition the BPU to create a utility-only money pool;
  - Not to invest in the PHI money pool after October 14, 2006 and to remove any existing investment by that time;
  - To continue borrowing from the money pool only to the extent that ACE can obtain a lower rate than it could if it issued its own short term debt.[68]

  We followed up on compliance with money pool restrictions in the current audit. ACE stated that it withdrew from the money pool on October 10, 2006 and that since that time has participated in the money pool "only to facilitate intercompany investments."[69] Although it is permitted to do so, ACE further indicated it has not borrowed from the money pool since September 25, 2006.[70] We confirmed the statements ACE made in data responses during our interview of PHI's Vice President and Treasurer.[71]

[68] Compliance Summary, recommendation 31, Letter form Jeffrey Snyder, ACE Assistant Treasurer, to Mark Beyer, NJBPU Chief Economist, September 25, 2006. (Response to Discovery, OC-1).
[69] Response to Discovery, OC-182 and OC-186
[70] Response to Discovery, OC-182
[71] Interview of Anthony J. Kamerick, PHI Vice President and Treasurer, December 10, 2008. Mr. Kamerick is also ACE's Treasurer.

Exhibit 7-5

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Chapter 3. PHI Service Company

PHI Service Company (PHISCO) provides management and administrative services to PHI's subsidiaries, including PHI's utilities, competitive energy companies and other subsidiaries. PHISCO is the successor company to Conectiv Resources Partners (CRP), the service company that existed under the Conectiv holding company umbrella prior to Pepco's acquisition of Conectiv in 2002. In the merger Conectiv contributed CRP's assets to a new holding company, Pepco Holdings, Inc. (PHI).[1]

After Pepco's acquisition of Conectiv and the formation of PHI, Conectiv Resource Partners was renamed PHI Service Company. Prior to the acquisition, Pepco was not subject to the restrictions of the Public Utility Holding Company Act of 1935 (PUHCA 1935) and, as a result, it did not have a service company organization similar to CRP. Instead of absorbing CRP into its own service company organization, PHI essentially converted CRP, including its processes and procedures, into PHISCO. As such, most of CRP's organization and accounting procedures, including the enterprise accounting system (SAP) and the pricing, cost pooling and cost allocation procedures, are the same as or similar to what they were at the time of the prior NJBPU audit of Atlantic City Electric, which covered a period prior to the merger.

Audit Scope, Objectives and Procedures

The scope of our audit of PHISCO consisted of service company activity and transactions during the three years ending December 31, 2007 ("the audit period"), with an emphasis on ACE direct charges, allocations and allocation factors. Service company expenses included in the audit scope are summarized by segment, and for power delivery, by subsidiary, below.

[BEGIN CONFIDENTIAL]

Table 3-1
PHI Service Company
Audit Period Cost Distributions to Segments and Subsidiaries

Segment	Amounts			Percentages		
	2005	2006	2007	2005	2006	2007

[END CONFIDENTIAL]

[1] PHI's S.E.C. Form 10-K, fiscal year ended December 31, 2002, p. 188.

The primary audit objective was to determine that PHISCO internal controls and accounting procedures were sufficient to prevent significant opportunities for cross-subsidization of the activities of the various utility, competitive and other subsidiaries to which PHISCO charged and allocated its costs. In particular, the audit focused on ensuring that PHISCO's cost assignments and allocations did not result in a significant potential for ACE to cross subsidize the activities of other subsidiaries.

Summary of Findings

1. Overall, the process PHISCO employed to allocate service company expenses to Atlantic City Electric resulted in a reasonable distribution of corporate and operating expenses during the audit period.

2. During the audit period, PHISCO's internal controls and the accounting procedures governing the service company cost accumulation and distribution process were adequate to facilitate a reasonable distribution of service company costs between regulated utility and non-regulated diversified operations and among PHI's three utilities. Specifically:

    a) Accounting procedures priced the services to be distributed to subsidiaries on a fully distributed cost basis; that is, the price included the direct, indirect and overhead charges attributable to the activities charged.

    b) Procedures included processes for periodic true-up to actual cost where service company prices and allocations were based on estimates.

    c) Organizational and accounting controls were adequate to facilitate a reasonable link between PHISCO services and the PHI businesses and subsidiaries that benefit from them. Specifically, these controls included procedures linking service company activities to service company departments focused on specific PHI business segments (Competitive Energy & Power Delivery) and accounting procedures linking organizational cost centers to cost pools. These procedures, which separate costs directly attributable to the Power Delivery segment from those attributable to the Competitive Energy segment, reduce the likelihood of cross-subsidization of non-regulated activities by the regulated utilities.[2]

[2] However, this does not mean that cross-subsidization cannot occur as the process is also highly dependent on decisions made by PHISCO employees.

d) PHISCO's allocation procedures generally take advantage of measures (including allocators and unit rates) that establish cost-causative links between service company activities and subsidiaries that benefit from them when such measures exist.

e) Due primarily to the nature of the corporate activities charged by PHISCO, many of the size-based allocation methods used to distribute corporate costs are "unattributable" and inherently arbitrary. However, due to the characteristics of PHI's current set of non-regulated businesses (primarily their size relative to the regulated utilities), PHISCO's allocation methods were generally adequate in the audit period to produce a reasonable distribution of corporate expenses between PHI's regulated Power Delivery and its non-regulated business segments. The allocation procedures also produced reasonable distributions among the three utilities, because the utilities share similar investment and operating characteristics. This finding is based on the PHI's businesses, organizational structure and allocation procedures as they existed during the audit period. It would not necessarily apply in the future if these characteristics became materially different.

f) As discussed below, we found specific problems with a few allocation procedures. However, our audit testing and sensitivity analysis demonstrated that ACE's billings for PHISCO services were not affected significantly by the way these allocators were calculated. As such, the problems we noted do not conflict with our finding that allocation controls and procedures, on the whole, were reasonable to protect ACE from cross-subsidization during the audit period.

3. The definitions for allocation methods and factors documented in PHISCO's Cost Allocation Manual (CAM); specifically, in an attachment to the PHISCO Service Agreement that accompanies the CAM, are inadequate. Specifically, while PHISCO uses more than four-dozen Statistical Key Figures (SKFs) to distribute allocable costs, it maintains allocation documentation only in the form of general definitions of methods that apply to groups of allocators. PHISCO maintains general definitions for *categories* of allocators (e.g. employee, asset and expense-based), but does not maintain definitions for the multiple specific factors, each with their own inputs and calculation procedures, within each category. The lack of documentation makes the factor calculation process a "black box," permitting factor calculation procedures to be changed at will and opening the door to management of allocation results. This would be less of a concern if factor definitions were fully documented in the CAM and Service Agreement and if regulators were notified when a factor's inputs or calculation procedure changed.

4. PHISCO's "Blend" allocator is based on a composite allocator with three parts: assets, labor costs and employees. Presumably, it is intended to capture several characteristics that influence the overall size of the service company's operation (even if they don't

directly "cause" specific PHISCO costs). However, by including both employees and labor costs, the allocator effectively double counts labor. Because the characteristics of PHI's businesses are such that relative levels of employees, operating expense and assets are not significantly different, the "double count" of labor does not significantly influence the amounts allocated to specific subsidiaries. However, it highlights the inherently arbitrary nature of "unattributable" allocators, especially those based on composites of several measures of size or usage.

5. Certain below-the-line activities, including labor associated with Political Action Committees, were appropriately charged below the line.[3] However, corporate brand advertising, which we believe should be either "retained" (charged to the holding company), and certain political and sponsorship expenses, were allocated almost 3/4ths to the utilities, and were charged to above-the-line receivers (account 923).[4]

6. An SEC audit performed in 2005 resulted in a change in allocations that caused the PHI Holding company allocation of certain corporate functions to decline from 10% to about 6%. The impact of this change on PHISCO costs charged to ACE was not significant.

7. Because of the way PHISCO's accounting procedures are structured, a manual process is currently required to identify the cost center and the SKFs (allocation methods) associated with PHISCO cost pools (secondary cost elements).[5]

Recommendations

1. <u>Include detailed definitions of the calculations of allocation factors (Statistical Key Figures, or SKFs) in the Cost Allocation Manual (CAM)</u> – SKFs are the factors used to allocate common service company expenses to subsidiaries. As discussed above, current CAM and Service Agreement documentation of allocation factors is limited to general descriptions that apply to groups of allocators. A lack of documentation creates a potential for changes to be made to calculations and a possibility for the manipulation of allocation results. Overland recommends that PHI incorporate definitions of all SKFs (allocation methods) in the CAM. The definitions should include descriptions of the inputs into the SKF and description of the calculations at a level of detail sufficient to permit an independent recalculation of the allocation factor by anyone possessing the proper financial or operational data. Overland further recommends that PHI adopt a procedure to notify the NJBPU of all intended changes in the methods and inputs used to calculate SKFs, including their impact on ACE's allocation percentage (by showing before and after percentage allocations to ACE), before the changes are implemented.

[3] Response to Discovery, OC-779; OC-621-627.
[4] Response to Discovery, OC-839.
[5] Response to Discovery, OC-837.

2. <u>Develop reports to show: a) how PHISCO's cost centers link with allocation cost pools; and, b) the SKFs (allocation factors) that are applied to cost pools</u>. To facilitate an overall understanding of how service company activities accounted for in individual cost centers are actually allocated to ACE and other subsidiaries, we recommend PHISCO develop the capability to provide:

    a) A report showing which service company cost centers link to each of PHISCO's 400-plus Secondary Cost Elements (cost pools),

    b) A report showing the methods (SKFs and ATPs) applied to each cost pool.

    It is Overland's understanding that establishing these relationships is currently a manual process. PHISCO did this for Overland on a sample basis (for 64 cost pools), but it currently has no automated way of documenting the links among cost centers, cost pools and allocation methods for the service company as a whole or on a regular basis. Providing documentation of these links is fundamental to a high level understanding of PHISCO's allocation process.

3. <u>Identify all PHISCO activities associated directly or indirectly with legislative and political advocacy, corporate sponsorships and corporate contributions and ensure that the costs of such activities, to the extent charged to ACE, are charged below-the-line.</u> Overland found that when PHISCO allocated certain government affairs expenses from activities such as advocacy and corporate sponsorships to ACE, they were charged to an above-the-line "receiver"; that is, to above-the-line account 923. PHISCO has mechanisms in place to charge these expense to below-the-line accounts to the extent they are allocated to the utilities. We recommend PHISCO conduct a complete review of its government affairs, donations, sponsorships and political and legislative advocacy activities to ensure that the expenses directly or indirectly connected to these activities including at least a share of the compensation paid to the Government Affairs Vice President, be charged to below-the-line "receivers" (accounts) to the extent they are charged or allocated to ACE.

PHISCO Organization and Services

For evaluation purposes, we divided PHISCO's organization and services into three categories. Key PHISCO functions and the amounts charged to ACE and the Power Delivery Segment audit period are summarized below.

Exhibit 7-5

Table 3-2 PHI Service Company Audit Period Cost Distributions to PHI Segments ($000s)									
	2005			2006			2007		
Functional Area	**ACE**	**Power Delivery Segment**	**PHI Total**	**ACE**	**Power Delivery Segment**	**PHI Total**	**ACE**	**Power Delivery Segment**	**PHI Total**
Executive Management	2,707	12,611	18,833	2,544	11,181	17,659	3,544	17,037	24,996
Procurement & Admin.	3,621	16,979	18,430	4,514	19,476	21,598	4,151	18,615	20,627
Financial Services	9,879	41,878	53,410	9,806	40,988	51,442	9,906	44,560	54,468
Human Resources Svcs	8,449	33,997	44,612	4,164	17,788	28,824	4,943	24,143	32,680
Legal & Internal Audit	2,066	11,690	14,031	2,392	13,067	15,420	2,880	14,652	17,035
Information Technology	5,472	45,193	48,684	5,059	44,146	46,961	3,876	41,890	44,335
Communications Svcs	776	3,059	3,766	784	4,836	5,688	666	3,726	4,519
Environmental & Safety	680	5,977	6,539	1,795	9,346	9,860	1,062	4,849	5,236
Internal Consulting	74	368	368	116	564	564	219	1,063	1,063
Interns					17	17	62	327	328
Miscellaneous	(39)	(1,351)	(1,401)	(88)	(331)	(376)			
Customer Services	28,361	59,019	59,043	28,007	61,006	61,027	32,082	72,877	72,898
Marketing Services	1,932	4,505	4,559	1,080	3,399	3,451	749	3,696	3,766
Regulated Gas& Electric	17,009	59,716	59,913	17,966	66,653	66,866	16,925	68,777	68,952
Energy Business	1,872	2,833	37,984	1,262	2,149	37,229	225	1,305	35,594
Adjustments	(5)	(13)	(13)	(139)	(626)	(626)	(63)	(243)	(243)
Total	**$82,855**	**$296,460**	**$368,757**	**$79,262**	**$293,660**	**$365,606**	**$81,228**	**$317,272**	**$386,253**

Source: Response to Discovery, OC-42.

The figures above, in percentage terms, are as follows:

Table3-3 PHI Service Company Audit Period Service Company Cost Distribution Percentages for ACE & Power Delivery						
	2005		2006		2007	
Functional Area	**ACE**	**Power Delivery Segment**	**ACE**	**Power Delivery Segment**	**ACE**	**Power Delivery Segment**
Executive Management	14%	67%	14%	63%	14%	68%
Procurement & Admin.	20%	92%	21%	90%	20%	90%
Financial Services	18%	78%	19%	80%	18%	82%
Human Resources Svcs	19%	76%	14%	62%	15%	74%
Legal & Internal Audit	15%	83%	16%	85%	17%	86%
Information Technology	11%	93%	11%	94%	9%	94%
Communications Svcs	21%	81%	14%	85%	15%	82%
Environmental & Safety	10%	91%	18%	95%	20%	93%
Internal Consulting	20%	100%	21%	100%	21%	100%
Interns				100%	19%	100%
Miscellaneous	3%	96%	23%	88%		
Customer Services	48%	100%	46%	100%	44%	100%
Marketing Services	42%	99%	31%	98%	20%	98%
Regulated Gas & Electric	28%	100%	27%	100%	25%	100%
Energy Business	5%	7%	3%	6%	1%	4%
Adjustments	38%	100%	22%	100%	26%	100%
Total	**22%**	**80%**	**22%**	**80%**	**21%**	**82%**

Note: ACE and Power Delivery Segment percentages both represent percentages of total PHISCO cost distributions.
Source: Response to Discovery, OC-42.

PHISCO's organization and services are divided into two broad categories:

- Corporate functions generally shared by both regulated utility, non-regulated energy subsidiaries and other unregulated subsidiaries.

- Shared operating services primarily dedicated to either the regulated utility or non-regulated energy segments, and shared mainly by the subsidiaries within the business segment.

Corporate Functions Provided by PHISCO

PHISCO's corporate functions include the following:

Executive Management - This area consists of PHI's senior corporate management, including the Chairman, President and CEO, CFO, VP-Treasurer and Corporate Secretary. It also includes the Controller, Risk Management and Government Affairs Vice President officers. Executive Management expenses were distributed through 16 different cost pools during the audit period. ACE was charged 14% of executive expenses during the audit period.

Procurement and Administrative - This area includes security, purchasing and materials management, vehicle management, "general" services (such as mail distribution), building services and real estate management. Expenses incurred by these functions are distributed through approximately two-dozen cost pools. ACE was allocated about 20% of the expense during the audit period.

Financial Services - The financial functions include insurance and claims, regulatory affairs, accounting (accounts payable, payroll, asset and project accounting), investor relations and shareholder services, financial reporting and Sarbox compliance and investment management. ACE was charged 18 to 19% of this area during the audit period.

Human Resources - This function includes the cost of certain benefits, including incentive pay, and true-ups and residuals (the difference between budget-based standard charges and allocations for pension, other retirement benefits and vacation accruals). It also includes the corporate human resources function (staffing, administration of benefits, liaison with subsidiary business units and compensation services). During the audit period these items were distributed through approximately two dozen cost pools. PHI billed ACE 19% of this function in 2005. By 2007, this had dropped to 15%.

Legal and Internal Audit - During the audit period there were five cost pools for the legal / audit functional area (three for legal, two for audit). Legal includes the General Counsel's office. Most other senior managers are incorporated within the Executive Management functional area.

ACE's share of the Legal and Internal Audit functions increased from 15% in 2005 to 17% in 2007.

Information Technology – IT includes the operation, maintenance, security and upgrade of the computer network, workstations and phone systems and various information systems, including SAP (enterprise accounting software), the customer service system and various systems used in power delivery and energy management. IT costs are distributed through approximately 40 cost pools and may be directly charged to ACE (as indicated by the amounts shown in Table 3 above), or indirectly charged to through other functions. For example, the customer service function shown above includes a significant amount of IT expense charged to the customer service function within PHISCO, and secondarily charged, using customer service allocation factors, to ACE.[6]

Communications - This area includes employee and internet communications, public and media relations and government affairs. Corporate contributions and political action committee activities are handled through this function. Audit period communications expense was distributed through 16 cost pools.

Environmental and Safety - This functional area includes environmental management, performance assessment and safety services. Audit period expense was distributed through 9 cost pools.

Shared Operating Functions Provided by PHISCO

Services in this category were predominantly assigned to either the Power Delivery or Energy segments and allocated among the subsidiaries within the segments.

Customer Service (Power Delivery Segment) - Shared customer services include call center operations and support of information systems used by the Carney's Point Customer Service Center shared by ACE and DPL. In addition to operations at Carney's Point, shared customer services include large company bill preparation, normal bill preparation and mailing, and remittance processing. In terms of cost, customer service is PHISCO's largest functional area, comprising almost 20% of PHISCO's total operating expense. Virtually all customer service expenses are distributed to the regulated utilities through more than 60 cost pools. During the audit period certain functions, such as the bill printing, envelope insertion and mailing, performance assessment and quality monitoring, revenue process management and metering

[6] Pepco received a much higher direct IT allocation during the audit period than ACE. ACE's relatively low share of direct IT can be seen in Table 3 (above). The table shows that although 93% of the IT expenses charged directly to subsidiaries were charged to Power Delivery, only 11% were charged to ACE. A primary reason for this is that Pepco's customer service function was not integrated with ACE and DPL during the audit period. Because it was separate, IT expenses attributable to Pepco's customer system were directly charged to Pepco by the IT function (and consequently appear under the IT function in Table 3 above), whereas IT expenses attributable to ACE's and DPL's shared customer system were charged to the shared customer service function, and are included in the table under customer service expense.

functions were performed on behalf of all three utilities. However, shared call center operations were limited to Carney's Point, shared only by ACE and DP&L. Pepco continued to maintain its own customer call center operations (within the utility) during the audit period. PHISCO customer service expenses increased as progress was made integrating Pepco into these shared functions. However, this also explains the decline in ACE's share of common customer service expense, from 48% in 2005, to 44% in 2007.

Marketing (Power Delivery Segment) - The Marketing function is small, consisting primarily of functions related to "manag[ing] customer perceptions." These activities are charged entirely to the Power Delivery segment. Marketing also includes corporate advertising, a relatively small activity that is allocated across business segments. ACE's share of marketing expenses decreased from 42% in 2005 to 20% in 2007, as Pepco was integrated into PHISCO Marketing. Marketing costs charged to ACE decreased from $1.9 million in 2005 to $750,000 in 2007.

Regulated Electric and Gas Delivery (Power Delivery Segment) - Regulated Power Delivery is the second largest PHISCO functional area, accounting for approximately 18% of total service company expenses during the audit period. It consists of system operations, meter shop, power procurement, and an extensive number of "other" delivery services, most of which consist of engineering, planning and the maintenance of related information systems. Most E&G Delivery services are common to all three utilities; however, in some cases Pepco continued to maintain its own independent functions and procedures during the audit period. Services in this functional area were distributed through almost 90 different cost pools. ACE's total allocation of shared power delivery remained even at about $17 million annually during the audit period. ACE's share of the total costs dropped from 28% in 2005 to 25% in 2007, as Pepco became integrated into many of the functions previously shared only by DPL and ACE.

Energy Business (Competitive Energy Segment) - Energy functions include the merchant functions (power planning, portfolio management, generation origination and dispatch, power and gas marketing and trading), generation plant management and administration, generation engineering and fuel supply. These functions are allocated primarily to the following four Conectiv Energy companies:

- Conectiv Energy Supply
- Conectiv Delmarva Generation
- Conectiv Atlantic Generation
- Conectiv Bethlehem

At the beginning of the audit period, when ACE still owned the B.L. England generating plant, ACE was allocated approximately 5% of the total expense in the Energy Business functional area. This included 12% of the generation engineering function and about 3% of generation management and administration. With the sale of the plant ACE's overall allocation of shared Energy Business functions dropped to less than 1% in 2007.

PHISCO Accounting Procedures and Internal Control

We reviewed PHISCO's accounting and cost distribution procedures to determine that

- PHISCO's functional organization and books were segregated from the organizations and books of the subsidiaries to which it charges costs.
- PHISCO's procedures for accumulating allocable service costs in cost centers were analogous to the functional areas in which services are provided.
- PHISCO processes for pooling and allocating or directly charging functional costs to cost objectives were consistent and logical.
- The financial and operating measures used as a basis for allocation factors were reasonable and free from calculation manipulation designed to skew common expense allocations toward utility cost objectives (i.e. to Pepco, DPL and / or ACE).

In general, we found that the accounting processes for accumulating, pooling and distributing PHISCO costs were well controlled. These processes are stable and have been in place for a relatively long period of time.

- Accounting procedures for pooling shared services costs were reasonable, consisting of assigning similar costs to specific "secondary cost elements" (SCEs), from which specific allocation and direct charging procedures are applied. The costs of activities pooled for allocation were based on fully-distributed costing principles. In addition to the direct cost of salaries and contractor services, pooled costs included payroll-related (benefits and payroll taxes) and facilities-related (facilities rent, equipment, facilities and information technology support) overheads.

