FINAL REPORT
Focused Audit of Affiliated Transactions and Management Audit of Elizabethtown Gas

Executive Summary

Presented to the:

Division of Audits
New Jersey Board of Public Utilities

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I. Introduction

The Liberty Consulting Group (*Liberty*) conducted on behalf of the New Jersey Board of Public Utilities (*BPU*) an audit of Pivotal Utility Holdings, Inc. (*Pivotal*), doing business as Elizabethtown Gas (*ETG* or *Company*). This audit included:

- An audit of the transactions between ETG and its affiliates
- A comprehensive management audit of ETG.

Prior to 2004, Pivotal/ETG was a wholly owned subsidiary of NUI Utilities, Inc. (*NUI*). AGL Resources (*AGLR*) acquired NUI in late 2004. ETG continues legally to be part of Pivotal, which consists of ETG, two other local distribution companies (*LDC*s) and several non-utility entities, and merged into AGLR as part of the NUI acquisition. ETG is one of six gas distribution utilities owned by AGLR. AGLR has a non-operating service company, AGLR Service Company (*AGSC*), which provides common services to the six utility companies, and to AGLR's other operating subsidiaries. AGSC provides services to ETG pursuant to a Services Agreement.

There have been a number of prior audits of ETG on behalf of the BPU, the most recent of which are:

- The *2003 EDECA* (New Jersey Electric Discount and Energy Competition Act) *Audit*: an audit of compliance with New Jersey's Competitive Offerings and Affiliate Standards (Docket No. GA02020099), completed in March 2003.
- A 2003 focused audit by Liberty undertaken in the wake of significant credit downgrades of NUI due to poor financial performance by its non-utility businesses.

The present audit is the first conducted for the BPU since ETG became a subsidiary of AGLR.

Liberty's audit began in November 2008 and ended in January 2010. The audit was organized into two phases. The affiliate transactions components of the audit comprised Phase One, including a review of:

- Gas supply procurement and purchasing
- Affiliate relationships
- Market conditions
- Status of recommendations from the 2003 EDECA Audit
- Cost allocation methods
- Remediation activities and costs
- Current compliance with EDECA requirements.

The comprehensive management audit components comprised Phase Two, including a review of:

- Corporate governance
- Corporate organization
- Human resources
- Strategic planning and budgeting
- Finance and cash management
- Accounting and property records
- Customer service
- External affairs

- Support services
- Contractor performance
- System operations and maintenance
- Compensation and benefits.

Liberty issued a final report for Phase One on November 24, 2009 and a final report for Phase Two on January 4, 2010. This document summarizes Liberty's major audit findings, conclusions, and recommendations in each of the Phase One and Phase Two audit areas. The full list of all conclusions and recommendations is included in Appendix A. The audit included more than 1,000 data requests to which ETG responded and 160 interviews. Liberty provided draft reports for the BPU Staff to review and subsequently provided the drafts to the Company for review. Liberty considered Staff and Company comments on the draft reports before issuing the final reports.

Liberty appreciated the opportunity to provide this service for the BPU and commends the BPU Staff for their interest and support throughout the audit. Liberty also thanks Company personnel for their cooperation during the course of the audit.

II. Phase One: Affiliate Transactions Review

A. Procurement and Purchasing

As part of its approval of AGLR's acquisition of NUI, the BPU approved the parties' recommendation that AGLR subsidiary Sequent Energy Management (*SEM*) take over ETG's gas-supply asset-management function, effective April 1, 2005. The initial asset-management arrangements ran for a period of three years. In late 2007, ETG affiliate AGSC, which performs the gas-supply function for ETG, negotiated with SEM an extension of the in-place asset-management arrangements, and presented them to the same interested parties who had participated in the initial stipulation. Those parties reached a new stipulation supporting the extension, and filed it with the BPU in March of 2008.

1. Organization, Staffing and Controls

AGLR organizes its activities around functions, rather than around legal entities, or "business units." In many cases, ETG employees providing support functions report to supervisors that are employees of AGSC, located in Atlanta. Units of three AGLR functional organizations with supervision in Atlanta perform gas supply planning, acquisition and management. While this multi-organization approach is efficient in bringing gas supplies to a large number of customers throughout AGLR's serving territory, Liberty found that it has caused difficulties in the past in reporting timely and accurate information in New Jersey regulatory filings. The Company has only recently (in 2009) begun to file required materials accurately and on time for ETG's BGSS filing with the BPU.

Liberty found that key personnel who administer the gas supply function for ETG are well qualified and experienced. AGLR does not maintain formal mission and function statements for each organizational unit, but key managers have a clear sense of their organization's objectives, both for the next 12 months and for the longer term. Each of the managers involved in the gas-supply function not only has an established set of individual performance objectives for the coming year, but also has a clear sense of his or her role in accomplishing his or her unit's objectives. Liberty found, however, that accommodating regulatory oversight has had insufficient priority as a performance objective. Liberty recommended that the Company ensure that AGLR's organizational units providing essential inputs to regulatory filings continue to afford those filings sufficient priority.

The various organizational units involved in providing gas supply to ETG's customers all have established policies and procedures governing their activities, but documentation of those policies and procedures varies considerably. Liberty found that the processes and documentation for approving gas-supply commitments are satisfactory and consistent with industry norms. Liberty found little or no documentation for requirements forecasting, or for supply-contracting processes, both commodity and capacity, however. Adequate process documentation is essential to guide various verification processes, such as internal audits, as well as regulatory oversight. Liberty recommended that the Company document all of the processes required to produce a BGSS filing as a first step, and file the documentation along with the Company's 2010 BGSS filing. ETG should also file draft policies regarding documentation at that time. The Company

and the BPU can decide what additional process documentation is appropriate after the initial material has been received and reviewed.

Good utility practice requires documentation of most decisions involved in the development of a utility company's gas-supply portfolio. Liberty could not find that AGSC routinely does this for ETG, and this finding was supported by the Company's internal audit finding for 2007. Documentation is required to support regulatory review, but also for external audit and internal review. Liberty recommended that AGLR's Internal Audit group develop guidelines for documentation of gas-supply decisions, for use by AGSC as it makes choices for ETG's gas-supply portfolio, and that the Company file them for BPU review with ETG's next (2010) BGSS filing.

2. Gas Supply Planning and Forecasting

The Company forecasts billing units and throughput for ETG by customer class, using different approaches for different customer class. The approaches are largely econometric, in most cases involving forecasts of usage per customer, number of customers, and incremental usage growth. Such econometrically-derived use per customer, times forecasted numbers of customers, all by customer class, is Liberty's preferred method for volume forecasting. Liberty is especially impressed that AGSC involves marketing personnel, both at the corporate level and in New Jersey, in assessing trends in customer usage, and in helping to calculate specific adjustments to the numbers to incorporate observed trends in them. The Company uses the same numbers for its internal forecasting that it provides to the BPU, which is testimony to the faith that the corporation has in the forecasts.

Liberty observed that the Company employs regression equations that use monthly data back to 1989. Data series of that length may obscure important trends that are more recent. Today's gas-using equipment is more efficient than that of 20 years ago, for example, and the field-price regime that exists today, even after the dramatic drop since last year, is still considerably higher than the one that prevailed through the 1990s, lasting until as recently as 2001/02. The Company's extensive use of its marketing resources in adjusting the results of the regressions is appropriate, but using much shorter data series for its use-per-customer regressions remains a need. Liberty recommended that the Company's Planning and Forecast group use shorter time periods for its use-per-customer regressions to see whether the more-recent trends can be picked up in the data.

The AGSC Gas Supply and Capacity Planning organization makes the design-day forecast, based on a regression analysis of monthly customer count, daily historic load, and heating degree-days. Liberty found AGSC's supply-capacity requirements forecasting to be comparatively less effective overall. Liberty reviewed this area in an audit of the relationship between Virginia Natural Gas Company and SEM for the Virginia Corporation Commission in 2005. AGSC performed the capacity-requirements forecasting function for Virginia Natural at that time, just as it does for ETG now. The sophisticated, industry-best-practices approach that we found then has deteriorated to an approach now that relies heavily on arbitrary assumptions. The design-day and design-winter design criteria have been established without analysis of how likely those conditions are to occur, for example; similarly, AGSC has adopted an "industry-standard" reserve-margin requirement of five percent without any analysis of whether any such

requirement is appropriate, or, if it is required, how large it should be. Liberty knows of no industry-standard reserve-margin requirement of the sort the Company cites. Liberty recommended that the Gas Supply and Capacity Planning organization be required to bring more analysis to its selection of the key parameters for capacity-requirements forecasting.