- Accounting procedures for pricing directly charged services included in our audit sample were reasonable. Direct services pricing was based on fully-distributed cost principles. For the direct charges included in our sample, fully-distributed costs consisted of average hourly rates for a group of similarly paid employees providing a particular service. The hourly rates included salaries and payroll-related benefits and taxes, facilities overheads such as the rental cost of space occupied by the employees, related employee expenses, and, as a result of a recommendation in the prior NJBPU audit, a small charge to cover the cost of services provided to service company employees, including the cost of employee benefits administration.

- In general, the allocation methods applied to the SCEs (cost pools) were reasonable for the costs and activities being allocated. The broad "unattributable," size-based methods used to allocate costs for many of the corporate functions are inherently arbitrary. However, PHI's non-regulated subsidiaries, primarily power production and marketing, contained sufficient financial and operating "weight," in relation to the utilities, to draw a reasonable share of the cost of corporate activities from which they derived benefits. We found that applying different size-based measures and calculating size-based factors such as O&M and "total cost" in different (but reasonable) ways would not have materially affected the total service company cost charged to ACE during the audit period.

- We tested PHISCO's most commonly applied allocation factors to determine whether they were calculated using inputs consistent with PHISCO's allocation method definitions, and to ensure that calculation idiosyncrasies did not work to the disadvantage of the regulated Power Delivery segment or ACE. We found that calculating size-based factors such as O&M and "total cost" in different (but reasonable) ways would not have materially affected the total service company cost charged to ACE during the audit period.

Detailed Analysis and Testing

Our technical analysis focused primarily on determining whether PHISCO's process for charging costs produced outcomes that caused ACE or PHI's other regulated utility subsidiaries to cross-subsidize the holding company or PHI's competitive subsidiaries. This testing included the following:

- Analysis of a sample of 64 cost pools allocated during the audit period. This sample was selected to capture the most significant expenses allocated to the Power Delivery segment and to ACE. Sampled costs were examined to determine:

    - The nature of the underlying PHISCO function and costs and their relationship to serving ACE and its ratepayers;
    - The appropriateness of the group of subsidiaries (the cost objectives) selected in relation to the expense distribution;
    - The appropriateness of the methodology (the allocation or direct charge methodology) used to distribute the cost to cost objectives.

- Analysis of the basis for and calculation of Statistical Key Figures (SKFs), PHISCO's term for the methods and factors used to allocate service company costs to cost objectives. We examined the SKFs to determine whether:

    - There was proper documentation of the basis for the SKFs.
    - The SKFs represented a reasonable basis for allocating the PHISCO expenses to which they were applied.
    - The SKFs were properly calculated based on their descriptions. For example, we examined the total cost (TOTCST) SKF to determine how "total cost" was

defined, and whether this definition was consistently applied to all subsidiaries in providing cost inputs to the SKF calculation.

PHISCO's Cost Accumulation and Distribution Process

In order to assess the service company functions and expenses charged to ACE, PHISCO's overall accounting process can be divided into two sub-processes: cost accumulation and cost distribution.

Cost Accumulation - PHISCO's enterprise accounting system, SAP, is essentially a large database that can group and categorize accounting information in numerous ways. To evaluate this process as it relates to distributing costs between regulated and competitive business segments, it is important to determine that costs are grouped, prior to cost distribution, into categories that align appropriately with the activities (services) being charged to subsidiaries, and that all direct and indirect costs related to these services are included in the appropriate category. Through examination of the cost pools (known as Secondary Cost Elements) included in our 64 item sample, Overland determined that, in general: 1) PHISCO's cost pooling process appropriately accumulates the costs associated with providing specific services, and 2) that the indirect and overhead costs associated with activities are appropriately accumulated with associated direct costs prior to cost distribution.

PHISCO's cost accumulation process centers on "Secondary Cost Elements" (SCEs). SCEs are cost pools produced from the expenses of one or more cost centers. PHISCO uses several hundred SCEs to group expenses for distribution. The large number of cost pools is dictated by the combination of 1) the functional categories into which costs fit; 2) the distribution method (specific allocation method or direct charge) linking costs with benefiting subsidiaries; and 3) the specific group of subsidiaries designated to share a particular cost. With so many cost pools, the predictability and stability of service company billings to ACE is dependent not only upon consistency in allocation and direct charge methods, but also in the cost accumulation process. We examined the year-to-year changes in PHISCO's active pools and found a reasonable, but not extraordinary, level of stability. The rate of change from year-to-year (cost pools added and deleted) was approximately 12%, with a bias toward fewer cost pools over time. This indicates that more than 85% the cost pools did not change from one year to the next during the audit period. The total number of available cost pools shrank from about 475 in 2005 to about 425 in 2007. The consolidation of service company cost pools should contribute to the stability, manageability and understandability of the charging process.

Cost Distribution - Depending on circumstances, unit rates or allocation factors were used to distribute costs from SCEs to "receivers" (cost objectives). "Activity Type Price" (ATP) is PHISCO's term for unit rates that are used as a basis for either directly charging or allocating costs to subsidiaries. "Statistical Key Figure" (SKF) is the term that PHISCO uses for "allocation factor." Based on our sample, it appears that SKFs were used to distribute a high percentage of

PHISCO's costs. Perhaps because it has been encouraged by regulators to directly charge whenever possible, Overland found examples in which PHISCO classified SKF and ATP-distributed costs as "directly charged", when, in fact, the costs were allocated.

- Direct Charges - Directly charged costs employed ATPs calculated based on the fully distributed hourly costs of performing a service. PHISCO employees who dedicated time to specific subsidiaries charged their time to the subsidiaries based on the ATP rate for their positions. Overland found that the number of opportunities for direct charging from the cost pools we sampled was limited. Where direct charging was used, we found that the rates (the ATPs) appropriately considered the difference between professional and administrative hourly rates, and appropriately included the indirect (employee benefits, payroll taxes, employee expenses) and overhead (facilities, vehicle expenses) costs of the activities.

- Allocations - Most allocated expenses employed SKFs (allocation factors) to distribute costs, but there were exceptions in which costs were effectively allocated with ATP unit rates.[7] There are more than four-dozen SKF factors, many of which are simply variations on a theme (e.g. ASSET, ASSET1, ASSET2 and ASSET3). The factors used to distribute a majority of the costs in our sample included the following, with the official code for the SKF in parentheses:

    - Subsidiary Total Cost (TOTCST)
    - Subsidiary Operations and Maintenance Expense (SC-O&M)
    - Utility Customers (CUSTMR)
    - Subsidiary Employees (PEOPLE)
    - Subsidiary Assets (ASSET)
    - Average of Subsidiary Employees, Labor and Assets (BLEND)
    - Service Company Billings (SC-BILL)

Results of Audit Testing

Test of Cost Pool Sample - We reviewed a sample of 64 allocations of PHISCO expense sampled from the months of June, 2005, 2006 and 2007. For each sample selection we:

- Examined the nature of the service company activities and expenses allocated, and if allocated to ACE, we considered whether the activities and expenses provided benefits to ACE.

[7] For example, the Human Resources benefits administration function uses an "per employee" ATP rate to allocate its costs based on relative employees. Although PHISCO considers this a direct charge, it is, in fact, an allocation driven by the relative size (relative number of employees) of the subsidiary cost objectives. There is no action taken by benefits administration employees (or the contractor that now accounts for much of this function) to directly charge the time spent on individual employee issues directly to subsidiaries.

- Whether the group of cost objectives (subsidiaries) to which expenses were distributed was appropriate given the nature of the underlying activities and expenses.

- Whether the distribution method (direct charge or the allocation method) provided an appropriate link (causative, when possible) between the services activities and expenses and the subsidiaries to which the expenses were charged or allocated.

The detailed results of this test are shown in spreadsheet form in Attachment 3-1.

In general, PHISCO distributed its expenses to subsidiaries using measures of relative size such as assets, operating expenses, customers and employees. Some factors can reasonably be defined as "attributable" allocators, meaning that the allocator bears at least some relationship to the amount of cost incurred by PHISCO to conduct the activity. Perhaps the best example of an attributable allocator is the customer allocator used to distribute the cost of the Carney's Point call center to ACE and DPL. In this example, the level of cost incurred by PHISCO does bear a relationship (although not perfect - some costs are fixed) to the number of customers that must be served, and so it is an obvious basis for allocation. Other size-based allocators, such as the "Total Cost" and "Blend" allocators used to distribute various PHISCO functions, are "unattributable"; that is, the amount of cost PHISCO incurs does not generally depend on the expense, employee and other amounts used in the allocator. The questions to be asked with unattributable allocators are:

- Is there an attributable allocator that should be used instead?

- If not, does the unattributable allocator distribute costs in proportion to the benefits received by the subsidiaries being billed. In other words, is it "fair"?

<u>Benefits of PHISCO functions to ACE</u> - A portion of the cost pools tested were directly charged or allocated to ACE for most of the cost pools sampled. Except for a few inherently "corporate" expenses, such as brand advertising, corporate contributions and corporate sponsorships, for which it can be argued that the holding company is the primary beneficiary, we did not find PHISCO costs charged to ACE that did not appear to benefit ACE.

<u>Appropriateness of the Cost Objectives Selected for Allocation</u> - In three of the 64 items tested, we found the cost objectives (subsidiaries) chosen for allocation were questionable. Details are as follows:

- <u>Sample item 51: SCE 6634, Public Relations</u> – Public relations was charged *only* to the Power Delivery segment. No public relations expenses were charged to PHI (the corporate entity) or to PHI's Competitive Energy segment. We believe PHISCO's determination that the benefits of public relations extend only to the regulated utilities is questionable. However, the cost reduction to ACE from allocating this activity more broadly would be minor.

- Sample item 53: SCE 7484, Regulatory Strategy and Policy - As with public relations, regulatory strategy and policy expenses are charged only to the Power Delivery function, which we believe is questionable. Regulatory strategy and policy efforts should provide benefits that extend beyond the regulated utilities, to the companies in the Competitive Energy segment. Again, the potential for cost reduction to ACE from allocating this activity more broadly is minor.

- Sample item 47: SC7655, Government Affairs - This cost pool distributes the expenses of PHI's Vice President of Government Affairs. PHISCO has procedures that enable the utility portion of an allocated cost to be charged to a "below-the-line" (non-operating) cost objective. Generally, below-the-line charges are limited to expenses such as political advocacy and charitable, civic and political donations that FERC account descriptions classify as non-operating. We determined that "advocacy" (legislative, political and community) was a significant focus of the Government Affairs Vice President and that this cost pool included various expenses that should have been, but were not, charged below-the-line. In particular, we found the following:[8]

  - PHISCO described the Government Affairs & Public Policy team's activities included coordinating with PHI entities to achieve consistent positions on issues, including legislative issues.

  - Contractor fees in the sampled month (June, 2007) included $46,294 paid to "Vocus", a provider of electronic software that provides "grassroots management solutions which include a professional online advocacy site." This was charged above-the-line (to FERC account 923).

  - "Training and registration fees" included $10,000 paid to the Institute for Education for a sponsorship contribution for the "Phillips Collection." This was charged above-the-line (to FERC account 923).

  - The Vice President of Government Affairs charged approximately $22,500 to ACE account 923 in the month we sampled. Extrapolating this monthly amount, ACE ratepayers were exposed to a maximum over-charge of approximately $270,000 annually, if the Government Affairs Vice President's function was deemed to be entirely chargeable to below-the-line accounts.[9]

[8] Response to Discovery, OC-621.

[9] Given that the function has regulatory and community elements, it is likely that a detailed examination would yield a finding that at least some of the activities met the requirements for above-the-line accounting. This level of analysis is beyond the scope of our review.

<u>Appropriateness of Allocation Methods</u> - When evaluating allocation methods, it is important to remember that when an activity or expense is "unattributable"; that is, when there is no "causative" link between it and the cost objectives to which it is allocated, there is also no single "best" allocator. Recognizing this, the question becomes whether the allocator is reasonable given the expense being allocated.

Generally, we found the allocation methods chosen were correct (for attributable allocators) or reasonable (for unattributable allocators) for the activities and expenses being allocated. As described in more detail under the discussion of allocation factors (below), it does not appear that PHISCO's allocation methods or its application of allocation factors to specific cost pools resulted in a material mis-allocation or over-allocation of expense to the Power Delivery segment or to ACE. However, we question the use of the "Blend" allocator in some cases. "Blend" is a composite of assets, employee counts and employee salaries, as described below. It is important to note, that in each case, because alternative allocators would have produced a similar result, we do not believe PHISCO's allocation choice resulted in a significant mis-allocation of cost to ACE or the regulated Power Delivery segment.

- <u>Sample item 1: SC7902 - Severance (June, 2005)</u> - This included the costs of employee severance for service company employees. It is not obvious why a composite of employees, employee salaries and assets establishes a better relationship between the cost and cost objectives than a simpler, size-based allocator such as operating expense.

- <u>Sample item 4: SC7414 - Senior VP & Chief Risk Officer (June, 2005)</u> - In this case, it is unclear how the Blend allocator, which is two-thirds weighted by employee measures (employees and employee salaries) is aligned with the "risks" that the Risk Officer expenses are incurred to mitigate. In its comments to Overland's draft report, ACE noted that this amount was reallocated in 2005 as a result of the SEC audit using the Total Cost ratio.

- <u>Sample item 5: SC7400 - Executive Management Incentive Pay (June 2005)</u> - The incentive pay associated with "corporate" executives was allocated using the Blend factor. It is not obvious why a composite of employees, employee salaries and assets establishes a better relationship between the cost and cost objectives than a simpler, size-based allocator such as operating expense or total cost. Our sample included this same cost pool in 2006. By then, PHISCO had changed the allocation basis to total cost.

- <u>Sample item 55 - SC7706 VP Environment / Safety (Corp Env Svcs) (June 2007)</u> – It is not clear that the Blend allocator, weighted two-thirds by employees, is aligned with the activities and assets in the subsidiaries that require PHI to incur environmental costs. It appears that PHISCO chose the Blend allocator because the cost pool includes safety costs - which can be attached to employees - and environmental costs - which can be attached to assets. It is not obvious, however, whether the arbitrary "two-thirds employee / one-third asset" weighting built into the Blend allocation is aligned with the costs included in SC7706.

- Sample item 59 - SC7401 - Miscellaneous Board Chairman Costs (June 2007) - This cost pool included miscellaneous expenses, such as vehicles, occupancy (rent) and parking. We question whether an allocator weighted two-thirds employee / one-third assets is superior to a simpler allocator based on total cost or operating expense.

Analysis of PHISCO Allocation Methods

During the audit period, PHISCO maintained more than 50 allocation methods and factors (SKFs) to distribute service company expenses to subsidiaries. Most were variations based on the following basic measures of size or service usage:

- Operating Expenses
- Assets
- Customers
- Employees
- Computers

We found a majority of the costs in our sample employed a relatively small subset of the available SKFs. We analyzed and tested the six SKFs discussed below, which were used to allocate most of service company expenses distributed from the cost pools included in our sample.

Table 3-4
PHI Service Company
Audit Period Allocation Percentages for Selected Allocation Factors (Statistical Key Figures)

		ACE				Power Delivery Segment			
SKF	**Ratio**	**2005**	**2006**	**2007**	**2008**	**2005**	**2006**	**2007**	**2008**
SC-O&M	O&M Expense	19.7%	19.2%	16.8%	16.1%	71.9%	69.2%	73.7%	73.1%
TotCST	"Total Cost"	18.2%	17.5%	16.5%	16.1%	73.3%	73.6%	76.2%	76.6%
Asset1	Assets	15.8%	16.7%	16.5%	16.7%	80.4%	81.3%	81.7%	81.5%
People	Employees	17.9%	18.1%	16.9%	16.1%	78.1%	80.0%	82.2%	80.3%
Customer	Utility Customers	29.6%	29.6%	29.7%	29.7%	100.0%	100.0%	100.0%	100.0%
Blend	Blend	17.4%	18.0%	17.0%	16.5%	77.9%	79.0%	80.7%	80.2%

Reasonableness of PHI's Broad-Based Corporate Allocations

The most basic way to test the overall reasonableness of corporate allocations based on financial size is to compare allocation results to financial ratios derived from financial statements. The table below shows Overland's calculation of various high-level measures of financial size for 2007. These can be compared with the 2008 SKF results shown in the table above (since the factors shown above are first quarter percentages derived from 2007 financial results).

Table 3-5
Relative Financial Size of PHI Segments and Power Delivery (Utility) Subsidiaries
Based on 2007 Financial Results, Before Corporate Eliminations

Financial Stmt Category	Pepco	DPL	ACE	Power Delivery	Conectiv Energy	PES	PHI Invstmts	Combined
Operating Revenue	22.8%	13.1%	15.4%	51.3%	23.4%	24.4%	0.9%	100%
Fuel, Purchased Power	16.9%	11.2%	14.5%	42.7%	26.8%	30.5%	0.0%	100%
Other Operating Expense	45.3%	20.2%	17.1%	82.6%	11.1%	5.8%	0.5%	100%
Interest, Income Tax & Non-Operating	29.5%	18.5%	23.6%	71.6%	16.2%	4.7%	7.5%	100%
Total Income Statement Cost	**22.4%**	**13.1%**	**15.4%**	**50.9%**	**23.6%**	**25.0%**	**0.4%**	**100%**
Net Income	32.9%	11.8%	15.7%	60.4%	19.4%	9.7%	10.5%	100%
Net PP&E	39.5%	22.8%	18.4%	80.7%	17.3%	1.7%	0.3%	100%
Total Assets	**34.8%**	**19.1%**	**19.7%**	**73.7%**	**11.4%**	**5.2%**	**9.7%**	**100%**

Source: PHI Consolidating Worksheet Data - Response to Discovery, OC-47.

A comparison of relative financial measures with the most closely correlated allocation factors yields the following for ACE:

<u>“Total Cost”</u>

Q1 2008 “TOTCST” SKF allocates	16.1%
2007 Total Income Statement Cost	15.4%

<u>O&M Expense</u>

Q1 2008 “SC-O&M” SKF allocates	16.1%
2007 O&M Other Operating Expense	17.1%

<u>Assets</u>

Q1 2008 “Asset1" SKF allocates	16.7%
Year-end 2007 total assets	19.7%
Year-end 2007 net property, plant & equip	18.4%

Total cost and O&M were the most widely used audit period allocation methods employing measures of financial size (the other two - customers and employees - are based on measures of operating size). The comparisons above show that allocations to ACE in the first quarter of 2008 were slightly below expected percentages using high-level calculations of O&M, PP&E and total assets, and slightly above expected percentages based on a calculation of total cost recorded on the income statement. However, while this comparison shows a reasonable result for ACE, it does not necessarily imply that the results for other individual subsidiaries or the methods PHISCO used to calculate the allocators were similarly reasonable.

Allocation Method Testing

We analyzed and tested the inputs used to calculate factors for PHISCO's four most commonly used allocation methods. This included:

- An examination to determine of the basis for calculating the allocation; and,
- Testing to independently verify the accuracy of financial and operating inputs used in the calculation.

We found that certain financial factors (e.g. total cost and O&M) were based on fairly detailed calculations and that the information needed to understand how the calculations were made could not be obtained from the allocation method definitions in PHISCO's Cost Allocation Manual (CAM) or the PHISCO service company agreement.

O&M Expense (SC-O&M SKF) - "SC-O&M" is one of several allocation factors based on O&M expense. SC-O&M is PHISCO's broadly based (corporate) O&M allocator. It distributes service company costs to all PHI segments and to most subsidiaries (including all subsidiaries with material amounts of O&M expense). 13 of the 64 cost pools in our sample were distributed using either "SC-O&M", or a variant, "O&M T&D" (transmission and distribution O&M). PHISCO defines the "O&M expense ratio" (applicable to "SC-O&M" and other O&M SKFs) as follows:

> A ratio the numerator of which is the total direct (i.e. excludes charges allocated by the service company) operations and maintenance expense, excluding depreciation and fuel costs, of a client company, the denominator of which is the total direct operations and maintenance expense, excluding depreciation and fuel costs, of all Client Companies using the service.

We attempted, without success, to calculate "SC-O&M" using the definition above. We incorporated additional information concerning the treatment of gains on sales of assets and settlement gains that we obtained in discussions about the calculation of the "total cost" allocator. The calculation involves a fairly complex, multi-step process that is not currently documented in the CAM or the Service Agreement. The steps involved in calculating SC-O&M begin with total recorded, pre-consolidated O&M, and proceed as follows[10]:

[10] Response to Discovery, OC-47 and OC-840.

Total recorded O&M
Minus:

- Cost of goods sold (wholesale power and gas purchased by non-regulated subsidiaries)
- Gains (sales of assets, claims, etc.)
- Assessments
- Common support, which consists of a portion (primarily the corporate component) of PHISCO allocations
- Amounts from companies with negative O&M (which would produce a negative allocation)

Plus:

- Selected inter-company accounts included in operating revenue
- "Order settlement" depreciation and interest expense

Sensitivity Analysis – After obtaining the information necessary to recalculate SC-O&M, we tested its sensitivity to changes in the way it was calculated. The table below shows the percentages attributable to the utilities under SC-O&M for the first quarter of 2008 as calculated by PHISCO, as adjusted to remove of all PHISCO allocations and direct charges from O&M, and using O&M as it appears in pre-consolidated subsidiary financial results (i.e. with none of the PHISCO calculation adjustments shown above). The results of this analysis are shown in Table 3-6.

Table 3-6
PHI Service Company
Sensitivity Analysis of Variations on Calculating Allocations Based on O&M Expense (SC-O&M)
Q1 2008 Allocation Factor

	Calculation Description	Pepco	DPL	ACE	Power Delivery
1	Q1 2008 SC-O&M, as calculated by PHISCO	36.6%	20.5%	16.1%	73.2%
2	Remove all allocated and direct service company charges from O&M for allocation calculation purposes	33.9%	18.0%	16.7%	68.6%
3	Use recorded O&M (no adjustments)	30.9%	23.8%	19.0%	73.8%

We believe PHISCO made reasonable modifications to recorded O&M expense for the purpose of calculating the SC-O&M allocator. For example, leaving common corporate support expense in the calculation creates calculation circularity, whereby expenses allocated using SC-O&M in one period affect the allocator calculated in the next period. Although we found the most significant adjustments to total O&M expense to be reasonable, we note that none of the adjustments are documented or explained in the CAM or the Service Agreement. Absent documentation, PHISCO is free to change the calculation methodology at any time. This, we believe, is a control weakness that should be corrected. A definition sufficient to explain the calculation of SC-O&M (and every other O&M allocation factor) should be included in the CAM and the Service Agreement.