3. Transportation and Peaking Assets

ETG is served by Columbia Gas Transmission (*TCO*), Tennessee Gas Pipeline Company (*TGP*), Texas Eastern Transmission Corporation (*Tetco*) and Transcontinental Gas Pipeline Corporation (*Transco*). ETG's Union service territory has access to Tetco and Transco. The Northwest service territory has access to all four and an arrangement with Public Service Electric & Gas Company, depending on the location within the territory. In the period since January 1, 2006, the Company reports that there have been several term extensions and additions of new capacity, but there have been no capacity expirations, re-negotiated rates, no de-contracting and no assignment or new long-term releases. The Company also buys bundled peaking services from some of its customers, and buys peaking services delivered to its city gates.

The Company reports that its firm transportation capacity portfolio has performed as expected and within the terms of its corresponding contracts prior to and since the time that AGLR acquired ETG. It notes, however, an increased number and duration of operational flow orders issued by delivering pipelines over the past several years. It also reports problems with two of its storage services over the same period. In view of the Company's location at or near the downstream ends of the pipelines which are the principal sources of its supplies, these problems require sustained, consistent attention, in order to forestall an unanticipated emergency.

Liberty is concerned that ETG's supply planners assume that their "industry-standard" reserve margin of five percent will cover any contingencies. ETG's supply planners must give its peak-period performance the kind of sustained, analysis-based attention necessary to provide cost-effective supply options at times of peak demand.

Almost all of the Company's gas injected into storage, and most of the supplies acquired to serve flowing-gas requirements, have been sourced from the Gulf of Mexico Producing Region. As a result of the gas-supply and capacity disruptions that occurred during and after the hurricanes in the fall of 2005, the Company decided to look for opportunities to diversify its supply sources. Participations in two capacity-expansion projects were added after that review. These two projects are a good start, but the Company could and should do more. Other LDCs in New Jersey have worked with their pipelines to adjust their capacity rights in ways that give them access to more diverse sources of supply.

Liberty recommended that AGSC should continue this effort to further diversify the sources of supply in its role as ETG's manager of these activities. In its discussion of its two new capacity additions, ETG focuses on upstream supply security in an era of damaging hurricanes. Supply security is certainly one reason for further diversification of supply sources, but gas price is another. As new sources of supply are added in different parts of the country, basis differentials adjust. Thus, supply sources that yield the best prices at ETG's city gates are likely to shift over time. ETG can take advantage of these changes by trying to obtain access to as many of them as possible.

Based on an examination of ETG gas-supply capacity, Liberty concluded that the Company has considerably more capacity than would be required, even at the extreme load conditions assumed for the design weather case. Liberty recommended restricting the addition of gas-supply capacity until ETG has worked off its current excess. ETG has ample capacity, even if its requirements were not over-estimated (which Liberty believes they are). ETG should stop adding capacity until: (a) it improves estimating its requirements, and (b) works off the excess. Prior to this year, ETG was showing growth in its numbers of customers, although its (weather-corrected) throughput growth was below the national average. New Jersey's Clean Energy programs may provide a boost to gas consumption, which could take up some of the excess capacity. ETG should have improved its requirements-forecasting methods, and show a new need for capacity, before it considers adding any more capacity.

4. Supply Capacity Management

ETG's supply-capacity portfolio is managed by affiliate SEM, pursuant to an Asset Management and Agency Agreement between ETG and SEM, with an associated Gas Purchase and Sale Agreement. The asset-management agreement covers all of ETG's transportation contracts, and most of its storages. ETG retains control over the storages that it uses for balancing; two peaking services that it buys from Transco, and its on-system LNG peaking facility; and the peaking services that it buys from its customers. ETG also contracts for delivered peaking services. The asset-management agreement specifies daily operational procedures. The agreement specifies which duties are to be performed by ETG and which by the asset manager, along with a daily schedule for completion of the various duties.