"Total Cost" (TOTCST SKF) - The total cost allocation method was used in the audit period to distribute PHI's executive management expenses (compensation and other expenses incurred by the CEO, COO, CFO, General Counsel, Controller, Treasurer, and certain vice presidents) and executive compensation services. It was also used to allocate some common financial (investor relations, shareholder services, financial reporting, Sarbox compliance), communications (government affairs and corporate communications) and internal audit services. The allocation method was implemented as a result of 2005 service company audit conducted by the Securities and Exchange Commission (SEC). At the time, the SEC was not satisfied with the arbitrary 10% distribution of certain high-level corporate expenses to the holding company, so it negotiated with PHISCO for a different method (no less arbitrary) in which corporate interest expense incurred at the holding company level serves to draw costs to the holding company. Beginning in 2005, as a result of negotiation with the SEC, PHISCO began using the TOTCST factor. As a result, the percentage of executive and other high-level corporate expenses retained by the parent dropped from 10% in 2005 to 6% in 2007.[11]

TOTCST was used during the audit period to distribute service company expense from 12 of the 64 cost pools in our sample. It is similar to the O&M allocator, except that its definition also includes service company allocations, interest expense and other taxes, it is similar to the O&M allocator. PHISCO's CAM defines the allocation method as follows:

> A ratio the numerator of which is the total expense of Client Company and denominator of which is the total expense of all Client Companies using the service. Total expense shall exclude depreciation, fuel costs, income taxes and merger-related costs that are charged directly to Pepco Holdings, Inc.

We found that this definition did not provide sufficient information to allow an independent calculation of the allocator. For example, "total cost," as calculated by PHISCO, also excludes gains on sales of assets, a component of operating expense, preferred dividends, costs charged to construction and other costs that could be included under a simplified definition of "total cost." Using consolidating financial data, and with assistance from PHISCO, Overland was able to come close to independently calculating PHISCO's TOTCST SKF.

Sensitivity Analysis – Because the set of income statement items included in the TOTCST factor is inherently arbitrary, we tested the sensitivity of the factor to changes in the items included in it. Specifically, we added other income statement items that could logically considered to be included in a definition of "total cost." As shown in the table below, we found that ACE's "best" calculation, from the standpoint of costs allocable to New Jersey, resulted from the cost items that PHISCO used in its calculation. For example, as shown in the table below, ACE's share of Q1 2008 service company expense allocated using TOTCST would rise from 16.1% under the existing calculation, to 19.1% if the broadest definition of total cost were applied. Conversely, the existing calculation is somewhat detrimental to Pepco, which would see a 1.7% decline in its share of allocable expenses under TOTCST if the broadest definition

[11] The impact of this change on ACE's PHISCO billing is insignificant. However, it is interesting to note that in successfully negotiating its preferred arbitrary allocation method, the SEC accomplished a lower retention of PHISCO costs by PHI.

of total cost were applied. The analysis showed that the allocator is not highly sensitive to what is included in the term "total cost."

Table 3-7
PHI Service Company
Sensitivity Analysis of Variations on Calculating Allocations Based on "Total Cost" (TOTCST)
Q1 2008 Allocation Factor

	Calculation Description	Pepco	DPL	ACE	Power Delivery
1	TOTCST as calculated by PHISCO during the audit period.	42.8%	17.7%	16.1%	76.6%
2	Include (add) costs charged to construction (capitalized expenses).	41.6%	18.6%	18.3%	78.5%
3	Include (add) income tax, depreciation (but not current capitalized expense), preferred dividends and "other" costs	41.1%	18.9%	19.1%	79.1%

<u>Customers (CUSTMR SKF)</u> - The customer allocator was used to distribute expenses from 10 of the 64 cost pools in our sample. PHISCO's CAM describes the customer allocator as follows:

> A ratio the numerator of which is the number of customers served by a Client Company, the denominator of which is the total number of customers for all the Client Companies using the service.

The CUSTMR SKF was limited to use within the Power Delivery segment and would be better defined as the *utility* customer allocator. It was used primarily to allocate costs of customer care operations between DPL and ACE, which include the Carney's Point call center, billing and credit and collection functions. Because Pepco maintained its own call center operation, it was not included in the calculation. For most of the audit period, the CUSTMR SKF split the costs of Carney's Point approximately equally between DPL and ACE.

Using the definition above, we compared the customers used in the Q4 2007 SKF calculation to 2007 year-end customer amounts published in PHI's 2007 Form 10K. The totals for Pepco and ACE were similar (rounded figures in the Form 10K were within one percent of the totals shown in the SKF calculation). However, for DPL, the electric and gas customers shown in the 2007 10K did not compare closely with the amounts used in the SKF calculation, as shown below:

DPL Electric Customers

Year-end 2007, per Form 10K	519,000
Q1 2008, per CUSTMR SKF calculation	462,241

DPL Gas Customers

Year-end 2007, per Form 10K:	122,000
Q1 2008, per CUSTMR SKF calculation	65,403

DPL Total Customers

Year-end 2007, per Form 10K:	641,000
Q1 2008, per CUSTMR SKF calculation	527,644
Difference	113,356

Most of DPL's electric customers (405,729 of 518,753) take only electric service from DPL (they do not buy gas from DPL).[12] However, most DPL gas customers (113,024 of 121,915 at the end of 2007) are also DPL electric customers.[13] For the purpose of allocating the Carneys Point call center shared by ACE and DPL, a DPL customer that overlaps both gas and electric service is counted only once. The 10K calculation counts electric customers and gas customers separately. The SKF calculation removes approximately 113,000 overlapping customers based on the premise that there is little to no incremental cost of servicing the customer's second utility.

Counting each utility service subscribed by DP&L customers, rather than each customer, would lower ACE's allocation of Carney's Point by approximately 4%. However, we agree with PHISCO's approach of counting a customer that takes two utility services once, rather than twice. The only situation that would justify counting an electric and gas customer twice (once for each subscribed utility) would be one in which the second utility caused the call center to incur incremental costs equal to or approaching the amount added by the first utility. However, PHISCO's methodology for counting customers and calculating its various customer allocators should be fully explained in the CAM and the Service Agreement. Currently, it is not.

Employees (PEOPLE SKF) - An employee allocator was used to distribute expenses from five of the 64 cost pools in our sample. There are several employee SKFs, including PEOPLE, "calculated in accordance with the employee ratio"; PEOPLE2, "a count of employees by legal entity and building;" PEOPLE4 - "calculated in accordance with the number of employees paid;" and PEOPST, "a subset of the PEOPLE SKF."[14]

We tested the PEOPLE SKF, which, according to PHI is directly associated with the Employee allocator, defined in the CAM as follows:

> A ratio the numerator of which is the number of employees of a Client Company, the denominator of which is the number of employees in all Client Companies using the service.

To test the inputs to the People SKF, we compared them to amounts shown in a published source, namely PHI's 10Ks. This comparison is shown below:

[12] Response to Discovery, OC-858.
[13] Id.
[14] Response to Discovery, OC-780.

Table 3-8
PHI Service Company
Comparison of Employees Reported in PHI's 10K to Employees Input into the PEOPLE (Employee) Allocation Factor

Employees Per 10K As Of:

Date	Pepco		DPL		ACE		PHISCO		Non-Reg		Total	
12/31/2005	1,526	27.8%	898	16.4%	632	11.5%	1,709	31.2%	716	13.1%	5,481	100.0%
12/31/2006	1,413	27.4%	907	17.6%	588	11.4%	1,756	34.1%	492	9.5%	5,156	100.0%
12/31/2007	1,365	26.6%	916	17.9%	507	9.9%	1,805	35.2%	538	10.5%	5,131	100.0%

People SKF Inputs

Period	Pepco		DPL		ACE		PHISCO		Non-Reg		Total	
Q1 2006	1,763	34.4%	1,295	25.3%	927	18.1%	-	0.0%	1,127	22.0%	5,112	100.0%
Q1 2007	1,698	35.8%	1,353	28.6%	864	18.3%	-	0.0%	815	17.2%	4,730	100.0%
Q1 2008	1,696	35.4%	1,378	28.8%	773	16.1%	-	0.0%	943	19.7%	4,790	100.0%

SKF totals for the periods comparable to year-end 10K figures are those in the following quarter (e.g. Q1 2008 is based on year-end 2007 employee data). We requested a reconciliation to understand the differences between 10K and SKF data. PHISCO reconciled the data for all three audit years. The significant differences are as follows:

- For cost allocation purposes, PHISCO employees either directly assigned to, or directly supporting a line of business, are added to the employees in that line of business.
- Corporate PHISCO employees are removed from the SKF calculation.
- PES employees excluded from the 10K data are added to the non-regulated total for SKF purposes.

In addition, there were small differences due to the cut-off dates for data. Cut-off differences accounted for 1% or less of total employees for PHI as a whole. The reconciliation adequately explains the differences between the employee data in public financial reports and the data used for the PHISCO allocation calculation. However, the CAM documentation describing the PEOPLE SKF calculation is inadequate. Specifically, it does not explain that PHISCO employees directly supporting a business unit are added to the employees in that business unit; that PHISCO employees supporting the corporation as a whole are excluded from the calculation; or the treatment of PES employees relative to the employees shown in public financial reports.

Exhibit 7-5

Attachment 3-1

AFFILIATE TRANSACTIONS AUDIT OF ATLANTIC CITY ELECTRIC
PHI SERVICE COMPANY BILLING ANALYSIS
June 2005 Sample Percentages

Ref No.	Cost Ctrs	Function	Cost Pool	Description	ACE 1500	Power Delivery Segment	Conectiv Energy Segment	Pepco Energy Services Segment	Other Non-Reg (Potomac Capital) Segment	Holding Company Charges	Total All Companies
1	3	Human Resources	SC7902 Severance Allocation (Salaries)	Severance salaries for service company employees	17.7%	78.4%	13.4%	8 0%	0.2%	0 0%	100 0%
2	8013	Customer Services	SC7613 C3 System Support Costs	Operations mgt, IBM support and PHI mainframe costs associated with the Carneys Point Call Center (C3). Activities Include\ maintenance of the database and other aspects of the C3 system, improvements in system functionality (per OC-604).	50.5%	100.0%	0.0%	0 0%	0.0%	0 0%	100 0%
3	931	Customer Services	SC7598 Carney CC-Revenue	Expenses of running the Carney's Point Call Center (reps, bill specialists, supervisors, contractors).	50.5%	100.0%	0.0%	0 0%	0.0%	0 0%	100 0%
4	812	Exec Mgt	SC7414 Sr VP & Chief Risk	Professional services (provide a strategic planning template, Booz Allen, per OC-606), and employee salaries, etc. associated with the Chief Risk Officer.	15.5%	70.1%	12.3%	7.4%	0.2%	10 0%	100 0%
5	3	Human Resources	SC7400 Executive Management	Long term incentive pay and general amortization	16.6%	74 9%	13.2%	7 9%	4.1%	0 0%	100 0%
6	3000	IT	SC7691 IT Workstation	Desktop computer and server costs (hardware leases, software, setup, maintenance, supplies)	15.5%	95 6%	4.4%	0 0%	0.0%	0 0%	100 0%
7	8020	IT	SC7673 SAP Applications	Secondary cost receiver containing costs related to maintaining the SAP system	14.9%	84.9%	14.7%	0.4%	0.0%	0 0%	100 0%
8	888	Customer Services	SC7596 Customer Care Billing	Salaries and salary-related overheads associated with billing. (See questions about this process)	50.5%	100.0%	0.0%	0 0%	0.0%	0 0%	100 0%
9	HRREC	Human Resources	SC6755 HR Employee Services	Empl ben admin. Outside svcs & software amort were > half the budget, which was "direct chgd" at $150/hr. Outside svcs & software amort are not usually proportonal to the efforts of the charging the cost.	18.4%	90.3%	9.5%	0 2%	0.0%	0 0%	100 0%
10	375	Regulated E&G Delivery	SC7978 PHI Pwr Del Plan/Fin	Professional services and salaries associated with the function. The consulting in this case was associated with Sarbox. (OC-607)	21.4%	100.0%	0.0%	0 0%	0.0%	0 0%	100 0%
SAMPLE NET TOTAL					29.4%	89.2%	6.7%	2 8%	0.4%	0 9%	100 0%
TOTAL PHISCO NET BILLINGS (IN AND OUT OF SAMPLE)					**22.5%**	**80.8%**	**14.4%**	**3.4%**	**0.6%**	**0.8%**	**100.0%**

Exhibit 7-5

Attachment 3-1

AFFILIATE TRANSACTIONS AUDIT OF ATLANTIC CITY ELECTRIC
PHI SERVICE COMPANY BILLING ANALYSIS
June 2006 Sample Percentages

Ref No.	Cost Ctrs	Function	Cost Pool	Description	ACE 1500	Power Delivery Segment	Conectiv Energy Segment	Pepco Energy Services Segment	Other Non-Reg (Potomac Capital) Segment	Holding Company Charges	Total All Companies
11	3	Human Resources	SC7400 Executive Management	Long term incentive pay, executive bonus pay and general amortization	17.3%	72.3%	13 9%	5.7%	3 0%	5 2%	100 0%
12	533	Human Resources	SC7990 PHISCO Pension Residual	The annual true-up for pension expense for PHISCO employees (OC-610). Estimates are accrued monthly. Each yr in June or July there is an updated actuarial val. This true up relates to the period Jan-June, 2006.	22.2%	80.1%	14.7%	2 9%	1 0%	1 3%	100 0%
13	931	Customer Services	SC7598 Carney CC-Revenue	Expenses of running the Carney's Point Call Center (reps, bill specialists, supervisors, contractors).	50.5%	100.0%	0 0%	0 0%	0 0%	0 0%	100 0%
14	8022	IT	SC7792 Network	Includes IT labor, vendor, leasing, contractor, depr expenses of maintaining the network & its hardware and the corporate email system. t also includes allocated platform costs (Intel, Unix and Storage. (per OC-612)	15.7%	92.0%	7.7%	0 2%	0 0%	0 0%	100 0%
15	8013	Customer Services	SC7613 C3 System Support Costs	Carney's Point Call Center ("C3"), maintframe operations mgt, IBM support and PHI mainframe costs associated with the C3.	50.5%	100.0%	0 0%	0 0%	0 0%	0 0%	100 0%
16	882, 2139, 2141, 2142 & others	Legal & IA	SC7490 Legal Services	Corporate legal expenses, mostly salaries, some outside services, Legal costs that are not directly charged. Also includes the costs of the General Counsel.	13.4%	90.3%	5 8%	1.4%	1 3%	1 3%	100 0%
17	2105	Financial	SC7503 External Reporting	Salaries and professional services related to external reporting. Prof services include the Price Waterhouse annual PHI audit. (per OC-614).	17.4%	72.8%	14.1%	5 0%	3 0%	5 2%	100 0%
18	888	Customer Services	SC7596 Customer Care Billing	Salaries and salary-related overheads associated with billing. (See questions about this process)	50.5%	100.0%	0 0%	0 0%	0 0%	0 0%	100 0%
19	380	Regulated E&G Delivery	SC7261 Emerg Preparedness	Salaries, salary related overheads related to the emergency prep function	22.0%	100.0%	0 0%	0 0%	0 0%	0 0%	100 0%
20	882	Legal & IA	SC6491 Legal	Direct legal expenses of the Legal department	17.0%	90.0%	9.4%	0 3%	0 3%	0 0%	100 0%
21	8007	Regulated E&G Delivery	SC7227 GIS System Support Allocation	IT and other expenses for the geographic information system containing locational and tracking data for electric distribution outside plant (per OC-616).	50.3%	100.0%	0 0%	0 0%	0 0%	0 0%	100 0%
SAMPLE NET TOTAL					**25.6%**	**84.9%**	**9.2%**	**2.6%**	**1.3%**	**2.0%**	**100.0%**

TOTAL PHISCO NET BILLINGS (IN AND OUT OF SAMPLE)	**21.1%**	**80.8%**	**14.3%**	**3.0%**	**0.9%**	**1.0%**	**100.0%**

Exhibit 7-5

Attachment 3-1

AFFILIATE TRANSACTIONS AUDIT OF ATLANTIC CITY ELECTRIC
PHI SERVICE COMPANY BILLING ANALYSIS
June 2007 Sample Percentages

Ref No.	Cost Ctrs	Function	Cost Pool	Description	PD ACE 1500	Power Delivery Segment	Conectiv Energy Segment	Pepco Energy Services Segment	Other Non-Reg (Potomac Capital)	Holding Company Charges	Total All Companies
22	3	Human Resources	Incentive Allocation	up - Corporate and Power Delivery (utility) business unit executives. Also see sample item 23 below.	19.1%	86 8%	8.2%	4 5%	0.5%	0.0%	100 0%
23	669	Energy Business	SC7132 Energy VP	Primarily an incentive pay true up; but also contains salaries & salary-related costs - managers and execs in the Conectiv Energy business unit. Also see sample item 22 above.	0 0%	0.0%	100.0%	0 0%	0.0%	0.0%	100 0%
24	931	Customer Services	Carney CC-Revenue	Expenses of running the Carney's Point Call Center (reps, bill specialists, supervisors, contractors).	51 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
25	8013	Customer Services	SC7613 C3 System Support Costs	Carney's Point Call Center ("C3"), maintframe operations mgt, BM support and PHI mainframe costs associated with the C3.	51 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
26	3	Human Resources	Executive Management	Executive Compensation	13.4%	64.7%	18.0%	11 0%	2.0%	4.3%	100 0%
27	8022	IT	SC7792 System Support	depr expenses of maintaining the network & its hardware and the corporate email system. t also	14.4%	91 9%	7.8%	0 2%	0.0%	0.0%	100 0%
28	5580	Customer Services	Customer Billing Insertion	of the expense (about 2/3) is postage. Also includes running the inserter, and the materials needed to	51 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
29	2105	Financial Svcs	External Reporting	reporting. Professional services are the Price Waterhouse annual "integrated" PHI audit. (per OC-	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
30	888	Customer Services	Customer Care Billing	Billing dept salaries and salary-related overheads	51 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
31	2141, 2142 & others	Legal & IA	SC7490 Legal Services	outside services, Legal costs that are not directly charged. Also includes the costs of the General	13 8%	88 0%	7.1%	1 5%	1.0%	2.4%	100 0%
32	3000	IT	SC7691 IT Workstation	Desktop computer and server costs (hardware leases, software, setup, maintenance, supplies)	13 8%	95.1%	4.9%	0 0%	0.0%	0.0%	100 0%
33	2104	Financial Svcs	Excess Liab Ins Exp	Liability insurance expense	16 9%	77 8%	10.8%	11 3%	0.2%	0.0%	100 0%
34	882	Legal & IA	SC6491 Legal	Direct legal expenses of the Legal department	15 8%	85 9%	10.8%	1.4%	0.2%	1.7%	100 0%
35	985	Human Resources	SC7971 Strategic Staffing	Salaries and related overheads of Human Resources people working on the workforce recuiting, selection, planning and similar employee-driven activities.	18 9%	90 8%	9.1%	0.1%	0.0%	0.0%	100 0%
36	388	Regulated E&G Delivery	SC6249 CPD Planning Engineer	Salaries and overheads of planning engineers	10.4%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
37	879	Human Resources	SC7804 Vacation Accrual	DPL vacation accrual	0 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
38	878, 8019, HRREC	Human Resources	SC7974 HR Employee Srv Costs	Several HR cost ctrs. Includes salaries, contractor costs [employee benefits outsourcing and legal costs to defend the cash balance pension plan]. Includes one time $94K of "general penalties" for to failing to pay a PBGC premium on time for '04. (OC617)	18 6%	90 9%	9.0%	0.1%	0.0%	0.0%	100 0%
39	903, 2120	Exec Mgt	SC7403 President & CEO	President, Chairman & CEO salaries, incentive pay and consulting expenses	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
40	2116	Financial Svcs	SC7539 Accounting Research & Controls	Charges from Deloitte Consulting, which included: temporary filling of the Mgr of Accting Research, "shadow the 10Q process" and assist developing accting policies. (OC-461)	15 9%	73 6%	16.5%	9 0%	1.0%	0.0%	100 0%
41	HRREC	Human Resources	SC6755 HR Employee Services	Salaries, contractor, depreciation associated with HR employee services (benefits administration)	17 0%	92.7%	7.2%	0 2%	0.0%	0.0%	100 0%
42	2143	Customer Services	SC7478 Utility of the Future	"Utility of the Future" - Primarily an accrual of contractor expenses associated with the Meter Data Management System project. Also includes some internal asset mgt and "strategic support svcs" labor. (OC-618).	22 3%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
43	2104	Financial Svcs	SC7464 Property Insurance Expense	Property insurance expense accrual.	10 3%	55 5%	40.1%	4.4%	0.1%	0.0%	100 0%
44	2104	Financial Svcs	SC7463 D&O Insurance Expense	Directors and Officers liability insurance	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
45	8007	Regulated E&G Delivery	SC7227 GIS System Support Allocation	IT and other expenses for the geographic information system containing locational and tracking data for electric distribution outside plant (per OC-616).	49 3%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
46	604	Energy Business	SC7103 Engineering Admin	Engineering for Conectiv Energy business unit.	0 0%	0.0%	92.5%	7 5%	0.0%	0.0%	100 0%
47	975	Exec Mgt	SC7655 Governmental Affairs Services	Salaries & related expense for the VP of Govt Affairs and an assistant; govt affairs "grassroots . . . Advocacy" software; sponsorship payments (per OC-621)	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
48	908	Exec Mgt	SC7402 Chief Financial Officer	Salary and related expense of the CFO; also includes over $15K in meal expense - this is related to an "All Hands Meeting" held in June, 2007, 228 attendees, which was charged to the CFO's cost center. OC-620.	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%