The gas-supply function as conducted by AGSC seeks to provide reliable supply at "best" cost, as most LDC gas-supply operations do, but it also pursues other objectives. Thus, rather than simply providing supply-management services to ETG, AGSC generally, and the Gas Supply and Capacity Planning department in particular, is charged with examining ETG's supply operations, and those of the other LDC affiliates, to look for business opportunities for other affiliates. This structure creates potential conflicts of interest that are inappropriate. These conflicts, plus the lack of arm's-length competition for the asset-management relationship, have real potential for increasing costs to ETG's customers. These relationships need to be re-examined from the perspective of imposing full-fledged competition on all of ETG's gas-supply relationships.

Liberty recommended bringing arm's-length bargaining to gas-supply relationships. It is clear that renewal of the asset-management relationship with the affiliate brought better terms than the one that had been in place before. Even better terms may be available through an arm's-length competition, however. Liberty strongly recommended that this possibility be tested.

5. Measurement and Balancing

Liberty noticed an increase in the Company's lost-and-unaccounted-for (*LAUF*) gas percentage over the period August 2005 through July 2008, and inquired about the Company's efforts to determine the cause. The Company responded that it has taken measures to reduce the recent LAUF rate; however, Liberty found that the improvements were insufficient to reverse the trend and thus it is not clear that the Company has successfully determined the causes of the increase

in the LAUF rate. Liberty recommended that the Company work to determine those causes. The Company should present a report with its next BGSS filings on its efforts to date, and what it plans to do to follow up its findings to that point.

Liberty reviewed the Company's meter maintenance and testing programs, and found them to be in accordance with applicable safety codes and prevailing industry standards. Liberty found AGLR's balancing strategies and practices are reasonable and fair to all classes of customers.

B. Affiliate Relationships

1. Nature and Magnitude of (Energy-Related) Affiliates' Businesses

AGLR manages its businesses through a non-operating corporate segment and four operating segments:

- Distribution Operations
- Retail Energy Operations
- Wholesale Services
- Energy Investments.

ETG operates one of six gas-distribution companies that comprise AGLR's Distribution Operations business segment. ETG engages in the purchase, transmission, sale, and transportation of natural gas for about 274,000 customers, in an area of about 2,500 square miles in seven counties in northern New Jersey. The other LDCs are:

- Atlanta Gas Light, providing gas delivery service to about 1.6 million customers in the northeast half of Georgia, which has separated the supply of natural gas from delivery service under legislative mandate
- Chattanooga Gas provides, providing retail natural gas service to about 62,000 customers in Tennessee
- Elkton Gas, providing natural gas service to about 6,000 customers in northeastern Maryland
- Florida City Gas, providing natural gas service to about 104,000 customers in southeastern and east central Florida
- Virginia Natural Gas, providing natural gas service to about 271,000 customers in southeastern Virginia.

SouthStar operates AGLR's Retail Energy Operations business segment, supplying natural gas to about 526,000 residential and commercial customers in Georgia, and to more than 300 interruptible customers throughout the southeastern U.S. SouthStar also provides gas supply to customers in Ohio and Florida.

AGLR's Wholesale Services business segment consists primarily of SEM, which provides natural gas asset management, producer and storage services, and full-requirements supply, including peaking services, throughout the U.S. and Canada.

AGLR's Energy Investments segment consists principally of the following operating units:

- Jefferson Island Storage & Hub, which operates a high-deliverability natural gas storage facility in southern Louisiana
- Golden Triangle Storage, which consists of a high-deliverability natural gas storage facility under construction in Texas
- AGL Networks, which leases telecommunications fiber to a variety of customers in the Atlanta, Georgia, and Phoenix, Arizona, metropolitan areas, and has a small presence in other cities in the U.S.

2. Relationships among Affiliates

More than 80 percent of AGLR's earnings before interest and taxes come from supplying gas to retail customers. Wholesale affiliate SEM provides asset-management services and gas supply to all six distribution companies. ETG receives spot-market gas and delivered peaking services from SEM, as well as seasonal, monthly and daily supplies.

AGLR provides common services to all of its subsidiaries through AGSC. Each subsidiary elects annually those services it wants to receive from AGSC. AGSC has made considerable investments in staffing and technology to provide a low-cost and scalable platform of common services to all of the affiliates. ETG has no distinct gas-supply capability at ETG. Rather, a member of AGLR's Gas Supply and Capacity Planning department serves as Manager, Gas Supply, for ETG. That person operates technically as an ETG employee due to AGLR's cost-assignment processes, rather than due to organizational affiliation.

Two affiliate contracts affect ETG:

- A Services Agreement with AGSC
- An Asset Management and Agency Agreement with SEM, which includes a Gas Purchase and Sale Agreement.

ETG is also a party to financing agreements that Liberty examined as part of the finance and cash management investigation in Part II of the audit.

Liberty concluded that the Services Agreement between AGSC and ETG appropriately and sufficiently identifies the services provided to ETG and the methods for allocating the costs of those services to ETG.

All gas-supply arrangements between ETG and its affiliates are covered by written agreements. SEM conducts asset-management and gas-supply activities for all the other distribution-company affiliates except Atlanta Gas Light (the nature of whose business is different from the others) under very similar arrangements. SEM also provides delivered peaking services and spot-market gas supplies to ETG. These services and supplies do not come under separate contracts; the Asset Management and Agency Agreement and its associated Gas Purchase and Sale Agreement cover them.

Liberty has reviewed a number of arrangements like the ones covered by the Asset Management and Agency Agreement and the Gas Purchase and Sale Agreement. These agreements fall in the mid-range of others Liberty has reviewed. Liberty concluded, however, that although the structure of the Asset Management and Agency Agreement and its associated Gas Purchase and Sale Agreement are reasonable, they should undergo rigorous competition. ETG has not ensured

that it has optimized the benefit against the costs of the current agreement with its affiliate SEM. Different asset managers operate in different ways. The SEM option has not been shown demonstratively to be the best option for ETG's customers. Liberty recommended putting ETG's asset-management arrangements out for bid when the current arrangements expire to help ensure maximum value for ETG.

The statements of corporate philosophy in the Company's annual reports, the interviews, and the data request responses provided to Liberty during the course of this audit make clear that AGLR's business model involves having SEM manage the affiliated utilities' assets. The responsible officers' roles in managing the relationship make clear that they understand the model. Transparency comprises a value in the design of the relationship between SEM and the affiliated utilities, but arm's-length bargaining does not. The terms of the asset-management relationship between ETG and SEM did not result from negotiations between the different AGLR entities.

3. Reporting and Control Systems

Liberty concluded that the Company has a strong gas accounting process. Gas accounting personnel verify and enter daily into an ETG-developed transaction-tracking system the seasonal, monthly, and daily transactions executed by ETG's Manager, Gas Supply. The Company uses those records to validate the Asset Manager's gas-supply invoices to ETG. Differences between the system-generated data and the invoice-billed amounts are pushed back to the gas trader and SEM for resolution. On a monthly basis, the Company also reconciles total delivered volumes, as measured by the delivering pipelines, to the total invoiced delivered volume. Liberty personnel worked through the various processes and spreadsheets used, and came away confident of their integrity.

Two key control elements apply to the gas-supply function:

- AGLR Gas Accounting verifies the prices and volumes of the logical-nomination gas ordered by ETG's Manager, Gas Supply, thereby confirming the validity of SEM's invoices to ETG for those amounts
- By agreement with the BPU Staff and interested parties in ETG's gas-cost proceedings, AGLR will conduct an internal audit of the operation of ETG's agreements with SEM, including how SEM performs the margin-sharing calculation and whether this process is non-discriminatory and consistent with the Stipulation adopted by the BPU.

Those controls operate internally to AGLR; no controls internal to ETG apply to the gas-supply function.

An area of controls weakness occurs before the gas price and volume data enters the transaction-tracking system, however. ETG does not keep records of its delivery-point adjustments when it agrees to SEM's proposals to shift volumes among its city gates. ETG's initial distribution of volumes among its city gates occurs on the basis of minimizing costs to its customers, consistent with reliability and the physical constraints imposed by the configuration of the Company's distribution system. Thus, any change of that distribution, almost by definition, increases costs to be borne by ETG's system-supply customers. Liberty recommended that the Company keep records of ETG's costs before and after the delivery-point shifts requested by SEM.