Exhibit 7-5

Attachment 3-1

AFFILIATE TRANSACTIONS AUDIT OF ATLANTIC CITY ELECTRIC
PHI SERVICE COMPANY BILLING ANALYSIS
June 2007 Sample Percentages

Ref No.	Cost Ctrs	Function	Cost Pool	Description	PD ACE 1500	Power Delivery Segment	Conectiv Energy Segment	Pepco Energy Services Segment	Other Non-Reg (Potomac Capital)	Holding Company Charges	Total All Companies
49	2100	Financial Svcs	SC7451 Shareholder Services	Postage, fees, lcenses and about 12K per month in salaries associated with shareholder services	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
50	893	Communications	SC7658 Media Relations	Primarily salaries and salary related expenses, aslo some contractor services, for the media relations function	15 9%	73 6%	16.5%	9 0%	1.0%	0.0%	100 0%
51	886	Communications	SC6634 Public Relations	Utility public relations.	29 2%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
52	2135	Communications	SC7555 Government Affairs-B/L	Training & registration fees, sponsorships, donations, entertainment	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
53	996	Financial Svcs	SC7484 Regulatory Strategy & Policy	Primarily salaries and salary related expenses	20 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
54	398	Regulated E&G Delivery	SC6283 Government Affairs - DPL	Primarily salaries and salary related expenses for 1) DPL President, 2) Senior Wholesale (customer) Relations Mgr, and 3) an Admin Asst. (OC-623)	0 0%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
55	630	Environmental & Safety	SC7706 VP Environment / Safety (Corp Env Svcs)	Primarily salaries and salary related expenses	16.7%	80 6%	11.8%	7 5%	0.1%	0.0%	100 0%
56	973	Communications	SC7537 Government Affairs-MD	Rent is the #1 cost, also salaries and salary-related expenses. Described in OC-624 only as a "resource cost center for two PHISCO employees"	0 0%	87.1%	0.0%	12 9%	0.0%	0.0%	100 0%
57	862	Financial Svcs	SC6504 Regulatory Reporting	Primarily salaries and salary related expenses	15 5%	100 0%	0.0%	0 0%	0.0%	0.0%	100 0%
58	2128	Communications	SC7469 Federal Corp Comm-B/L	Contractor (outside legal, professional, consulting)	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
59	804	Exec Mgt	SC7401 Chairman of the Board	Facilities, vehicle and membership charges	16.7%	80 6%	11.8%	7 5%	0.1%	0.0%	100 0%
60	2127	Communications	SC7468 MD Gov't Affairs-B/L	Contractor (outside legal), $500 in registration fees	0 0%	87.1%	0.0%	12 9%	0.0%	0.0%	100 0%
61	2129	Communications	SC7467 Political Action Commitee-B/L	Labor expense associated with a "Budget & Ethics Compliance Analyst" who also serves as Political Action Committee administrator (OC-627)	16.1%	76.1%	10.4%	4 8%	2.7%	6.0%	100 0%
62	879	Human Resources	SC7990 PHISCO Pension Residual	Pension residual charges	22 0%	83.1%	12.4%	3.1%	0.8%	0.6%	100 0%
63	879, SCOPEB	Human Resources	PHISCO OPEB Residual	OPEB Medical residual charges	22 0%	83.1%	12.4%	3.1%	0.8%	0.6%	100 0%
64	3	Financial Svcs	SC7417 Corporate Expenses	Contractor accrual reversal	15 9%	73 5%	16.5%	9 0%	1.0%	0.0%	100 0%
SAMPLE NET TOTAL 2007					**23.7%**	**80.9%**	**16.2%**	**1.3%**	**0.4%**	**1.2%**	**100.0%**
TOTAL PHISCO NET BILLINGS (IN AND OUT OF SAMPLE)					**20.5%**	**80.9%**	**15.5%**	**2.4%**	**0.5%**	**0.7%**	**100.0%**

Chapter 24. Support Services - Information Technology

Information Technology (IT) is housed in PHI Service Company and is one of its largest corporate support functions.

Summary of Findings

1. In most cases, the IT department met or exceeded audit period Service Level Expectation targets. The IT department maintained approximately 30 service level expectation (SLE) metrics to measure the quality, reliability and time efficiency of various IT services and systems performance. Target performance for SLEs is established by a committee that includes members of the IT department and representatives of the "client" departments that IT serves. Some of the targets are set based on industry benchmark data, including IBM's "best in class" data. Generally, the department met or exceeded its SLE targets during the audit period.

2. Most of PHI's major information systems are 10 years old or less and most are either new or have been upgraded within the past five years. However, the legacy customer service systems used by ACE / DPL and Pepco were found in 2005 to be inadequate and in need of integration and replacement. Thus far, no action has been taken to implement a more modern, integrated customer service information system. Overland did not perform a detailed analysis to determine whether PHI's information systems were up to date. However, a study performed by a team composed of both PHI IT employees and an outside consulting firm, TMG, found that the legacy customer service systems were out of date and in need of replacement. The team found the most viable solution was a commercial, off-the-shelf system. The study found a number of the legacy systems' components to be either "unsatisfactory" or "failing." The "C3" system used by ACE and DPL fared somewhat better than the CIS system used by Pepco. To date, PHI has not committed to replacing and integrating the legacy customer service systems. The IT department's current intention is to replace the system sometime between 2011 and 2014, after the anticipated implementation of automated meter reading.

3. Post merger integration enabled PHI to reduce pre-merger IT budget and staffing levels by about 25%. Most of the staffing reduction occurred prior to our audit period. The budget increased in 2007 due mainly to the transfer of Business Systems and Customer Care "core systems" groups moved from the Power Delivery Utility Operations organization. Adjusted for these transfers, the budget has been flat for several years.

4. Recent IT department business plans seem to indicate that staffing and training budgets are inadequate to provide necessary core systems support while also managing new projects. The 2007/2008 business plan (November, 2006) noted "deep reductions in proposed projects" and stated that the budget has "eliminated initiatives needed to support IT strategies." The 2008 / 2009 business plan (November, 2007) noted that "the

increased number and business importance of projects led by the Blue Print for the Future and utility integration are driving risks over the plan period" and that "[u]nless these risks are managed we could fail to meet plan objectives." It cited the need for 26 additional staff to meet plan objectives. It is not possible, given the level of analysis we performed, for Overland to determine whether the concerns expressed are valid, are lobbying by the IT department for a bigger slice of a fixed O&M budget pie, or something in between. As for new projects, as stated above, it is clear that a 2005 study performed in part by an outside consultant determined that the legacy customer service systems should be replaced and integrated, and that as of 2009, this has yet to receive approval and funding.

5. <u>PHI IT does not make use of project management organizations (PMOs) to oversee the development and implementation of large scale projects</u>. A benchmarking study done by the Hackett Group notes that PHI IT does not use PMOs for large-scale project management. The study cites the use of a PMO as a best practice, and noted that PMOs were employed by 70% of the companies in the study peer group.

Recommendation

1. <u>Perform an assessment of the benefits and costs of forming a project management organization (PMO) to oversee development and implementation of large scale projects</u>. A PMO can instill project management discipline by providing project management guidance, ensuring adherence to standardized processes and methodologies, and providing a centralized source for managing project timelines, resources and skills. A benchmarking study performed by the Hackett Group noted that the use of a PMO was a best practice and that PMOs were utilized by IT departments in 70% of peer group companies included in the study. We recommend IT perform a qualitative (project management pros and cons) and quantitative (cost / benefit) analysis to consider whether it makes sense for PHI to adopt a PMO in its IT organization. We also recommend that ACE provide a copy of the results of this analysis to the NJBPU.

IT Organization and Budget

PHI's IT function is headed by Kenneth Cohn, Chief Information Officer (CIO). He reports to Joseph Rigby, PHI's Chief Operating Officer. Cohn also held this position during the audit period.

IT has reduced its staffing and budget in the years since Conectiv and PHI merged as it moved from a "dual geographic-centric model into a single function-centric model."[1] Most of the savings relating to integration occurred prior to the audit period, primarily in 2003. Just prior to

[1] Response to Discovery, OC-990 PHI IT Business Plan, 2007-2008, pp 10-11. PHI notes that IT achieved staffing reductions of 25% from pre-merger levels by early 2004.

the merger Conectiv and Pepco IT had a combined O&M budget of $123 million and staffing of 378 full time equivalents (FTEs). By 2004, this was reduced to $93 million, with staffing reduced to 284 FTEs. The budget remained flat in 2005 and 2006 at $93 million. In 2006, the organization was realigned to include mail insertion and business systems analysis, which had been part of Utility Operations. The realigned budget for 2006, with these transfers, was $112 million. The budget approved in 2007 was $107 million.

In 2005 and at the beginning of 2006, the IT function included approximately 260 employees. By 2007, with the transfer of Customer Care Core Systems and Power Delivery Business Systems groups from Utility Operations, headcount increased to approximately 340. At the end of 2007 IT consisted of the following groups and headcount[2]:

- Infrastructure (70 employees) - This group consists of three sub-groups: Workstations, Application Integration and Network. It supports workstations and laptops, corporate email, phones, software distribution, application integration and the network (servers, internet, storage, remote access and firewall security).

- Power Delivery Business Systems (35 employees) - As described by ACE, this group consists mainly of business analysts who develop and enhance utility operations systems and applications, maintain relationships with vendors, assess and report data, and support Utility Operations business processes. In 2007 the group moved into the IT function from Utility Operations. Systems include Outage Management (OMS), Mobile Dispatch (MDS), Geospatial Information (GIS), Graphical Work Design (GWD), and the Workforce (WFMS) and Maintenance (MMS) Management systems.

- IT Services (40 employees) - Subgroups include Client Support and IT Security / Business Alignment. Client Support runs the help desk (the contact point for IT users) and provides on-site (field) support (installations, moves, adds, changes, repairs). Security / Business Alignment maintains security-related policies and standards, assesses security and conducts IT SOX compliance, emergency preparedness, and IT budgeting and procurement.

- Customer Care Core Systems (30 employees) - CCCS supports and maintains billing and telephone systems. The Customer Care Core Systems subgroup develops business requirements, designs, tests and implements application changes to the customer information systems. The Telephony Support subgroup provides maintenance and support to the customer service telephone system (voice response unit and related systems).

- Customers Systems (70 employees) - This is composed of three subgroups. Enterprise Systems Engineering manages and maintains the IBM mainframe that runs the ACE /

[2] Response to Discovery, OC-698. Employee counts are rounded.

DPL and Pepco customer information systems (CIS). Computer Operations schedules, executes and monitors CIS functions and runs the process of producing and distributing customer bills. Customer Care Systems supports and maintains Pepco's CIS. On the ACE / DPL side, programming support for the CIS system is outsourced to IBM. The group grew in 2007 when 7 employees from the bill insertion function were moved from the Utility Operations group into the IT department.

- IT Applications (90 employees) - This group develops, maintains and supports corporate applications other than the customer systems. These include SAP, which supports Finance and Accounting, Human Resources and Supply Chain activities; PowerPlant, the utility asset management system; Outage Management, Mobile Dispatch and Geospatial Information. The primary position is the Applications Analyst, who interfaces with business analysts in the Power Delivery Business Systems Group and system end users. Subgroups include SAP Functional Development and Support; SAP Technical Development and Support; Power Delivery Development and Support and Corporate Systems Development and Support.

In 2007 Corporate Facilities transferred responsibility for network-attached copiers to IT, but this did not require a change in organization and headcount, which remained mostly unchanged through 2008.[3]

IT Resources and Information Systems

Key hardware managed and maintained by the IT function consists of the following[4]:

- An IBM Mainframe computer and peripherals used to support both the Pepco and ACE/DPL customer information systems.
- Desktop and laptop computers - IT is responsible for maintaining approximately 3,400 desktop and 1,400 laptop computers.
- Wide area and local area network and servers - IT supports three corporate data centers connected via WANs and LANs. These connect approximately 565 Windows and 225 Unix-based servers.
- Radios, cell phones and BlackBerry units - Nearly 1,000 radios, including vehicle-installed, hand-helds, and various others, are assigned to ACE. About 330 cell phone and BlackBerry units are assigned to ACE.
- Field force automation units (mobile dispatch terminals) - Approximately 200 of these devices, which communicate job information between field and office, are assigned to ACE.

[3] Response to Discovery, OC-990 PHI IT Business Plan, 2008-2009, p.11.
[4] Response to Discovery, OC-700

Major corporate information systems used by or serving ACE include[5]:

- C3 and Navigator - C3 is the ACE/DPL mainframe-based customer service system supported by IBM. It provides billing, customer information, rate change implementation and reporting. C3 interfaces with various subsystems (meter records, meter reading management and collection tracking). It was implemented in 1999 and has not undergone a major upgrade. Navigator is the graphical user interface for the C3, implemented in 2001. It displays customer information, including customer history and outage status and supports trouble ticket generation. Pepco has a separate customer information system. The two systems are not currently integrated and will not be in the near future, although PHI indicated there are long-range plans to create a single customer system.[6]

- Geospatial Information System - GIS is a General Electric product used to model, map and track facilities and equipment, including transmission and distribution facilities. It interfaces with the Outage Management System. Essentially, it is a geographically oriented database of T&D equipment. PHI implemented GIS in 2001 and upgraded it in 2004.

- Graphical Work Design - GWD is a GIS application from Cook Hulbert. It is used for facility and construction design and editing. It allows users to create work sketches, perform engineering calculations. It is integrated with the GIS and Work Management Systems. GWD was implemented in 2001 and upgraded along with GIS in 2004.

- Mobile Dispatch System - MDS is a field force automation application that electronically replaces the printed copy of a field work order. It interfaces with C3 and OMS to receive work orders. It is also used to validate and send work completion information to update host systems, produce SAP time sheets and produce field performance reporting. MDS was implemented in 1999 and upgraded in 2007.

- Outage Management System - During the audit period the OMS used by ACE was a General Electric application. OMS receives customer trouble reports and provides information for crew dispatch. It includes a database that contains customer information, the electrical network configuration of feeders, transformers and the location of switches, fuses and taps. OMS analyzes trouble reports to pinpoint the source of outages. The GE-based OMS was implemented in 2001 and upgraded in 2005. PHI is in the process of migrating ACE and DPL from the GE system to the Oracle/SPL-based system currently used by Pepco.[7] This began in 2008 and is scheduled to be completed in 2009.

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[5] Response to Discovery, OC-699 supplemental
[6] Telephone interview, Noel Underwood, PHI IT, March 26. 2009
[7] Response to Discovery, OC-1007

- Work Force Management System - WMIS manages the distribution system design and construction process. It schedules work requests, tracks equipment and materials and forecasts resource usage. WMIS was implemented in 1998 and upgraded in 2007. A study is planned for 2009 to consider replacing WMIS with SAP.

- SAP - SAP is a vendor-licensed enterprise resource and planning system (also known generically as an enterprise accounting system). It is the primary information system for financial accounting, human resources, payroll and materials and maintenance management. SAP provides a general ledger and related financial accounting functions, cost center, project and payroll accounting, FERC reporting, accounts payable, purchasing, inventory, personnel administration and plant maintenance. It was installed in 1997 and upgraded in 2006. There are no plans to replace SAP.

- PowerPlant - This is an asset management accounting system containing PHI's plant ledger (continuing property records). It supports mass and specific asset accounting. It interfaces with SAP and WMIS. PowerPlant was implemented in 2008.

- Load Profiling and Settlement System - The LPSS Billing Expert is a specialized billing application for non-standard bills. It was implemented in 1999 and upgraded in 2006 to integrate load profiling and settlement for all three PHI utilities. The upgrade included development of a new automated interface with the ACE/DPL billing system.

- Telephone Voice Response Unit - The telephone VRU, an Avaya system, includes a platform that allows customers to perform self-service transactions (bill reprint, bill payment and customer information updates) over the phone. It also directs inbound call traffic in the customer call center. It was implemented in 2006.

- Nexus Customer Self Service - This system, from vendor Aclara, is an internet-based self-service application. In addition to performing the functions permitted by the VRU, Nexus can provide energy consumption information and advice on how to minimize bills. It was implemented in 2006.

Business Plans and Staffing Levels

A review of IT business plans for the years 2005 through 2008 shows that IT has tried to reconcile operational requirements and the implementation of new technology with budget constraints. The plans contain a section called "Gap / Risk Analysis and Resource Requirements" that reads as an appeal to upper management for increased resources. The Gap / Risk Analysis in the 2007-2008 Plan (November, 2006) notes the following:

> To achieve such deep reductions, all proposed projects except 50% of high risk projects were cut. These cuts have eliminated initiatives needed to support IT strategies. For example:

- Reduction in knowledge transfer and new technology training
- Elimination of some scheduled renewal for key infrastructure ([computer] network switches and PBXs)
- Elimination of new technology pilots
- Elimination of security improvements

> Allocation system core support and new projects compete for a limited pool of resources. Generally this has constrained resources for discretionary enhancements and leave[s] little to no contingency to address unforeseen regulatory enhancements or unknown requirements.[8]

In the 2008-2009 Plan (November, 2007), the “Gap / Risk Analysis” discussion included the following:

> The increased number and business importance of projects led by the Blue Print for the Future and utility integration are driving risks over the plan period. Unless these risks are managed we could fail to meet plan objectives.
>
> <u>More Resources Needed</u> - Current estimates are that 26 additional FTEs are required for Blue Print for the Future in 2008. Successfully on-boarding new resources to backfill for staff or perform a project role is a key to keeping projects on track and maintaining operations.
>
> <u>Limited Key Resources</u> - The number of related Blue Print for the Future and integration projects may over-subscribe resources with special skills or knowledge. We have just started bringing projects online and struggle to fill project leadership positions.
>
> <u>Aging Workforce</u> - The impact of the aging workforce will coincide with key projects. Maintaining legacy systems scheduled for replacement will be difficult if key resources with older technology knowledge leave. New projects may also be impacted if key functional resources are lost.[9]

We requested information about how many of the 26 additional FTEs discussed as being needed in the plan had been hired. PHI responded that “the 26 FTE estimate . . . was a high level representation of incremental project requirements above those that could be provided with existing IT complement. Positions were not added . . . A provision was made in the 2008 IT budget to cover the additional project requirements with contractors. Resources were acquired as needed and did not exceed the budget.”[10] Based on this, it does not appear that any of the additional positions requested by IT were approved. A detailed assessment to determine whether “risks” were adequately managed and “plan objectives” were met is beyond the scope of this audit; however, it is clear that IT did not receive the resources it requested during the audit period.

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[8] Response to Discovery, OC-990, PHI IT Business Plan - 2007-2008, November 21, 2006
[9] Response to Discovery, OC-990, PHI IT Business Plan - 2008-2009, November 20, 2007
[10] Response to Discovery, OC-1019

Integration of Pepco and ACE / DPL Customer Information Systems

The most significant information systems that have not been integrated between ACE / DPL and Pepco are the customer information systems. In 2005 PHI hired an independent consultant, TMG Consulting, to work with PHI IT (on a team basis) to determine whether and how the Pepco CIS and ACE / DPL C3 systems should be integrated. Both are legacy systems running on the same PHI mainframe computer.[11] TMG interviewed employees, including CIS and C3 system users, examined the components of the legacy systems, compared various alternatives, and assessed the functionality of the system components using an industry standard functionality template.

One of the most significant things the TMG / PHI team determined was that the functionality of many of the components of the existing legacy systems was judged to be "failing."[12] Overall, the functionality (functional fit) of the Pepco CIS system was scored at 59% (failing) and the ACE / DPL C3 system was scored at 67% (unsatisfactory).[13] By comparison, the functional fit of a typical leading CIS packaged application was scored at 90%. The team recommended that "PHI replace its existing system with either an outsourced, hosted or managed [commercial, off-the-shelf] CIS system." It indicated that the next step was to issue an RFP to solicit the market and obtain real bids for the various options."[14]

Although the recommendation to replace the CIS and C3 systems was made in 2005, the next step has not been taken, and PHI continues to operate customer information systems whose functionality is, according to the TMG / PHI team that studied it, significantly below industry standards. During a brief interview with Ken Cohn, PHI's Chief Information Officer, we asked why the recommendations of the TMG / PHI team had not been pursued. Mr. Cohn indicated that subsequent to 2005, the smartgrid and automated metering became issues that could affect a CIS replacement.[15] According to Mr. Cohn, IT plans to revisit a plan to integrated CIS in the 2010 budget cycle, with the hope that vendors producing CIS systems can integrate automated metering technology into the systems in one to two years. It appears that PHI's current plan is to replace both CIS systems (Pepco and ACE/DPL) in the 2011-2013 timeframe.

IT Performance Measurement

Balanced Scorecard - We reviewed the 2007 and 2008 balanced scorecards for the IT function. The table below summarizes 2007 and 2008 targets and results.

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[11] Response to Discovery, OC-1018, Attachment, *A Blueprint for CIS Success*, June 3, 2005

[12] Components included account management, billing management, credit & collection management, customer choice, customer managemen, customer service, financial management, inventory management, usage management, rates management, service location and service order management, system design and technology management.

[13] Response to Discovery, OC-1018, *A Blueprint for CIS Success,* p.18

[14] Response to Discovery, OC-1018, *A Blueprint for CIS Success,* p.49

[15] Automated metering is in the testing and field acceptance state in Delaware, and possibly several years away in New Jersey. ACE plans in New Jersey are to deploy automated metering in a few pilot cities.