SEM performs two types of computations that go into determining ETG's gas cost:

1. Monthly invoices for gas delivered to ETG's city gates
2. Sharable margins from SEM's use of ETG's gas-supply resources.

AGLR's Gas Accounting group reviews SEM's invoices. Computation of sharable margins involves application of considerable discretion by SEM, which introduces the opportunity for discrimination among SEM's asset-management clients, possibly in response to differences in rewards to SEM due to differences in sharing percentages in the different asset-management contracts, or other incentives.

The terms of the Stipulation adopted by the BPU in its approval of the extension of ETG's capacity-management and gas-supply arrangements with SEM require the Company to evaluate SEM's performance through a third-party analysis to be conducted in 2009 for the 2008 contract year. The Stipulation also provides that, following the completion of the first year of the Agreement (and each year thereafter), AGLR will conduct an internal audit of operation of the Agreement. The auditor will have responsibility for verifying: (a) proper margin crediting to ETG's BGSS-P clause in the manner required by the Stipulation and the Agreement, and (b) SEM treatment of ETG in a non-discriminatory manner, as compared with SEM's other asset-management arrangements.

Liberty recommended that this audit examine and document how ETG's transactions get valued and the basis for each assumption required for valuation. The auditor must also examine books of business for other asset-management clients that involve the same assets, to assess whether SEM applied processes in the same manner for all asset-management clients. A related concern is the protection of SEM's transaction-assignment decisions against subsequent revision. The auditor must determine whether transactions originally assigned to ETG can be reassigned to another asset-management client with a more favorable margin-sharing arrangement.

4. Impacts of Affiliate Relationships

Liberty found the logical-nomination process, as specified in the asset-management arrangements with SEM and administered by ETG's Manager, Gas Supply, to be representative of provisions of that nature that have been negotiated at arm's length, except for the delivery-point shifts discussed above. This part of the asset-management arrangements produces appropriate costs. The credits generated by the optimization activities of the Asset Manager also affect ETG's gas costs. Liberty has some concerns about the integrity of the transaction-tracking systems that form part of the determination of those credits, and about potential increases in costs that could offset those credits. However, the valuation scheme specified for the optimization transactions compares favorably with ones that have been negotiated at arm's length.

SEM's participation in a competition for delivered peaking services does not appear to have increased costs, but gives cause for concern. The presence of an affiliate as a competitor affects the competition, generally adversely. Thus, Liberty recommended that SEM not be allowed to compete for supplies of this type.

The Company's approach to securing spot-market supplies does not promote costs optimization for ETG. ETG's Manager, Gas Supply, tends to default to spot-market supplies from ETG's affiliate. Moreover, the affiliate has the right to match any third-party offers that ETG receives.

By the winter of 2008/09, SEM was virtually the only supplier of spot-market gas. This situation creates the unacceptable result of placing SEM in the position of naming its own price for the supply. The result is elimination of competition for ETG supply. Liberty recommended that the Company develop an improved process for seeking spot-market gas supplies.

Liberty found that the Gas Supply and Capacity Planning department, the AGLR entity charged with planning ETG's gas-supply costs, does not demonstrate a sufficient cost-control focus. Liberty could find no evidence that the people who plan for ETG's gas supply have any clear objective for reducing ETG's gas costs. Those people have the incentive to look for additional revenue opportunities for AGLR, however. The quest for additional revenue for AGLR, in the absence of any sign of interest in reducing ETG's gas costs, has the potential for increasing those costs. Liberty recommended that the Company make reducing ETG's gas costs an explicit objective for AGLR's Gas Supply and Capacity Planning department.

The Company reported that SEM had recently paid a civil penalty for self-reported violations of the U.S. Federal Energy Regulatory Commission's (*FERC's*) policies on capacity release, including the posting and bidding requirements and the shipper-must-have-title rule, over a 28-month period. Part of the civil penalty included settlement of an alleged violation of the rules prohibiting buy/sell transactions. These violations of the FERC's capacity-release policies have the potential for adverse impacts on ETG customers. The Company's responses to Liberty's data requests about this issue make clear that gas-supply assets under contract to ETG were involved in the violations. Thus, it is possible that ETG's customers' interests were adversely affected. Liberty recommended that upcoming, independent review of the asset management relationships should address this issue.