Exhibit 7-5

Table 24-1
PHI Information Technology
Balanced Scorecard Customer and Financial Success Targets & Results (1)

Year / Category	Weight	Target (Plan)	Result	Assessment
2008				
Customers				
Corporate Application & Integration Projects completed by target or 12/31/2008	10%	5 of 7	2 of 7	Missed
Information Technology Core Projects completed	15%	4 of 5	UNKNOWN (2)	UNKNOWN (2)
Blueprint for the Future & Customer-facing Projects	10%	4 of 6	4 of 6	Met
SLE and Performance Goal	15%	No results < threshold; 75% above	1 of 30 below threshold; 29 of 30 met or exceeded	Marginal
Financial Success				
Utility ops admin overhead relative to budget	5%	$160M	$159.7M	Met
Total IT O&M spend relative to budget	25%	$114.6M	$108.7M	Exceeded
Total IT capital spend relative to budget	5%	$16.9M	$14.1M	Exceeded
2007				
Customers				
IT Application Projects	15%	4 of 6	4 of 6	Met
Information Technology Renewal	15%	4 of 5	5 of 5	Exceeded
Complete CIS/MDM Requirements Definition Project	5%	By 6/8/2007	5/18/2007	Exceeded
IT SLE and Performance Goal	15%	No results < threshold; 75% above	1 at threshold 26 met or exceeded	Met
Financial Success				
Total IT O&M spend relative to budget	20%	100%	96.7%	Exceeded
Total IT capital spend relative to budget	5%	100%	94.4%	Exceeded
Implement Virtual IT Help Desk	5%	By 3/31/2007 w/ <$100K savings	3/31/2007 w/ $300K savings	Exceeded

Source: Response to Discovery, OC-71, 992, 993 & 996.
(1) Excludes employee safety & diversity metrics. (2) Data response did not contain the result.

Balanced scorecard results are used to determine payouts under PHI's Annual Incentive Plan. Generally, an overall result that meets targeted (budget plan) performance levels should correspond to a 100 percent of payout under the AIP based on a percentage of employee base pay. Exceeding targets results in more than 100% AIP payouts; while results below target result in less than 100%. The overall result for IT is based the sum of results for each category shown above after multiplying by the weight attached to each measurement.[16] As shown in the chart above, for the customer and financial areas, IT generally met or exceeded its balanced scorecard performance expectations.

Service Level Expectations - The nature of many IT services is such that they can be assessed quantitatively. During the audit period PHI IT maintained approximately 30 service level expectation (SLE) metrics to measure the quality, reliability and calendar efficiency of

[16] The items in the chart cover the "customer" and "financial success" components of balanced scorecard. In addition, there are "employee" components covering things such as safety and diversity, that we have not included. Results in the employee category contribute between 15% (2008) and 20% (2007) to overall balanced scorecard results.

various IT services and systems performance. As shown in the table above, SLEs contribute 15% of the overall weight to balanced scorecard results, which means they contribute directly to the AIP (variable) component of employee compensation.

IT's SLEs are developed by the IT department with input from the IT steering committee. The steering committee is composed of employees from PHI's IT department and key "clients" (employees in departments that use IT services). Targets and ranges are established for each SLE based either on historical experience or on external metrics such as IBM's "best-in-class" benchmarks. During the audit period SLEs covered the following areas:

- Services
  - Help desk phone response time, problem resolution and client satisfaction
  - Security request on-time delivery
  - Workstation installation, maintenance, adds, changes
  - Application integration, support & cycle on-time delivery

- System Performance
  - SAP
  - CIS and billing (C3 and Pepco)
  - OMS
  - Lotus Notes

Some of the SLEs can be compared from one year to the next during the audit period; however, many SLEs are subject to changes each year as the IT steering committee considers ways to improve measurements and to target activities and systems that "client" organizations deem important. For most SLEs, audit period performance exceeded targeted expectations. For example, in 2007, the IT department exceeded expectations for 21 of 29 SLEs we reviewed. The department met expectations for 7 of the remaining 8 SLEs, and was "marginal" (just under meeting expectations) for one of 29 SLEs. We found only one case during the three-year audit period in which a SLE measurement "failed to meet" expected service levels.[17]

[17] Response to Discovery, OC-451, SLE results. In 2006, Lotus Notes (the corporate email system) experienced 111 "outage minutes." This was classified as "failed to meet" expectations. In 2007, the SLE was adjusted so that 150 outage minutes experienced in 2007 was considered to "meet" expectations.

Exhibit 7-5

Table 24-2 **PHI Information Technology -** **2007 Service Level Expectations with 2005 & 2006 Comparison Statistics (where available)**	**YTD Dec. 2005**		**YTD Dec.2006**		**YTD Dec. 2007**	
	Result	**Target**	**Result**	**Target**	**Result**	**Target**
Help Desk						
Avg. Time to answer (D.C. only '05 & '06)	12.9	Meets	11.8	Exceeds	7.4	Exceeds
Abandoned Calls	3.3%	Meets	6.3%	Meets	3.3%	Meets
Problem Resolution by priority:						
Urgent - resolved same day	100.0%	Exceeds	100.0%	Exceeds	100.0%	Exceeds
High - resolved same day	95.8%	Exceeds	96.5%	Exceeds	94.9%	Meets
Medium - resolved 2 days or less	97.4%	Exceeds	95.5%	Meets	92.9%	Meets
Low - resolved 4 days or less	97.0%	Exceeds	98.2%	Exceeds	97.8%	Exceeds
Survey response - client satisfied	95.3%	Meets	96.1%	Meets	97.8%	Exceeds
Security Requests						
LAN ID < 24 hours *	99.9%	Exceeds	97.3%	Exceeds	99.9%	Exceeds
Application Access <24 hours			99.6%	Exceeds	99.8%	Exceeds
Network Resource Access <24 hrs			NM		99.9%	Exceeds
Application Service Delivery						
On-time Integration Request	91.9%	Exceeds	93.7%	Exceeds	94.7%	Exceeds
On-time Support Requests	NM		NM		98.5%	Exceeds
On-time Cycles	NM		NM		99.6%	Exceeds
System, App. & Resource Availability						
Storage Area Network workday outages	NM		NM		0	Exceeds
Lotus Notes workday outage minutes	34	Marginal	111	Fails	150	Meets
SAP Outages / Outage hours	0 / 0	Exceeds	2 / 2.5	Marginal	0 / 0	Exceeds
OMS Outages / Outage minutes	NM		NM		1 / 46	Exceeds
ACE/ DPL C3 Customer Service System						
System still in update at 7AM (late cycles)**	4	Meets	3	Meets	3	Meets
Outages lasting > 4 hours / outage mins.	NM / 150	Exceeds	NM / 606	Exceeds	0 / 2	Exceeds
Bill prints late	NM		5	Marginal	2	Meets
Bill insertions late	NM		NM		0	Exceeds
Online system response % < 1 sec.	95.1%	Exceeds	94.9%	Meets	96.6%	Exceeds

Source: Response to Discovery, OC-451
NM = Not measured for the indicated period
*2005 stat includes LAN ID and application access requests. ** 2005 measurement basis not comparable.

SLE results contribute 15 percent of the weight in the balanced scorecard.

Benchmark Data - PHI provided data comparing its IT to the IT functions of other companies. The data was prepared by Gartner. Inc. High-level data (an executive summary) from a study prepared for PHI IT by the Hackett Group was also provided.

Gartner Data - The Gartner data focused mainly on IT staffing and spending. The key metric used by PHI is IT spending as a percentage of revenue. Comparison of the Gartner data to data developed by PHI internally (for PHI) show that from the beginning of the audit period through the forecast for 2008, PHI spent considerably less on information technology as a percentage of revenue than the Gartner industry average. This is summarized in the table below:[18]

[18] Response to Discovery, OC-994

Table 24-3
PHI Information Technology
IT Spending as a Percentage of Revenue - IT Industry vs. PHI

Source	Year	Benchmark	PHI
Gartner Energy Utility IT Spending	2005	2.42%	1.61%
Gartner Energy Utility IT Spending	2006	2.25%	1.42%
Gartner IT Spending and Staffing Report	2007	2.10%	1.77%
2008 Budget Forecast	2008	not available	1.98%

Source: Response to Discovery, OC-994

Hackett Group Study - In December, 2008, the Hackett Group completed benchmarking PHI's IT function against a peer group of 9 other U.S. utility holding companies.[19] The study utilized 2007 data. PHI was somewhat smaller than the peer group median in most measures of size and scope.[20] The study focused on a subset of PHI's total IT spending (about $66 million out of a budget of $110 million).[21] Data focused on 11 processes in four areas, as summarized in the table below.

Table 24-4
PHI Information Technology Benchmarking
Major Functions and Processes Covered by the Hackett Benchmarking Study

Technology Infrastructure	Application Mgt.	Planning & Strategy	IT Management & Administration
Infrastructure Mgt Operations Management Security Management Disaster Recovery Planning	**Application Maintenance** Application Support Enhancement Delivery Upgrade Execution	**IT Business Planning** Alignment Project Prioritization Communication	**Function Management** Function Oversight Personnel Management Policies and Procedures Oversight
End User Support Help Desk End User Training	**Application Development & Implementation** Planning Constructing Implementing	**Enterprise Architecture** Governance Standards Management	
Infrastructure Development Planning Construct Implement		**Emerging Technologies** Technology Evaluation **Quality Assurance** Change Management **Risk Management** Audit and Compliance	

Source: Hackett Study, Response to Discovery, OC-995 (restricted).

[19] *Information Technology Benchmark Results Executive Briefing*, Response to Discovery, OC-995 (restricted)

[20] PHI was below the peer group median in terms of employees (about half the median number of employees), operating locations (less than half) and IT end users (about half). PHI was slightly above the median in terms of revenue, but this is because the study's revenue figures were based on total corporate revenue. In PHI's case, this includes revenue from Pepco Energy Systems (PES), the competitive retail affiliate. PES is small (less than 200 employees), and draws relatively little corporate IT expense, but due mainly to the pass-through of wholesale energy costs it has a very large revenue profile.

[21] Among the applications that were outside the scope of the study were PowerPlant, the SAP Asset Management and Work Planning modules, GIS, OMS and Energy Trading. The costs associated with these omitted applications should explain most or all of the difference between IT's total spending and the $66 million included in the study.

The study showed that PHI was close to the peer group medians in most categories measured.

- PHI IT's overall cost per IT "end user" was very close to the peer group. Technology cost per employee was 22% higher than the peer group median.[22]
- PHI's IT staffing levels were somewhat below the peer group median.[23]
- PHI's IT's labor costs were relatively low for application management and relatively high for technology infrastructure compared with the peer group.
- PHI was comparable to the peer group in delivering projects on-time (83% for PHI vs. 85% for the peer group) and within budget (90% vs. 85% for the peer group).
- The level of accounting automation, measured by percentage of transactions performed electronically, varied but was lower in many categories than the peer group. Categories included: invoices (2% electronic), purchase orders (40% electronic), payments to vendors (20% electronic), customer remittances (98% were electronic - higher than the peer group), expense reports (0%), management reports (80% - higher than peers), employee records (90%) and employee benefit enrollment (100%).

Among the things that stood out in the Hackett study were the following:

- PHI has a higher ratio of managers to professionals (3 times more on a percentage basis) than the peer group and just a little more than half as many staff per manager as the peer group. In other words, PHI IT has a lot of managers.

- PHI IT does not make use of project management organizations (PMOs), either at the enterprise level or the IT project level. The study notes that it is a "best practice" to have all large scale projects controlled by PMOs. 70% of projects in the peer group were managed through a PMO and about 25% of the peer group had a "formal enterprise-wide" project management organization.

- The study found PHI used and adhered to standard definitions in the hardware, software and communications acquisition processes (somewhat better than peers), and noted that this was a best practice.

- Only 60% of PHI's development projects utilized a formal business case / cost-benefit analysis. The study noted that tracking delivery metrics (based on a business case) was a best practice.

- Although PHI utilizes and meets or exceeds nearly all of its service level expectation metrics, including those used to measure help desk performance, PHI IT resolved only 40% of help desk questions and issues on the first call. The peer group did significantly

[22] Technology cost includes the cost of hardware, software and telecommunications and includes depreciation.

[23] However, only a subset (about two-thirds) of the IT employees discussed in the organization section of this chapter were counted in the Hackett study. Presumably, the same subset was covered in the peer group companies.

better. PHI IT experienced only a little more than half the calls, per IT end user, as its peers.

Chapter 25. Support Services - Other

This chapter covers PHI's and ACE's management of the following support functions:

- Facilities and real estate
- Supply chain (purchasing)
- Vehicles and transportation equipment
- Corporate records
- Corporate security
- Legal
- Insurance and claims

Summary of Findings

Facilities and Real Estate Management

1. Facilities and Real Estate Management is a sub-set of the Safety and Strategic Services organization. Grouped with such disciplines as Security and Document Services, the entire organization was comprised of approximately 130 employees in September 2008. Approximately half of these employees are assigned to a specific utility or facility (mostly Facilities Operations and Maintenance personnel) and the other half provide services to all of PHI.

2. ACE owned six operations facilities and leased four customer courtesy centers, its regional headquarters in Mays Landing, and two other offices as of November 30, 2008. ACE leased the May Landing complex from an affiliate, Atlantic Southern Properties, on a year-to-year basis. In addition to these occupied locations, ACE also owned or leased a number of vacant facilities. The most significant of these were either in the process of being sold or were being sub-leased in early 2009.

3. Employees in the Facility and Real Estate Management organization achieved a pay-out of 65 percent of target for meeting all 2008 customer-oriented performance goals but fell short of most safety and financial success goals established in the Annual Incentive Plan. These goals were not tied to a consolidated business plan. Expectations are that a top-down business plan with associated initiatives, service level expectations, and performance metrics will be in place in 2010.

4. Benchmarking data and company comparisons for Facilities Management were only available for the 2003-2005 timeframe. Based on its own comparisons, ACE did not compare favorably to the survey group, which was comprised of companies throughout North America in a variety of industries. However, we question whether any relevant conclusions can be drawn from these comparisons.

Supply Chain

1. The Supply Chain organization is composed of two primary groups - the Logistics group and the Supply Chain and Sourcing group. While some employees support ACE solely, most provide services to either the entire Power Delivery group or the combined legacy Conectiv utilities (ACE and DPL). This organization is not responsible for the procurement of power supply.

2. Employees in the Supply Chain organization met or exceeded every performance goal established for the Annual Incentive Plan in 2008. However, these goals were not part of a consolidated business plan. Expectations are that a top-down business plan with associated initiatives, service level expectations, and performance metrics will be in place in 2010.

3. PHI's Supply Chain organization had the results of two benchmarking studies at its disposal from the last 3 years. Of the key performance indicators developed from the most recent study, PHI out-performed the multi-industry peer group in all but one metric.

4. Physical inventories conducted by Supply Chain employees and Internal Audit yielded no material discrepancies from 2005 through 2008.

5. The Supply Chain organization and other internal stakeholders have created a working group to oversee the automation of the Company's sourcing process. One recent example of the work of this group is the automation of construction management tools (e.g., the Service Request form).

Vehicle Resources Management

1. ACE's transportation cost per customer was 14% lower in 2007 than an average of utilities from 46 utility holding companies studied by Utilimarc, a utility industry transportation consultant that performs fleet benchmarking.[1]

2. ACE's cost per fleet vehicle was 44% higher than PHI's overall average in 2007. This is primarily due to ACE's audit period fleet mix, which contained vehicles that were larger (more heavy duty) and therefore more costly than the average for the PHI fleet.[2] Although ACE's cost per vehicle was high, ACE had significantly more customers per

[1] Responses to Discovery, OC-73, OC-1020 and OC-1057. Utilimarc, *Pepco Holdings, Inc, ACE 2007 Fleet Benchmark.* Utilimarc's study included 46 participants, most of which were utility holding companies with more than one operating company. We did not attempt to count the utilities in the study, but from the participants listed it is apparent that it included a substantial number of the investor-owned utilities in the U.S. We estimate it included between 75 and 100 individual operating utilities (including three within PHI).

[2] When compared with PHI, the following factors may be in play: 1) The PHI average includes DPL, which is an electric and gas utility. DPL's gas operations vehicles should be smaller and less costly, bringing the average cost down compare with ACE. 2) ACE operates in a more rural territory than largely urban and suburban Pepco. Pepco may have a less for larger, heavier duty buckets than ACE. 3) Fuel cost is affected not only by the larger average size of ACE's vehicles, but also by the fact that they are driven almost 25% more miles per year than the average PHI vehicle.

vehicle than either PHI as a whole or the average participant in the Utilimarc benchmark study. This translates to a lower-than-average transportation cost per customer for ACE compared with PHI and with the study participant average.

Records Management

1. PHI has a corporate records policy covering most types of corporate records. The policy specifies storage, retention and disposal requirements. Records policy is a component of the business policies to which management employees must annually certify their knowledge.

2. ACE and PHI appear to have a practice, but not a policy, covering the retention and disposal of corporate email. It appears that the general practice is for IT to archive and retain corporate email that has not been deleted by employees from their mailboxes for 7 years. There is, however, no written policy requiring that this be done; furthermore, existing record retention policy applicable to "routine correspondence" (without regard to its electronic or paper format) suggests that most corporate email should be retained and then destroyed after five years. Nothing in records retention policy or in the email archive practice as described by ACE specifically covers the maintenance or deletion of corporate email correspondence by employees.

3. ACE does not maintain records of the results of its site visits to Nova Records Management, the company to which physical records storage, retrieval and disposal is outsourced.

Corporate Security

1. Corporate Security policies and procedures appear to adequately address the security of revenue, people, facilities and other physical assets. Security policies cover the hiring and training of security personnel, inspection and audit of facilities, administrative and criminal investigations, theft of energy, government and regulatory compliance and the protection of assets (facilities and materials). Facilities protection is based on a tiered structure in which the level of security at a facility is matched with the level of risk associated with the facility.

2. PHI's Corporate Security Manual appears to adequately cover the responsibilities of the Corporate Security department and the procedures necessary to maintain security. The manual provides detailed coverage of alert levels (levels of situational threat and appropriate response procedures), building access and parking, search procedures, emergency responsibilities and procedures (civil disturbances, sabotage and, bomb threats) and procedures for handling company property (removal, transfer, loans and scrap).

3. The Atlantic Region Electric System Operations procedure provides detailed instructions and restrictions for access to the system control room. The procedure includes secure, escorted and unescorted access requirements and guidelines for the use of ID cards.

4. ACE conducts security audits of "manned facilities" (Mays Landing, Carneys Point and smaller operations and "customer courtesy" facilities) on a four-year cycle.

5. Corporate Security conducts inspections of approximately 150 ACE substations on approximately a two-year cycle. The inspections are being conducted as planned; however, Corporate Security lacks a procedure to ensure follow-up on the deficiencies noted during the inspections to ensure they are corrected. Most deficiencies involve items requiring minor maintenance, such as washouts that may permit entry to the substation area from underneath fencing, torn fence fabric, broken locks or overgrown vegetation.

6. PHI's Corporate Security Strategy policy document, dated November, 2007 contains a goal of conducting an annual review of corporate security policies and procedures. To date (April, 2009), no review has been conducted.

7. PHI's IT organization has taken a series of steps since the beginning of the audit period to prevent and deter cyber attacks, including the installation of firewall, spyware, internet filtering and web security software, conducting network penetration testing and security assessments, installing intrusion detection sensors, and reviewing the security of third-party network connections.

8. Although, as indicated above, PHI has taken pro-active steps to enhance cybersecurity, the Company permits employees "limited" use of the internet for personal purposes (web browsing, personal emailing and similar activities). Most cyber attacks on corporate networks gain access through internet connections. The use of the internet for personal purposes on computers performing critical functions could increase the risk of intrusion into company systems, notwithstanding other steps PHI has taken to enhance security. This being stated, Overland recognizes that it may not be practical or necessary to ban the personal use of the internet on company computers across the board. However, it may be practical and advisable to consider doing so on computers that control or have sign-on capability to critical operating systems.

Legal

1. The Legal organization is structured along practice areas which include a) employment, benefits, tax, environmental, and real estate; b) claims litigation, commercial law, bankruptcy, and intellectual property; c) federal and state regulation; d) NYSE and SEC compliance, securities law, and corporate secretary matters; and e) special projects, corporate policy, and SOX coordination. A full-time in-house attorney, Philip J.

Passanante, an employee of PHI Service Company, is assigned to matters concerning the New Jersey BPU.

2. PHI incurred between $14 million and $19 million in annual outside legal fees between 2005 and 2007. For the first nine months of 2008, the Company incurred approximately $9.5 million in outside legal fees. If the trend in legal fees for the last quarter of 2008 is similar to that of the first three quarters, it would represent a vast improvement over prior years. PHI management has indicated that a concerted effort has been made to handle more matters in-house. Additionally, half of the weighting of Legal's balanced scorecard is tied to controlling outside legal expenditures.

3. Outside legal billings are managed by the Company through the use of a third-party software system called Serengeti Tracker. A decision to acquire a document management system was tabled when management suspended all discretionary spending in the fourth quarter of 2008 due to financial turmoil in the economy.

Insurance and Claims

1. Insurance and claims are handled by two different organizations within PHI. Insurance is managed by Treasury, and Claims is managed by the Legal Services Department.

2. ACE is covered under blanket insurance programs maintained by PHI. Insurance limits and deductible amounts are benchmarked against other utilities to determine appropriateness and adequacy of coverage. Data indicates that PHI's insurance deductible levels are higher than the industry for excess general liability and lower than the industry for directors and officers liability.

3. All claims are investigated, and if need be, reserved if probable exposure is greater than $5,000. The most significant claims-related contingencies disclosed by ACE at the end of 2008 include several environmental remediation sites in which ACE has been identified as a potentially responsible party, a contract dispute involving a previously sold generating facility, and income tax matters.

Summary of Recommendations

Facilities and Real Estate Management

1. We recommend the Company implement a program of service level expectations similar to what is used in the Information Technology department to measure and assess Facilities, Security, and Real Estate Management performance.

2. We recommend the Company consider updating its benchmarking data on Facilities and Real Estate Management so that relative company performance can be assessed. Industry-specific or geographically relevant data would be preferred over data that has been obtained in the past.

Supply Chain

1. We recommend the Company implement a program of service level expectations similar to what is used in the Information Technology department to measure and assess Supply Chain performance.

Vehicle Resources Management

1. Given ACE's significantly higher-than-average cost per vehicle (compared with PHI and the Utilimarc benchmark study average), as heavier duty vehicles (large pickups and bucket trucks) are retired from service, we recommend ACE determine, on a case-by-case basis, whether they can be replaced with smaller, lighter versions of the same vehicle type. A list of retired heavy duty vehicles and their replacements should be maintained and, when it is determined that less costly replacements are not feasible, the reason should be documented. The list should be reviewed annually by the Vehicle Resources Group Manager in conjunction with annual transportation budget to provide a second level of review as to whether smaller, less costly vehicles can be acquired as heavy duty vehicles are retired.

Records Management

1. We recommend ACE (and PHI) implement a policy addressing the retention of corporate email. There is currently no policy covering email and, based on potentially conflicting practices and requirements (as discussed below), it does not appear that the generic applicability of corporate records policy is sufficient to provide assurance that records maintained as emails and email attachments will be retained for required periods. The policy should address 1) the types of emails that constitute a corporate record, 2) retention of email correspondence and attachments by employees on their computers, and 3) retention of archived email correspondence and attachments by the IT organization. We do not recommend specific retention periods, or conditions under which emails should be or may be deleted by employees prior to archiving, but both of these should be considered and defined by PHI in developing an email retention policy.

2. We recommend ACE maintain records of the results of site visits to Nova Records Management. ACE indicated that "periodically, Company representatives will visit the Nova Records facility to ensure ACE documents are adequately stored."[3] ACE stated that it visits Nova "1-2 times per year" but does not maintain any documentation of the visits. Nova appears to be responsible for the care of most, if not all, of ACE's record archive. The findings from the site visits should be documented and maintained. PHI should consider having the findings sent to its internal audit department for their review and recommendations.

[3] Response to Discovery, OC-705, response to question 4 (restricted)

Corporate Security

1. Implement a program of service level expectations similar to what is used in the Information Technology department to measure and assess Corporate Security performance. Currently, PHI does not employ operational metrics to assess the performance of the security function. It is Overland's understanding that a system of service level expectations is being implemented beginning in 2010.

2. Standardize corporate security training across all PHI companies. Provide the corporate training given to Pepco uniformed security personnel to security personnel in ACE territory.

3. Perform and document the annual review of security policy and procedures as indicated in the Corporate Security Strategy document.

4. Implement a procedure to followup on and ensure correction of deficiencies found during substation inspections. Currently, Corporate Security performs substation inspections, documents noted deficiencies (most of which by themselves are minor), and sends inspection reports to the Substation Maintenance organization, where it is assumed corrections will be performed. We recommend a simple followup procedure be implemented to ensure corrections are made: 1) Corporate Security should hold the inspection report open until 2) Substation Maintenance reports back that it has addressed and corrected the noted deficiencies. This can be done by having someone in Substation Maintenance sign off on the deficiencies when corrected and sending a copy of the signed report back to Corporate Security.

Facilities and Real Estate Management

The Facilities, Security, and Real Estate Management organization is part of the larger Safety and Strategic Services group which also includes Vehicle Resource Management and Supply Chain among others. The Facilities, Security, and Real Estate Management organization has primary responsibility for facilities operations and maintenance, real estate management (including rights of way), corporate security, and document services (e.g., mail, messenger, records retention, and reprographic services). We have discussed the Corporate Security and Records Retention functions separately in other areas of this chapter.

Organization - The head of the group is David Motil, Manager of the Facilities, Security and Real Estate Management Group. Mr. Motil reports to Hallie Reese, Vice President of Safety & Strategic Support Services. The Facilities, Security and Real Estate Management group consisted of approximately 130 employees as of September 2008.[4] The organization is about evenly divided between PHISCO employees who provide services to all of PHI and utility

[4] Employee counts include open positions.

employees with responsibilities limited to a utility or a location. A good example of the latter is an employee working in building and grounds operations and maintenance.[5] Functionally, employees work in the following areas:[6]

- Facilities Operations and Maintenance (65 employees) - Responsible for the construction, reconfiguration, operation, and maintenance of new and existing facilities. Also ensures compliance with local, state, and federal laws (e.g., safety and health, environmental, etc.).

- Corporate Security (26 employees) - Responsible for the technical and physical security of the Company, its employees, and the general public. Also directs investigative support and surveillance activities.

- Real Estate & Right of Way:

  - Document Services (21 employees) - Responsible for the Company's mail, messenger, records retention, and reprographic services.

  - Real Estate (18 employees) - Responsible for the acquisition, leasing, sale, and management of land and transmission / distribution right-of-way.

- Administrative (3 employees)

ACE Facilities - In 2008 ACE owned six operations centers in the following locations:[7]

- Pleasantville
- Cape May Court House
- Bridgeton
- Glassboro
- Winslow
- West Creek
-

In addition, ACE leases office space for the following purposes (term of lease included parenthetically):[8]

- Atlantic City - Customer Courtesy Center (January 2009 - December 2012)
- Turnersville - Customer Courtesy Center (April 2000 - March 2009[9])
- Millville - Customer Courtesy Center (April 1990 - March 2012)

[5] Response to Discovery, OC-1140.

[6] Responses to Discovery, OC-215 and OC-1140.

[7] Response to Discovery, OC-715 (as of November 30, 2008).

[8] Response to Discovery, OC-715.

[9] Response was provided January 21, 2009.

- Pleasantville - Customer Courtesy Center (September 1999 - August 2010)
- Trenton - Government Affairs Office (October 2004 - September 2011)
- Newark (September 2005 - August 2011)
- Mays Landing - Office / Warehouse / Exterior Storage (year-to-year)

The Company disclosed no vacant space in any of the owned or leased facilities listed above. However, ACE did acknowledge that during the period from January 2006 to November 2008, it either owned or leased a number of other facilities that were vacant. The most significant were the Administration Center in Egg Harbor Township with a net book value of $16,650,248; the Brian Parent Center Holly Farm with a net book value of $3,318,776; and the Atlantic City Operations Facility with a net book value of $1,317,534. The first two were under contract for sale at the end of January 2009 while the latter was being sub-leased to mitigate costs.[10] In addition, ACE owned a number of land parcels that were vacant for some or all of the time between 2006 and 2008. This includes a 1,282-acre site in Cumberland County, New Jersey that is intended to be used for a generating station.[11]

During 2007 and 2008, ACE was a tenant of one facility leased from an affiliate, and a landlord of two pieces of property leased to affiliates. A summary of these properties is included in the following table:

Table 25-1
Property Leased to/from Affiliates
2007-2008

Description	**Mays Landing Complex**	**Combustion Turbine Site**	**Thermal Plant**
Location	Hamilton Township	Millville City	Atlantic City
Type	Office / Warehouse / Exterior Storage	Ground Lease	Ground Lease
Lessor	Atlantic Southern Properties	ACE	ACE
Lessee	ACE	Conectiv Atlantic Generation	Thermal Energy Partnership I
Square Footage	58,983 finished / 109,875 unfinished	6098400	22132
2007 Cost	$2,812,198	$16,464	$45,000
2008 Cost	$2,331,506 *	$16,464	$45,000

Source: Response to Discovery, OC-717.
* Described as "(as of 11/30/2008) Annual Cost to ACE".

The Mays Landing complex lease is described in more detail in the chapter on Affiliate Relationships and Transactions.

Business Planning and Performance Measurement - As noted elsewhere, the Safety and Strategic Services organization historically did not prepare a consolidated organizational business plan. Instead, different disciplines within the organization had their own budget and balanced scorecard. A roll-up of the individual scorecards was performed at the Safety and Strategic Services level to ensure that objectives being pursued by individual disciplines were not in conflict. However, management adopted a more formalized, top-down approach to

[10] Response to Discovery, OC-716.
[11] Response to Discovery, OC-725.

business planning for the 2009 plan year. A new purpose statement and areas of focus were developed. Initiatives to drive improvements in the focus areas were identified, and the 2009 scorecard metrics were tied to these initiatives.[12] While other shared services (such as Information Technology) have developed service level expectations for their organizations, it is our understanding that such a system will not be implemented for the entire Safety and Strategic Services organization, specifically including the facilities management function, until 2010.[13]

The 2008 performance of the Facility and Real Estate Management group as measured by balanced scorecard metrics is summarized in the following table. These results are used in determining the level of Annual Incentive Plan pay-outs to employees:

Table 25-2
Facility and Real Estate Management
Balanced Scorecard Results

Description	Weighting	6/30 Target	6/30 Actual	AIP %
Employees - Fatalities	Trigger	0	0	
Employees - Recordables	5%	1	2	0%
Employees - Preventables	5%	1	2	0%
Employees - Complete all safety related work orders within 10 working days	15%	95%	95%	15%
Customers - Implement Green Initiatives	15%	39628	39628	15%
Customers - Develop and complete a Project Plan & estimated timeline and identified milestones to exit Edison Place	20%	39628	39628	20%
Customers - Provide a plan to meet all of the NERC requirements and targeted milestones	15%	39628	39628	15%
Financial Success - Facility, Security, & Real Estate "Total Spend" Relative to Budget	25%	$59.8M	$61.7M	0%
TOTAL	**100%**			**65%**

Source: Responses to Discovery, OC-1118 and OC-1151 (supplemented by July 2, 2009 e-mail clarification).

Although the organization did not make its safety or financial goals in 2008 (ignoring the triggering goal), it did achieve all customer-oriented goals. The resulting pay-out under the Annual Incentive Plan was approximately two-thirds of the target established by management.

Internal Audits - Because PHI's risk-based selection process for internal audits did not identify facilities management as a significant, high-risk operational area, no internal audits were conducted on ACE's or PHI's facilities management function, process, or procedures from the beginning of 2005 to the end of 2008.[14] However, both security audits and substation inspections were routinely performed in years past and are discussed more extensively in the Corporate Security section of this chapter.

[12] Response to Discovery, OC-1023.

[13] Responses to Discovery, OC-718.

[14] Response to Discovery, OC-719 (restricted).

Benchmarking - When asked about the existence of benchmarking studies, the only one identified for Facilities and Real Estate Management was a non-industry-specific study purchased from the International Facility Management Association (IFMA). Using 2005 data, PHI compared its results with those of the study. ACE's results are summarized in the following table:

Table 25-3
Facilities and Real Estate Benchmarking Comparisons
2005

Description (1)	ACE (2)	Study Mean (3)	Applicable Percentile Range (4)
Housekeeping Costs ($ / RSF)	$1.72	$1.35	75th - 90th
Utility Costs ($ / GSF) (A)	$1.84	$2.34	50th - 75th
Maintenance costs ($ / RSF)	$2.81	$2.54	50th - 75th
Current Replacement Value Index (B)	3.5%	1.7%	90th - 95th
Cost of Operations ($ / RSF)	$6.35	$6.39	50th - 75th
Cost of Providing the Fixed Asset (C)	$3.99	$6.19	25th - 50th
Occupancy Cost ($ / RSF)	$16.51	$11.34	75th - 90th
Occupancy Cost per Occupant	$9,698	$4,706	90th - 95th

Source: Response to Discovery, OC-73.
Note: Percentiles are measured as follows: 1st percentile = best, 100th percentile = worst.
(A) ACE used the same figure for rentable square feet (RSF) and gross square feet in its calculations (GSF).
(B) Current replacement value index is the ratio of annual facility maintenance operating expenditures to the current replacement value.
© Cost of providing the fixed asset includes capital costs, capital leasehold improvements, taxes, insurance, and depreciation. It does not include lease costs, project, or support costs.

Although ACE's 2005 results fluctuated around the study's participating-company average (see Columns 2 and 3 above), they were noticeably substandard when percentiles were assigned by the Company to its results (see Column 4 above). However, conclusions cannot necessarily be drawn from this data because of the nature of the survey (multi-discipline, North American-wide) and differences in the timing of the data being compared (the survey was based on 2003 and 2004 data while ACE used 2005 data). We would expect that the higher cost of living in the northeastern U.S. would skew ACE's labor costs higher relative to a continent-wide survey of companies. In addition, general inflation in costs would drive ACE costs higher than those experienced in the earlier years reported in the survey. However, one would expect that these impacts would be offset to some degree by lower costs associated with the location of ACE facilities in smaller communities as opposed to the large metropolitan areas that were likely embedded in the IFMA survey. The effect that the nature of ACE's utility business would have on any comparisons to a non-industry-specific survey are unknown.

Supply Chain

The Supply Chain organization is part of the larger Safety and Strategic Services group which also includes Vehicle Resource Management and Facilities Management, among others. The Supply Chain organization has primary responsibility for the sourcing of services and materials and the control of company inventory.

<u>Organization</u> - The Supply Chain organization is headed by Douglas Myers, Director of Supply Chain. Mr. Myers reports to the Vice President of Safety & Strategic Services, Hallie Reese.[15] As of September 2008, this organization has approximately 140 employees divided among the following groups:[16]

- <u>Supply Chain and Sourcing (22 employees)</u> - This group actually has 4 separate managers who report to Mr. Myers. It is tasked with the sourcing of services and materials (contract review, negotiation, etc.) and the investment recovery process (e.g., disposition of surplus assets). It also includes two employees who provide technology support to the rest of the organization. Employees are dispersed throughout the PHI service territories (Delaware, Maryland, Washington, DC), although none are physically located in New Jersey.

- <u>Logistics (116 employees)</u> - Reporting through one manager to Mr. Myers, this group is responsible for managing Power Delivery's inventory, which includes procurement, inventory control, warehousing, and physical distribution. A sub-set of this group also is responsible for managing Pepco's hazardous waste. While some employees provide shared services to all PHI utilities, the stores function is segregated between the legacy Conectiv utilities and Pepco. Unlike the Supply Chain and Sourcing group, Logistics has employees working from New Jersey locations such as Mays Landing.

This organization is <u>not</u> responsible for power supply. Power supply management is discussed in Chapter 14.

<u>Business Planning and Performance Measurement</u> - In 2008, the Supply Chain organization was measured for purposes of determining incentive payments under the Annual Incentive Plan. This was a departure from 2006 and 2007 when Logistics and Strategic Sourcing were measured separately.[17] Given the relatively few employees assigned to Strategic Sourcing, this is understandable.[18]

The 2008 actual results and associated targets under this plan are summarized in the following table:

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[15] Response to Discovery, OC-215.

[16] Responses to Discovery, OC-215, OC-1142, and OC-1143.

[17] Response to Discovery, OC-1024.

[18] Included in the Supply Chain and Sourcing group previously identified is a sub-set of employees assigned to Strategic Sourcing. In September 2008, this group totaled 9 employees (see response to Discovery, OC-215).

Table 25-4
Supply Chain
Balanced Scorecard Results

Description	Weighting	Target	Actual	AIP %
Employees - Fatalities	Trigger	0	0	
Employees - Recordables	5%	2	1	7.5%
Employees - Preventables	5%	1	1	5.0%
Customers - Implement SAP Barcoding System in X PHI storerooms	15%	3	4	22.5%
Customers - Contribute to the PHI Corporate supplier diversity goals *	15%	28%	36%	22.5%
Customers - Improve overall PHI inventory accuracy to 96% *	10%	96%	97%	12.5%
Customers - Emergency Preparedness - Conduct refresher training and Table Top Exercise for all Logistics Staging Area personnel (A)	10%	85%	100%	15.0%
Customers - Number of documented green / environmentally friendly initiatives negotiated with suppliers and / or internal process improvements	5%	10	11	5.5%
Financial Success - Total Supply Chain spend relative to budget	25%	$21.3M	$18.9M	37.5%
Financial Success - PHI Cash Flow Requirement Impact (cost reductions & cost avoidance) *	10%	$12M	$23M	15.0%
TOTAL	**100%**			**143.0%**

Source: Responses to Discovery, OC-1118 and OC-1151.
* Designated as a “key metric” in the monthly management report submitted to the President/COO and Senior Vice President of Operations (see response to Discovery, OC-1208).
(A) Percentage of employees who have been assigned a role within the Logistics Incident Management Team and have received training by a specified date.

As can be seen in the previous table, the Supply Chain organization met or exceeded every Annual Incentive Plan performance measure in 2008.

Until 2009, different disciplines within the larger Safety and Strategic Services organization (such as Supply Chain) were monitored through individual cost center budgets and balanced scorecards absent the structure of a consolidated organizational business plan. However, beginning in the last quarter of 2008, management adopted a more formalized top-down approach to business planning for Safety and Strategic Services for the 2009 plan year. A new purpose statement and areas of focus were developed. Initiatives to drive improvements in these areas of focus were identified, and the 2009 Business Scorecard metrics were then tied to these initiatives.[19] While other shared services (such as Information Technology) have developed service level expectations for their organizations, it is our understanding that such a system will not be implemented for the entire Safety and Strategic Services organization, presumably including Supply Chain, until 2010.[20]

<u>Benchmarking and Key Performance Indicators</u> - The Supply Chain organization has two benchmarking studies at its disposal from the past three years. The first was performed by Analytic Results in 2006 and compared PHI’s inventory management and sourcing activities to

[19] Response to Discovery, OC-1023.
[20] Responses to Discovery, OC-718 and follow-up to OC-1002.

those of a multi-industry peer group and a utility peer group. Initiatives identified by Analytic Results for PHI consideration included:[21]

- Inventory and Treasury need to partner on impact of inventory on working capital management at PHI.

- Continue downward pressure on inventory and utilize all resources for inventory rationalization.

- Strategic Sourcing and Treasury need to lead the discounting validation and the payment terms effect analysis.

- Evaluate purchasing-card (P-Card) utilization.

ACE's inventory balance has decreased from 2008 to 2007, which conforms to the consultant's recommendation. However, it should be pointed out that stores inventory purchases make up a small percentage of total spend at ACE. In 2007, stores transaction throughput was $17 million.[22] To put this amount in proper perspective, capital expenditures in 2007 were $149 million and accrual-based fuel and purchased energy costs were $1.051 billion.[23]

P-Card usage was reviewed in two internal audits conducted in 2008 that covered the period from May 1, 2005 through June 30, 2008. The primary concern raised concerning P-Card usage was the possibility that employees could be directly reimbursed for expenses that had already been paid by the Company to the P-Card issuing bank (Scotiabank). The Company addressed this problem when it decided to pay all charges on P-Cards of PHI employees and no longer reimburse them for their usage beginning on December 26, 2007. In the latter audit, Internal Audit observed that ". . . changes regarding the use of P-card charges and expense have been effective . . ."[24] P-Card spend increased from $16 million to $18 million between 2006 and 2007.[25]

In 2007, PHI purchased the results of a benchmarking study completed by CAPS Research. This work was co-sponsored by the Institute for Supply Management and Arizona State University. The study was <u>not</u> utility-industry-specific but rather based on a cross section of 200 to 300 companies. Using data from the time period from 2004-2006, PHI identified several benchmarks summarized by CAPS Research as key performance indicators. Those are summarized in the following table:

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[21] Response to Discovery, OC-73 (Analytic Results Working Capital Management Project).

[22] Response to OC466 (December 2007 Safety and Strategic Services Monthly Report).

[23] PHI 2008 Form 10-K, pp. 324 and 327).

[24] Responses to Discovery, OC-724 (Expense Reports & P-Card Audit Review dated June 9, 2008 and Expense Reports Audit dated December 9, 2008) (restricted) and OC-952.

[25] Response to Discovery, OC-73 (PHI's results for Key Performance Indicators).

Table 25-5
Strategic Sourcing (SS)
Key Performance Indicator Comparisons
to the CAPS Research Survey

Description	CAPS Industry Benchmarks		PHI	
	2005	2006	2005	2006
SS Operating Expense as a % of Purchased Spend	1.01%	0.84%	0.7%	0.5%
SS Employees as a % of Total Employees	1.45%	2.72%	0.47%	0.53%
Purchase Spend (in million $'s) per SS FTE	$21.08	$24.22	$27	$35
Cost Reduction & Cost Avoidance as a % of Total Leverageable Spend	N.A.	N.A.	4%	2%
% of Purchases Made with Diversity Suppliers (A)	9.4%	7.6%	23%	22%
% of Leverageable Spend via P-Card	1.69%	1.86%	2.63%	1.83%

Source: Response to Discovery, OC-73 (CAPS Research Survey and Strategic Sourcing KPI's).
(A) Data in PHI column for this specific row is ACE/DPL only.
FTE = full-time equivalent

In all cases but one, PHI compared favorably to the diverse peer group included in CAPS Research's survey. The one exception, percent of leverageable spend via P-Cards in 2006, indicated that PHI was generally consistent with the peer group included in the survey.

<u>Physical Counts and Internal Audits</u> - According to ACE's financial statement filings, the Company had $14 million and $15 million of inventory as of December 31, 2007 and 2008, respectively. This is comprised of generation, transmission, and distribution materials and supplies and is less than 0.6% of ACE's total assets for these two years.[26]

In compliance with FERC regulations, ACE is required to complete physical inventory counts of all stock every two years. To monitor on-going accuracy, random counts of 200 inventory items per region are conducted quarterly by storeroom supervisors for inventory not under their control.[27] Based on performance measures reported to management, PHI achieved inventory accuracy of 91% and 97% in 2007 and 2008, respectively. The 1997 results were skewed downwards because of Pepco's 89% accuracy.[28]

Internal Audit also conducts physical inventory counts. The results of these counts are documented in short reports. From the time period from the beginning of 2005 to the end of 2008, Internal Audit reported results for Bridgeton (November 15, 2005), West Creek (September 8, 2006), and Glassboro (July 29, 2008). Using Audit Command Language software to provide a statistical sample of inventory items to count, Internal Audit concluded that all of these locations' inventories were within acceptable error limits, and as a result, the inventory was fairly valued.[29]

[26] PHI 2008 Form 10-K, pp. 325 and 334.

[27] Response to Discovery, OC-720 (Inventory - Stock Material (Delmarva/ACE) Work Practice 742A).

[28] Response to Discovery, OC-466 (December 2007 Safety and Strategic Services Monthly Report) and OC-1208. ACE's inventory accuracy was 98% in 2007. ACE's 2008 results were not disclosed in the 2008 report.

[29] Response to Discovery, OC-720(B). If the calculated "upper error limit" is within 10% of the total value, the site is considered to have passed the test.

In addition, Internal Audit incorporated a review of inventory in its audit of the Pleasantville District Operations in 2007. Overall, the office was found to be “operating effectively and efficiently and [had] adequate controls to ensure compliance with established company policies and procedures.” However, Internal Audit did make the following recommendation concerning meter inventory: “Meter Department should develop district operations meter inventory and tracking policies and procedures” when it noted that there was a lack of tracking information on meter movement between the New Castle Regional Office and district stores.[30] According to the Company, when the matter was last communicated to management, it was still in process as it was expected that the Energy Vision - Automated Meter System application, which is scheduled to be completed in the third quarter of 2009, would inventory and track meters.[31]

Recent Initiatives - Beginning in 2008, Supply Chain management and internal stakeholders formed a cross-functional working group to automate certain aspects of the PHI sourcing process, which encompasses qualifying, bidding, evaluation, and purchasing processes. One example of this is the use of a Lotus Notes workflow tool for the Construction Management team’s Service Request Form. This form is used by Construction Management to manage projects from the bidding phase through completion in the field.[32]

Vehicle Resources Management

The Vehicle Resources Management (VRM) organization oversees PHI’s utility transportation function and fleet. As of October, 2008, the organization was headed by Frank Cottone, Group Manager, Vehicle Resources. Two managers reporting to Mr. Cottone are responsible for ACE, DPL and Pepco fleet operations and administration.

ACE’s Transportation Fleet

ACE currently operates a fleet consisting of approximately 530 transportation units. This includes vehicles (cars, SUVs, and light to heavy duty pickup, bucket and digger trucks), trailers and power operated equipment (forklifts, backhoes and trenchers).

Table 25-6
Atlantic City Electric
Fleet Profile

Type of Unit	2005	2006	2007	March, 2009
Vehicles	382	385	349	389
Power Operated Equip.	39	37	36	39
Trailers	89	87	88	77
Other	19	22	22	27
Total	**529**	**531**	**495**	**532**

Fleet Benchmark Studies, Responses to Discovery, OC-73 (2005) & OC-1057 (2006 & 7); OC-706 (2009)

[30] Response to Discovery, OC-724 (Pleasantiville District Operations Audit Report dated October 23, 2007) (restricted).

[31] Response to Discovery, OC-859 (restricted).

[32] Response to Discovery, OC-1146.

"Other" units account for about 1 percent of fleet cost and consist primarily of tow-behind equipment such as cable tensioners and arrow boards (used to direct traffic). Much of ACE's transportation equipment, and most vehicles, are leased. Owned units consist primarily of trailers and power operated equipment. A few dozen vehicles assigned to and operating in ACE's territory are owned or leased by affiliates. Most of these are DPL vehicles (DPL leased the vehicle), but the vehicle is stationed and used in ACE's territory.

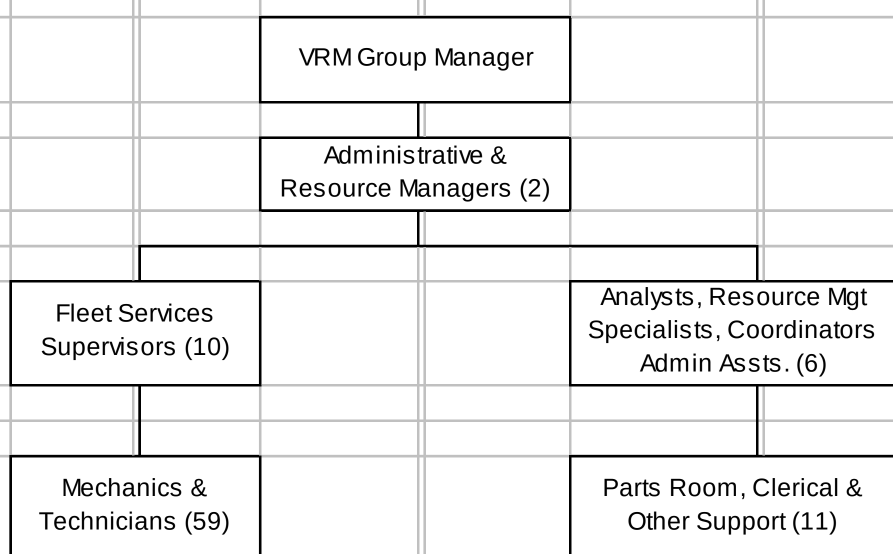
Transportation Organization and Operations

Organization - PHI's Vehicle Resource Management (VRM) group resides within the Safety and Strategic Services organization (a unit of Utility Operations - Revenue Process). In 2008 VRM consisted of approximately 90 employees. VRM is headed by a group manager who is responsible for directing fleet operations (acquisition, maintenance, repair, fuel, licensing and disposal) as well as planning, budgeting and performance objectives. Two administrative managers, responsible for operations and maintenance centers in various PHI regions, report to the group manager. Fleet services supervisors, who oversee day-to-day operations and maintenance activities, report to the administrative managers. The general layout of PHI's VRM organization is summarized in the table below:

Table 25-7

PHI Vehicle Resource Management

Organization Structure, August 2008



ACE's component of VRM consists of two fleet services supervisors, 15 mechanics and a parts clerk (storekeeper). ACE is also allocated VRM management and support cost performed on its behalf by PHI Service Company.

Transportation Budget - During the audit period, ACE was responsible for approximately $9 million from a $37 million annual operations and maintenance budget for PHI VRM as a whole. The table below summarizes ACE's VRM O&M expenses for 2006 and 2007.

Table 25-8
Atlantic City Electric
Vehicle Resource Management Expenses
Amts in $000s

Category	2006	2007
Lease	$ 3,217	$ 3,157
Depreciation	112	79
Interest	0	0
Licensing	139	150
Ownership Cost	$ 3,468	$ 3,386
Mechanic	1,614	1,783
Contract	207	157
Parts	635	661
Fuel	1,439	1,439
Operating Cost	$ 3,895	$ 4,040
Support Labor	1,498	1,377
Other Support Cost	429	482
Support Cost	$ 1,927	$ 1,859
Total VRM Cost	**$ 9,290**	**$ 9,285**

Source: Utilimarc Benchmark Study, Response to Discovery, OC-1057

Vehicle Assignment - During the audit period most of ACE's transportation units were assigned to various operations areas (electric distribution, maintenance, meters, etc.). In some cases vehicles were assigned to specific employees. Operations managers determine how the vehicles and other units are assigned and used on a day-to-day basis. ACE maintains a small motor pool of four passenger cars for assigned short term use as needed.[33]

Repairs and Maintenance - ACE maintains facilities for maintenance and repair at the following seven locations.[34]

- Winslow
- Glassboro
- Bridgeton
- West Creek
- Pleasantville
- Cape May
- Mays Landing

As noted above, as of August, 2008, ACE employed 15 mechanics and one storekeeper. These employees report to two fleet supervisors. (See DR 1044). ACE performs repairs and

[33] Response to Discovery, OC-706-3
[34] Response to Discovery, OC-707-2

maintenance both internally and externally depending on the nature of the work, the internal availability of someone with the required skill, cost and timeframe.[35]

Vehicle Procurement and Administration - VRM is responsible for procurement as well as for administration of vehicles and other rolling stock. When acquiring vehicles, ACE indicated that VRM follows the Strategic Sourcing department's Guiding Principles for Sourcing. VRM's administrative functions include, in addition to procurement, specification (determination of what is needed and what to acquire), registration, fueling and disposal. Replacement decisions are based on age, mileage and maintenance records. ACE's Regional Resource Manager (not part of VRM) reviews the potential transportation unit replacement list and makes changes based on ACE's business needs. The Resource Manager approves the list and forwards it to VRM, which performs the disposal and procurement activities to complete the replacement.

Utilimarc Benchmark Study - Utilimarc, a consultant that specializes in utility industry fleet operations, performed benchmarking of PHI's VRM organization in 2005, 2006 and 2007. The table below summarizes key statistics for ACE and PHI as a whole for 2007, compared with the averages for all of the utilities in a group of 46 utility holding company study participants.

Table 25-9
Atlantic City Electric and PHI
Key Fleet Benchmarks - 2007

Benchmarks	ACE	PHI (Pepco, DPL & ACE)	Participant Average
Cost Drivers			
Average Age Vehicles	6.4	6.8	5.9
Average Age Trailers	14.9	17.6	14.3
Average Age Power Op Units	11.9	10.9	10.7
Maint / Repair Hrs per Mechanic	1,917	1,951	1,945
Maint / Repair Hrs per Support Employee	3,768	3,768	6,050
Units per Mechanic	33	41	43
Units per Support Employee	87	80	134
Customers per Unit	1,091	824	768
Total Annual Cost per Vehicle	$ 24,510	$ 16,984	$ 17,438
Total Annual Cost per Trailer	2,414	2,313	2,809
Total Annual Cost per Power Operated Unit	11,361	10,852	9,251
Cost per Retail Customer (1)	$ 17.13	$ 17.43	$ 19.88

Source: Utilimarc 2007 Fleet Benchmark, Response to Discovery, OC-1057

1. Cost per customer calculated using an average of year-end 2006 & 2007 customers reported in PHI's Forms 10K. The calculation reported in the benchmark document, $34.39 per customer, was approximately double the correct amount and was in error.

The study shows that ACE's 2007 cost per vehicle was considerably higher than PHI as a whole and the benchmark study participant average. It also indicates a relatively high level of support overhead for both ACE and PHI, evidenced by a significantly lower number of units and repair

[35] Response to Discovery, OC-706-3

hours per support employee than the participant average. ACE's higher cost per vehicle in 2007 was due to primarily its fleet mix, which had more heavy-duty (and more costly) vehicles than the average utility in the study.[36] Although ACE's vehicles were larger and more costly than average, ACE had over 40% more customers per vehicle than the average utility in the study. Thus, although ACE's cost per *vehicle* was relatively high, its cost per *customer* (which translates more directly to a cost-based customer rate) was relatively low. ACE's vehicles were about 6 months older than the study average. A review of the data provided in response to Discovery, OC-706 shows that ACE added a number of new vehicles in 2008, bringing down the average age of the fleet.

Records Management

The Records Management function has primary responsibility for records retention policy and for record storage, retrieval and destruction.[37] In addition, employees are responsible for managing and retaining records within their own control.[38]

Records Storage

PHI Document Services is responsible for the storage of physical corporate records. The Information Technology organization is responsible for the storage of electronic records (data). Document storage, retrieval, pickup and delivery for ACE is outsourced to Nova Records Management.[39] Nova also "offers destruction services . . . but they do not make the determination on what ACE records to destroy."[40] ACE stated that "periodically, company representatives will visit the Nova Records facility to ensure ACE documents are adequately stored."[41] We requested the findings from these visits, but ACE indicated that the are not logged or documented.

Corporate Records Policy

PHI's corporate records policy broadly defines corporate records to include virtually any work or company-related information created in the course of business.[42] It notes that records can be stored on a variety of devices, including home computers. It states that employees and others working with company information are expected to comply with the policy. It contains the following key provisions:

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[36] In an email to Overland provided in response to a question about the benchmark study, VRM Group Manager Frank Cottone provided statistics that showed that ACE's vehicles were driven almost 25 percent more miles than the PHI average. Therefore, in addition to vehicle size, the costs of fuel and maintenance associated with the additional miles also contributed to ACE's higher cost per vehicle.

[37] Response to Discovery, OC-705 (restricted)

[38] Response to Discovery, OC-705, Attachment 2 (restricted)

[39] Response to Discovery, OC-705, response to question 1(d) (restricted).

[40] Response to Discovery, OC-1059, response to question 2

[41] Response to Discovery, OC-1059, response to question 3

[42] Id.

- Retention - The policy notes that records have defined minimum retention periods to meet legal and regulatory requirements. There are controls (procedures) to ensure retention for required periods.

- Disposal - The policy provides that records should be kept only while being actively used, unless a longer retention is required by law, rule, regulation, or for a business purpose (such as historical reference).

Reports are provided to department heads listing records scheduled for destruction. Department heads have the opportunity to approve records due for destruction or extend retention periods.[43]

Corporate Records Retention - ACE has a detailed retention schedule for various types of corporate records.[44] Examples of retention periods include:

- General accounting records - 6 years.
- Journals and ledgers - 50 years.
- Plant accounting records - 25 years.
- Securities (stocks, bonds, other financial instruments) - 25 years
- Audits and related workpapers - 6 years.
- General Administration - 5 years.
- Security records (building, facility, material security, access authorization, visitor logs - 5 years.
- Shareholder communications and shareholder lists - 3 years
- General contracts and performance documentation - 6 years.
- General employment - 3 years.
- Environmental plans and policies - 3 years
- General legal matters - 10 years
- Liability claims - 2 years
- Hazardous contamination - retain indefinitely
- Business licenses and permits - retain indefinitely

In general, the procedure calls for records destruction at the end of the retention period. The retention period is defined in general as beginning when the records become inactive (for example, when a claim is closed). ACE indicated that the retention schedules are consistent with federal, state and IRS regulations applicable to ACE and its affiliates.

Data Retention - PHI Information Technology, acting on behalf of the Chief Information Officer, is responsible for the development and implementation of electronic data retention policy. ACE provided Overland with a copy of PHI's Data Retention Standard (DRS), which became effective

[43] Response to Discovery, OC-705, response to question 1, item e (restricted).
[44] Response to Discovery, OC-705, attachment 1 (restricted).

after the audit period (October 1, 2008). The DRS applies to information stored electronically "on disk, tape, or other media, or virtual and electronic reports."[45] The DRS:

- Specifies that the retention period for data is applicable to all data which falls under the categories of corporate records found in the Record Retention Table (retention schedule).

- Distinguishes between offline data (tape and other media not directly accessible from the corporate network) and online data (accessible through the corporate network through an application system or database). Online data, generally, is "retained during the entire life cycle of the system or application which uses the data." Offline data is generally retained until "its scheduled retention time [as defined in corporate records retention policy] expires.

- Distinguishes "backup retention" from "data retention", with backup defined as data "currently in production", retained to "allow critical functions to resume in case of an interruption in computer processing."

The DRS suggests that the Corporate Records Retention Policy, and the specific instructions set forth in the Record Retention Table, is the overriding policy governing the retention of information held in the form of electronic data. In other words, while the DRS defines and distinguishes between various types of electronic information, electronic information consisting of corporate records must be retained in accordance with the Corporate Records Retention Policy.

Corporate Email Retention - The IT Infrastructure Group is responsible for email storage, retention and destruction.[46] With regard to retention, ACE indicated that corporate email "falls under the same policies and standards applicable to all information assets."[47] This might be interpreted to mean, for example, that if an email contains a discussion of a liability claim, it should be retained for two years, but if it discusses a general legal matter, it should be retained for 10 years. ACE indicated that "[e]mail archives are retained for 7 years unless special requirements are identified in accordance [with] policies and standards referenced in response number 1."[48] This further supports the interpretation that if an email fall under one of the specific record types for which retention periods are listed above, it should be retained for that period; otherwise, it is archived and retained for 7 years. As a practical matter, it seems highly unlikely that employees would maintain a copy of the Records Retention Table at their desk to parse their emails into retention groups. It also seems impractical to expect the IT organization to sift through emails at the end of the archive period to salvage emails for which a longer retention is applicable under the corporate records policy.

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[45] Response to Discovery, OC-1058, response to question 1, attachment
[46] Response to Discovery, OC-1058, response to question 2
[47] Response to Discovery, OC-1058, response to question 1
[48] Response to Discovery, OC-1058, response to question 3

ACE indicated that the following retention language "was reviewed and approved by the IT Steering Committee and recommended as a modification to the Records Retention Table (the table containing specific retention requirements, including the examples, listed above)":

> A retention period of 7 years is specified for "any other corporate records (electronic or document) including but not limited to *customer records, outage reports and work requests* (emphasis added)."

It is not clear whether ACE is stating that this language actually applies to corporate email because email is not among the types of records cited. In addition, we could not find the cited language in the Records Retention Table. Overland therefore interprets the data response to mean that the policy modification *could* be interpreted to apply to email, but at this stage it has been *recommended*, not implemented. Further clouding retention policy, the Records Retention Table contains the following requirement which can be interpreted to include most routine corporate email:[49]

> General Administration - General administrative records, *including routine correspondence* . . . Disposal: Keep for 5 years after becoming inactive. Disposal triggers: Destroy 5 years after becoming inactive (emphasis added).

Records Disposal - Physical (Paper) Records - Destruction of records is outsourced to Nova Records Management, but is controlled by PHI Document Services. ACE stated that reports of documents scheduled for destruction are provided to department heads, who may approve the scheduled destruction or extend the retention period.[50] Document Serv ices can proceed automatically with destruction after providing reasonable notice to department heads. However, Document Services follows up with department heads before proceeding and usually obtains a written response regarding the disposition of records listed on the destruction report.[51]

Records Disposal - Electronic Records (Data) - Disposal of PHI data is governed by the DRS. It provides that "[r]etention of data beyond its established retention period is permitted, but the data should not be retained beyond the Company's requirements if:

- The data exist is in another system or format and need to be available only in one form (either paper or electronic); both are not required.
- The system which created the data or allows access to it no longer exists."

[49] Response to Discovery, OC-705, Attachment 1, PHI Retention Schedules (restricted).
[50] Response to Discovery, OC-705, response to question 1, item e (restricted).
[51] Response to Discovery, OC-1059, Response to question 4, item a.

Corporate Security

Corporate security can be divided into two broad categories:

- Revenue, people (employees, contractors, visitors), facilities and other physical asset security (including the electric distribution system).
- Electronic systems and data (cybersecurity).

PHI's Security organization is primarily responsible for revenue, people and physical asset security. The IT organization is primarily responsible for cybersecurity.

Corporate Security Organization

PHI's Corporate Security organization is part of the Safety and Strategic Services organization, which is part of Utility Operations - Revenue Process. Corporate Security is responsible for the security of revenues, people and physical assets. As of September, 2008 it consisted of 18 employees (26 authorized positions) and 72 contract security officers.[52] The department is headed by a Manager, Corporate Security Group, who reports to the Manager, Facilities Services (Security and Real Estate Management). Below the Group Manager, the 18 employees consist of a Security Services Manager (who is responsible for ACE's and DPL's security), a Security Liaisons and Investigations Manager, a Manager of Security Systems and Compliance, Security Supervisors, Specialists, Special Officers and Investigators.

During the audit period ACE's Corporate Security, a subgroup of the PHI organization, consisted of the following:[53]

- Manager, Corporate Security (Ron Dollin)
- Senior Security Investigator
- Security Investigator (retired since the end of the audit period, position currently open)
- Two theft of service investigators (contractors)
- 10 uniformed guards (contractors)
- Two open Security Investigator positions

Except for the uniformed guards stationed at Mays Landing, ACE security personnel are shared with DPL. Ron Dollin, the Senior Security Investigator has responsibility for the Atlantic (ACE), Bay (DPL) and New Castle (DPL) regions. The two theft of service investigators work exclusively in ACE's territory. Some of the uniformed guards work at the Carneys Point call center, which provides customer services to ACE and DPL.

[52] Response to Discovery, OC-215 and OC-702.

[53] Response to Discovery, OC-377 (employee organization charts), OC-702, OC-998 and Interview with Ron Dollin, April 20, 2009.

Security Policies and Procedures

We requested ACE's procedures for securing assets, for maintaining the security of office, operations, maintenance and warehouse facilities, and for maintaining the security of the electric grid. ACE responded by providing the following two documents:

1. **PHI Corporate Security Strategy (November, 2007)** - This policy document lists corporate security goals, which are divided into categories relating to "people," "process" and "protection." People goals concern hiring, training and retaining Corporate Security employees. Process goals relate to the ongoing responsibilities of the security organization. They include audits of manned facilities and annual reviews of department policies and procedures. Protection goals are aimed at ensuring that assets and employees are adequately protected. The document lists specific requirements for facility protection, including things such as electronic access control, perimeter protection (fences, etc.), security officers, closed circuit television, alarms, audits and inspections. Assets and facilities are ranked according to risk level, with things such as servers, control centers and call centers ranked in the highest category.

2. **PHI Corporate Security Manual (April, 2008)** - This document describes the responsibilities of the Corporate Security department:

   - Establishing security policy
   - Setting security standards
   - Promoting security education and awareness
   - Providing special advice and notification
   - Monitoring compliance with federal, state, local and company standards
   - Investigating security incidents
   - Liaising with law enforcement and security agencies.

   The security manual indicates that the group manager is responsible for formulating and implementing corporate security policy as established by the executive security council. The group manager is also responsible for providing security at all facilities. The security manual contains an alert system based on a ranking of threats from low (minimum threat, low likelihood, routine security measures are responsive) to high (credible terrorist or criminal threats, actual events in the PJM system or credible threats to other infrastructure, such as computer system). The manual includes recommended general and security responses for each alert level. Also covered in the security manual:

   - Facilities access procedures for employees, contractors and other visitors.
   - Automated access procedures (card readers)
   - Vehicle access
   - Search procedures
   - Responses to emergency situations, including bomb threats.

Revenue Protection
One of the key responsibilities of the corporate security function is revenue protection. Revenue protection is geared primarily toward the prevention and detection of service theft. ACE has two contract investigators who focus primarily on detecting theft of service in larger (commercial and industrial) accounts.

Cybersecurity
PHI's IT organization has the primary responsibility for cybersecurity. We asked PHI to list and describe initiatives taken in the past four years to maintain and improve the safety of information systems from cyber attacks. We also reviewed, from a security perspective, company policy governing the security of information assets and system user activities through which unauthorized access to company systems is most often acquired: web surfing, file transfers from home and other unsecured computers, attachment of devices and media to company computers (flash drives and CDs or DVDs) and the use of personal email on company computers.

Initiatives to Improve Cyber Security
We asked ACE to provide a list of the steps it has taken in the past four years to improve the safety of its network and information systems from cyber attacks. Assessing the effectiveness of these steps in creating and maintaining an adequate level of security is beyond the scope of this audit. However, we noted PHI has taken an extensive set of measures to improve cyber security, including the following:[54]

1. Adding firewall protection, spyware protection and disk encryption to all laptop computers,
2. Installing software to report and alert on Active Directory changes (Among other things, the active directory determines who has access to what systems and databases and who is authorized to make changes to the directory structure, systems and databases),
3. Conducting network penetration testing and security assessments,
4. Installing software to monitor and manage external threats,
5. Documenting and reviewing the security of third-party network connections,
6. Installing intrusion detection sensors,
7. Installing internet filtering and web security software,
8. Establishing site-specific firewalls at generating plants,
9. Installing a system to analyze network traffic and behavior and provide perimeter security to detect and mitigate denial-of-service (DoS) attacks.

[54] Response to Discovery, OC-1050, question 1.

Policies to Protect Information Assets
In accordance with its Information Security Program Charter, PHI has a series of information security policies and procedures. Below is a summary of significant policies:

- Acceptable Use - This policy applies to "corporate production systems, together with their associated data, interfacing processes and supporting infrastructure, owned by or under the custodial care of the PHI Information Technology organization." Acceptable Use approval authority is vested in the Chief Information Officer and all employees, contractors and other users of PHI's information assets are responsible for it. It is a blanket policy for the following specific standards:

  - Internet Acceptable Use - Limits the use of the internet for personal purposes and prohibits the use of the internet to access "objectionable" sites and materials, requires the use of company-approved browser software and reserves the Company's right to monitor users' internet activity.
  - Electronic Mail Acceptable Use - Covers areas similar to the Internet Acceptable Use policy, applies to the corporate email system.
  - Software Acceptable Use - Covers requirements for the appropriate business use of company software.

- Asset Identification and Classification - This policy defines information assets. Like the Acceptable Use policy, it is a blanket policy for a series of standards.

  - Information Classification Standard - Requirements for classifying information assets with respect to security level.
  - Information Handling Standard - Instructions and requirements for handling "high-security" information assets.
  - Records retention policy - Instructions for retaining records to meet company needs and external legal or regulatory requirements (discussed elsewhere in this chapter).
  - Data Retention - Specific instructions for the retention of data.

- Asset Protection - This policy defines the Company objectives for standards to protect the confidentiality, integrity and availability of information assets. It covers the following standards:

  - Access Control Standard - Requires proper identification and authentication for access to company information assets.
  - Remote Access Control Standard - Requires an approved business need to authorize remote access to information assets and provides specific instructions for remote access.
  - Internet Firewall Standard - contains instructions and requirements for system firewalls.

- <u>Integrity Protection Standard</u> - Contains instructions and requirements to ensure that information is "correct, auditable and reproducible."
- <u>Encryption Standard</u> - Contains instructions and requirements for encryption to protect "high security" information assets.
- <u>Anti-virus Standard</u> - Contains requirements for protecting information assets from viruses and malicious code.
- <u>Auditing Standard</u> - Requires auditing to record relevant security events and maintenance of audit logs.

System Vulnerabilities Created by Employee Use of Company Systems
PHI's information systems are connected to the internet. A recent article in Electric Light and Power magazine noted that "at the end of the day, every system is connected to the Internet [and] every company should have a very strict security policy in place."[55] It further noted that SecureWorks, a security services provider to more than 100 utilities, blocked an average of 49 cyber attacks *per utility per day* in the first four months of 2007. During the next five months, the number of attempted intrusions increased to 93 per utility-day. To limit the ability of cyber attackers to penetrate company systems, one expert on network intrusion prevention was quoted in the article recommending the following restrictions on employee activities:

- Do not web surf
- Do not bring files from home
- Do not plug in thumb drives or CDs into work computers
- No personal e-mail at work.

We asked PHI to provide its policies with respect to each of the above-listed activities.

- <u>Web surfing</u> - The Internet Acceptable Use Standard governs the use of the internet by company employees and contractors. It limits, but does not prohibit, the use of the internet for personal purposes. Specifically, it states that "Company Internet Resources are provided primarily for official and authorized Company business use and purposes." But it also states that "[l]imited personal use of Company Internet Resources is acceptable as long as it does not conflict with Company business and interests . . . " The Acceptable Use Standard also prohibits the use of the internet to access "objectionable" material. PHI also noted in its data response that it uses a web filtering technology to block access to business-inappropriate sites.

- <u>File transfers to and from company computers and use of thumb drives and CDs</u> - We were unable to find any standards regulating the transfer of files between company-owned (and system-connected) computers and external computers.

[55] Nancy Spring, *Cyber Security: Are We Doing Enough?*, Electric Light and Power, May, 2008.

- Personal email - The Internet Acceptable Use standard implicitly allows the use of personal email accounts. The Email Acceptable Use standard explicitly permits the "limited" use of the Company email system for personal purposes.

Training - Pepco's employee and contracted uniformed security officers receive training several times per year "to reinforce PHI expectations regarding security practices and procedures." The training is provided by Corporate Security managers and supervisors. The procedure that discusses this training requirement, dated November, 2007, indicates that it "is not currently available for the Atlantic, Bay and New Castle regions."

Security Audits and Inspections

The primary responsibility for security audits is not vested in Internal Auditing, but in the Corporate Security organization itself.[56] Corporate policy requires security audits of "manned facilities" at least once every four years.[57] The policy requires the audits to be conducted by teams of at least two security personnel. It requires the audits to cover all security practices and equipment currently in place, including facility access control, alarms, perimeter protection, lighting, CCTV, guard performance, security records, adherence to procedures, security of materials and coordination with public safety officials to assess external impacts on facility security.

We requested copies of security audit reports conducted in ACE's territory during the years 2005-2008.[58] As part of a larger audit that included safety, health and environmental areas, a comprehensive audit of security was performed at Mays Landing in 2007. In 2008 ACE conducted less comprehensive physical security audits of the West Creek Operations Center, the Tilton Road Customer Courtesy Center and the Millville Customer Courtesy Center. It does not appear any security audits of manned ACE facilities were conducted in 2005 or 2006.

Substation Inspection

ACE provided reports covering substation inspections between September, 2007 and October, 2008. ACE attempts to inspect about 5 substations per month. Certain critical substations (defined as such in conjunction with the NJBPU) are inspected every year. We noted that most of the deficiencies indicated on substation inspection reports were minor, involving things such as torn fencing, washouts and overgrown vegetation. For example, an inspection of one substation conducted in February, 2008, yielded the following of deficiencies:[59]

[56] We requested internal audit reports addressing ACE's security infrastructure. The only thing we received was a copy of the report for a 2007 audit of Pleasantville district operations Audit that included a finding about card access to facilities. The audit found that employees and contractors were sometimes given access in "access groups" (groups of facilities and doors) and noted in some cases the number of buildings and doors was beyond what was needed.

[57] Response to Discovery, OC-702, PHI Corporate Security Strategy, pp. 2-3.

[58] Response to Discovery, OC-999

[59] Response to Discovery, OC-997. It should be noted that this inspection produced a higher-than-average number of deficiencies, but the deficiencies noted are typical.

- Broken top-guard
- Inadequate signage
- Numerous washouts
- Wire and material stored along fence line.

Ron Dollin, who is in charge of security for ACE, indicated that substation inspection reports are sent to the substation maintenance organization. A copy is also sent to the Corporate Security office in Washington, D.C. However, there is no formal process to followup on whether deficiencies noted on the inspection reports have been corrected.

Security Performance Measurement and Assessment

We asked ACE to describe how PHI assessed and measured its security infrastructure and operations. The Company responded with the following:

- Participating in industry security meetings, including the Edison Electric Institute Security Committee, NJ Electric and Gas Working Group / NJBPU, FBI Infraguard, and Middle States Metal Theft Task Force.

- Performing periodic inspections of substations and facilities.

- Adherence to security industry best practices.

- Employing a formally trained contract guard force to protect infrastructure.

- Providing security awareness programs to employees.

- Periodic liaison with law enforcement.[60]

These are primarily operational and management activities, rather than measurement or assessment. We also asked if Corporate Security used a service level expectations methodology similar to what is used in the Information Technology function. ACE initially indicated that the Security function did not use service level expectations for self-assessment.[61] ACE revised the response to the following:

> Currently, ACE or PHI has not used an assessment methodology equivalent or a process similar to what is reflected in the Service Level Expectations goals and review maintained by the Information Technology function to assess the performance of its security function. However, the 2009 Safety and Strategic Services Business Plan addresses steps necessary to develop meaningful SLEs for 2010. Specifically, the following steps will be conducted in 2009: a) identify critical S&SS maintained equipment and ensure availability (Initiative KL2) and b) identify critical S&SS services and ensure delivery (Initiative KL3) The sub

[60] Response to Discovery, OC-703, item 1
[61] Response to Discovery, OC-703 item 2

initiatives that support these main initiatives will address the dialogue with key business leaders to determine those items that are of a critical nature, to gather data in 2009 to support the development of an SLE for 2010.[62]

Atlantic Region Security Incidents

The table below summarizes reported incidents in the Atlantic Region for the years 2005 through 2008.

Table 25-10
PHI Corporate Security
Incidents Reported in the Atlantic Region 2005-2008

Incident Category	2005	2006	2007	2008
Assault	1	1	1	
Break and Enter			1	
Dumping	2			
Financial offenses	1		1	2
Fraud			2	
General Complaints		1		
Policy Violation	1		2	2
Suspicious Activity	2	2		1
Theft	13	4	4	9
Threats / Difficult Customers	7	1	4	8
Trespass	7	1	2	1
Vandalism			4	1
Wire Theft	7	6	16	39
Total	**41**	**16**	**37**	**63**

Source: Response to Discovery, OC-703

The only thing that stands out in the table is the dramatic increase in wire theft incidents, which is almost certainly the result of rising copper prices during the past several years. ACE's Manager of Security confirmed that copper theft, which can include theft of *installed* copper, picked up in recent years as a consequence of the increase in copper prices. He stated that ACE and other utilities have begun a regional program to address copper and similar thefts that may be perpetrated by individuals who target more than one utility.

Legal

Organization

As of late 2008, the Legal organization was headed by William Torgerson, Vice Chairman and Chief Legal Officer who reported directly to the CEO of PHI.[63] Mr. Torgerson was responsible for the Legal organization and for Ethics Compliance and Government Affairs & Public Policy. Reporting to Mr. Torgerson was Kirk Emge, Senior Vice President and General Counsel, a

[62] Response to Discovery, OC-703 item 2, revised

[63] Response to Discovery, OC-18. Mr. Torgerson was planning to retire in June 2009 when we interviewed him in December 2008.

position Mr. Emge had assumed earlier in 2008 as part of a long-range management transition. Mr. Torgerson had previously been General Counsel.[64]

After Mr. Torgerson's retirement, Mr. Emge began reporting directly to the CEO of PHI. In addition to the Legal organization, Mr. Emge continued to head External Affairs Administration, but unlike Mr. Torgerson, he was not responsible for Government Affairs and Public Policy. After Mr. Torgerson's retirement, the head of this group also began reporting directly to the CEO.[65]

The Legal organization is comprised of approximately 30 attorneys, including "dotted-line" reports from the unregulated businesses, and support staff. An Associate General Counsel is generally the highest level assigned to an employee without supervisory responsibilities, while the title of Deputy General Counsel is assigned to those with the most significant supervisory responsibilities. In late 2008, there were five employees holding the title of Deputy General Counsel with the following assigned practice areas:[66]

- Employment, benefits, tax, environmental, and real estate;
- Claims litigation, commercial law, bankruptcy, and intellectual property;
- Federal and state regulation;
- NYSE and SEC compliance, securities law, and corporate secretary matters; and
- Special projects, corporate policy, and Sarbanes Oxley coordination.

A full-time in-house attorney, Philip J. Passanante, an employee of PHI Service Company, is assigned to matters concerning the New Jersey BPU.

Management of Outside Counsel

Since the merger of Pepco and Conectiv, a concerted effort has been made to perform more of the legal work in-house, consistent with a recommendation made by a consultant in the 2002-2003 timeframe. To the extent that outside counsel is retained, the primary attorneys (as identified by management) and related assignments are:[67]

- Covington & Burling - corporate matters and financing
- Orrick, Herrington & Sutcliffe - contract matters, Mirant bankruptcy, Bluewater Wind
- Hunton & Williams - environmental issues

The following table summarizes the amounts spent by PHI on outside legal counsel over the past 3+ years:

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[64] Interview with William Torgerson, Vice Chairman and Chief Legal Officer, and Kirk Emge, Senior Vice President and General Counsel (December 9, 2009).

[65] Response to Discovery, OC-1120.

[66] Interview with Kirk Emge, Senior Vice President and General Counsel (December 10, 2009).

[67] Interview with Kirk Emge, Senior Vice President and General Counsel (December 10, 2009).

Exhibit 7-5

Table 25-11
PHI
Outside Legal Counsel

Firm	Expertise	2005	2006	2007	2008-1st 3 Qtrs
Swidler Berlin	Mirant Bankruptcy	$2,973,971	$208,958	(A)	(A)
Bruder Gentile	Corporate, FERC	2,059,204	1,213,753	809,071	412,410
Dickstein Shapiro	Litigation - Spent Nuclear Fuel	973,972	1,003,197	1,914,653	726,275
Covington & Burling	Corporate, Financing	756,447	1,195,203	2,194,350	1,258,613
Hogan & Hartson	Corporate, HR	657,516	1,043,431	644,317	497,257
Hunton & Williams	Corporate, Environmental	511,552	947,879	889,948	495,106
Day Pitney	Regulatory (DPL & Pepco)	(A)	(A)	1,639,957	(A)
Orrick Herrington	Delaware IRP/RFP, Mirant	(A)	746,125	1,295,938	802,086
Schiff Hardin	Regulatory	(A)	176,551	473,264	1,027,206
Venable	Trademarks, SunGuard	269,877	455,354	(A)	761,457
Other		7,242,937	7,584,773	8,854,913	3,539,861
TOTAL		**$15,445,476**	**$14,575,224**	**$18,716,411**	**$9,520,271**

Source: Response to Discovery, OC-693
(A) Amount below $100,000 and not disclosed.

Within the Legal organization, any matter expected to incur legal fees of $100,000 or more must be budgeted.[68] Legal matters are monitored by PHI through Serengeti Tracker (Serengeti); a third-party, web-based software system. Serengeti has the following functionality:[69]

- Electronic Billing (invoice auditing, approval routing, and spending alerts)
- Matter Management (case development and deadline alerts, requirement enforcement, results analysis, evaluation, collaboration management)
- Budgeting and Accruals (actual vs. budget comparisons, roll-up of project budgets to department, accruals for unbilled time)
- Reporting and Trending (filtering, customizable reporting and graphing)

PHI requires that all outside counsel upload their bills to Serengeti for payment. Bills must be detailed and have itemized fees and expenses so that PHI management can perform a thorough review before payment is made. When all necessary approvals have been obtained, Serengeti data is uploaded to SAP for payment.

[68] Interview with Kirk Emge, Senior Vice President and General Counsel (December 10, 2009).
[69] Response to Discovery, OC-694.

In the second half of 2008, Legal was considering the acquisition of a new document management system. However, due to the financial turmoil in the fourth quarter of the year, management suspended all discretionary spending and tabled plans to pursue a new software package.[70]

Performance Measurement

As with other organizations, Legal is measured against a balanced scorecard. In 2008, the metrics tracked for Legal and their associated weights were as follows:

Table 25-12
Legal
Balanced Scorecard Metrics

Description	Weighting	Target
Employees - Fatalities	Trigger	0
Employees - Recordables / Preventables	5%	0
Employees - Conduct one new safety awareness activity per quarter	10%	4
Employees - % of exempt employees conducting or participating in diversity discussions	10%	95% in 5
Customers - Client survey distributed and returned by year-end to measure Legal's responsiveness to it's customers (A)	15%	85%
Financial - Achieve the O&M budget	10%	35,929,000
Financial - Reduce adjusted outside counsel expenditures below benchmark	50%	18,650,000
TOTAL	**100%**	

Source: Response to Discovery, OC-70.
(A) Satisfaction must be 3 or above on a 5-point scale.

Performance against these metrics was not made available.[71] However, as noted in Table 25-11 above, expenditures on outside counsel through the first three quarters were tracking at approximately 51 percent of the adjusted annual expenditures targeted.

Insurance and Claims

Insurance and claims are handled by two different groups within PHI. Insurance matters are the responsibility of the Manager of Corporate Insurance, who resides within the Treasury Department of PHI Service Company.[72] On the other hand, issues surrounding claims are assigned to a sub-group of the Legal Services Department. ACE has an on-site claims supervisor and adjuster at Mays Landing and another adjuster at the Carney's Point facility in southern New Jersey.[73]

[70] Response to Discovery, OC-694.
[71] Response to Discovery, OC-1118.
[72] Response to Discovery, OC-709.
[73] Response to Discovery, OC-713.

Insurance

Program limits and deductible amounts are benchmarked against other utilities to determine the appropriateness and adequacy of coverage. Benchmarking data is obtained both internally through a periodic, small industry survey and by the insurance broker.[74] ACE does not carry its own insurance policies, but rather is covered under several blanket insurance programs with other regulated and unregulated subsidiaries of PHI. The primary blanket insurance policies include:

Table 25-13
PHI
Blanket Insurance Policies

Type	Term	Deductible	Cost
Property	March 1 - March 1	$100,000 - $2,500,000	$2,988,000
Excess General Liability	October 31 - October 31	$2,000,000	6,545,000
Directors & Officers Liability	August 1 - August 1	$1,500,000	2,709,000

Source: Response to Discovery, OC-710.
Note 1: There are multiple insurers for each policy listed above.
Note 2: Deductibles, coverages, and insurers have remained the same between 2007 and 2008.
Note 3: The cost of these policies is allocated to ACE according to criteria on file with the SEC.

The benchmarking data provided by the Company indicates that its deductible for excess general liability is higher than the industry median and mean while the deductible for directors & officers liability is lower than the industry median and mean. No benchmarking data was provided for property insurance.[75]

According to the Company, the performance of the Insurance sub-function of Treasury is not assessed using formal service level expectations, a tool employed elsewhere (e.g., Information Technology).[76] In addition, most likely due to its classification as a part of Treasury, we found no evidence that Insurance had its own balanced scorecard.[77]

No internal audits of the Insurance function were conducted between January 2005 and January 2009.[78]

Claims

As previously mentioned, PHI has staffed the Claims function for ACE on-site for quick response and investigation of matters that arise in the eastern and southern portions of New Jersey.

Claims come to the attention of the Claims department through a number of different sources. Tariff-related claims are generally submitted by e-mail by the Customer Service Department. Claims can also emanate from the Operations Department or direct contact with the claimant. All claims are investigated, and after review, a decision is made to either deny the claim, adjust

[74] Response to Discovery, OC-709.
[75] Response to Discovery, OC-711.
[76] Response to Discovery, OC-711.
[77] Response to Discovery, OC-70.
[78] Response to Discovery, OC-712 (restricted).

it, settle it, or prepare for litigation. Any claim having a probable exposure of greater than $5,000 is reserved within the Claims system. Loss reserves are established on an individual basis, and litigation cases are evaluated by inside/outside counsel.[79]

As of the filing date of its 2008 Form 10-K, ACE disclosed the following significant claims-related contingencies in the footnotes to its financial statements:[80]

- A $25 million claim for indemnification by the purchaser of the B.L. England generating facility contending that if a contract for terminal services with a third party (which was sold as part of the purchase) is not found to be enforceable by an arbitrator, ACE should make payment.[81]

- As one of three potentially responsible parties (PRPs) at the Delilah Road Landfill site in Egg Harbor Township, New Jersey, ACE has been actively participating in the remediation of the site for a number of years. ACE has estimated it share of additional costs associated with post-remedy operation and maintenance of the site to be $555,000 to $600,000. In late 2008, one of the other PRPs filed for bankruptcy. ACE does not believe that its liability for this site will have a material adverse effect on it regardless of the impact of this bankruptcy.

- In 2007, ACE was informed by the New York Department of Environmental Conservation that it was identified as a PRP at the Frontier Chemical Waste Processing Company site located in Niagara Falls, New York based on manifests indicating that ACE had sent hazardous waste to this site. ACE is participating in a group of other PRPs to establish its responsibility at the site. ACE does not believe that its liability for this site will have a material adverse effect.

- In late 2008, the Environmental Protection Agency (EPA) informed ACE that it was a PRP at the Franklin Slag Pile Superfund Site in Philadelphia, Pennsylvania. ACE had previously sold boiler slag from the B.L. England generating facility to the former operator of the site. In its assertion, the EPA contends that if found liable, ACE would be responsible for historical and future clean-up costs and EPA-mandated remedies. The EPA has spent $6 million to date at the site and expects to spend another $6 million. However, other parties have been sent similar letters by the EPA. Although it does not believe it is liable based on the facts of the case, ACE is unable to predict what costs it will ultimately bear at this site.

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[79] Response to Discovery, OC-713.

[80] 2008 PHI Form 10-K, pp. 354-357.

[81] Subsequently, the arbitrator issued an interim award, ruling that the contract is enforceable. ACE believes this relieves it of responsibility, but it cannot predict the purchaser's future actions (June 30, 2009 PHI Form 10-Q, pp. 40-41).

- PHI and the IRS are still in settlement negotiations with respect to prior year income tax returns. In dispute is the treatment of certain construction expenditures and related depreciation. In 2006, PHI deposited the amount of additional taxes and interest that it believed was owed. A recent IRS offer of settlement pertaining to ACE has led management to believe that it would owe less than the previously-deposited $121 million.

As with Insurance, Claims does not employ formal service level expectations. However, it does have the following goals and each individual is evaluated based on the accomplishment of the following objectives:[82]

- Contact 95 percent of claimants within 72 business hours to acknowledge receipt of their claims;

- Thoroughly investigate claims, ensuring all facts and evidence are gathered and secured; and

- Aggressively negotiate and obtain favorable settlements in property damage and bodily injury claims by fairly and accurately assessing company liability.

No internal audits of PHI's Claims function have been completed since January 2005. However, an audit of the claims process was begun in December 2008.[83]

[82] Response to Discovery, OC-714.

[83] Response to Discovery, OC-712 (restricted).

Exhibit 7-5

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