C. Market Conditions

Liberty found a broad spectrum of suppliers doing business on ETG's system, with 17 active suppliers doing business on ETG's system as of year-end 2008. ETG has a good representation of national and regional suppliers, and is well represented in each market segment. Many of the suppliers have been active in New Jersey for at least 10 years, and the field has stabilized after a shakeout in the earlier years. Overall, ETG has had as many as 44 different suppliers doing business on its system since 1992.

Liberty found that ETG does have basic, standardized procedures for estimating supplier volumes, creditworthiness review and periodic review of existing suppliers. Although the activity in this area is relatively low, ETG should have such procedures. This issue has become more important in recent years as a result in staff turnover and relocation of some of the functions to AGLR.

Liberty found that accessing the list of active suppliers on ETG's website is burdensome to customers, and requires that a customer be willing to navigate through a number of links and screens which are often confusing. Liberty recommended adding a supplier page to the ETG website with a link to the ETG home page to make it user friendly and enable timely updating.

In comparison to other states, New Jersey has a good number of reliable suppliers to the residential market. New Jersey is also one of a small number of states that has implemented full

unbundling and retail choice for all customers. However, New Jersey ranks at the low end among states in which more than one per cent of residential customers has migrated to third party suppliers. In particular, ETG's migration levels may have reached steady state, and ETG is at the low end of migration rates relative to the other LDCs in New Jersey. The overall low migration percentages in New Jersey, however, make the comparison inconclusive. Liberty concluded that ETG's low migration percentages are primarily functions of overall state, regional, and national market structure and performance rather than ETG's management of its Energy Choice program.

With the EDECA statue and the various BPU order and actions, New Jersey set the stage for Energy Choice. The state has also gone further than many, perhaps most jurisdictions in removing structural barriers with the EDI and customer account protocols. Nonetheless, it has become clear that competition in the retail residential market as currently structured is barely functional. While the BGSS rate structure may contribute to that situation, the fragmented structure of the state, regional and national markets is the predominant factor. Under EDECA, residential competition must remain available. However, absent any significant actions, it will likely continue at very low levels. Allowing it to continue as currently configured may be the best course of action, but it may be time to revisit the underlying policies and programs. Liberty recommended that ETG consider initiating a dialogue with the BPU regarding its vision, goals and objectives for competition in the retail residential market.

D. Recommendations and Review of Previous Audit

Liberty reviewed status of ETG's compliance with each of the 15 recommendations made during the 2005 EDECA audit. That audit was completed prior to the acquisition of NUI by AGLR. Liberty concluded that seven of the 2003 EDECA Audit recommendations are now moot because of changes in corporate structure since the time of the audit, many resulting from the AGLR acquisition. The remaining eight recommendations continue to have some relevance, although the specific applicability has been affected by the intervening corporate structure changes. Liberty addressed ETG's compliance with these eight recommendations as part of this new audit, specifically as part of the affiliate relationships and cost allocation methods reviews.

E. Cost Allocation Methods

Liberty reviewed the systems, methods, and results of affiliate cost assignment and allocation allocations that occur among AGLR's utility and non-utility segments. Liberty examined how affiliate costs are incurred and how the Company charges, assigns, or allocates them to ETG and other affiliates. Liberty also reviewed whether the methods for changing, assigning and allocating affiliate costs treat utility operations objectively and at arms' length.

Liberty concluded that Services Agreement with AGSC adequately identifies centralized services provided to ETG and other affiliates and the methods for allocating costs. New Jersey statutes require approval of such an agreement. The BPU authorized ETG to enter into the Service Agreement with AGSC that was in place at the time of acquisition. That agreement had been approved by the Securities and Exchange Commission, but the BPU has not formally approved it. Liberty recommended that ETG make a formal filing seeking BPU review and approval of Services Agreement.

AGSC has an Accounting Process Manual, which the Company uses to describe the processes for the accounting and allocation of costs and to define the internal controls to support transaction flow costs between affiliates and as the source of Company practices and procedures documenting the development and accounting of cost allocations. Liberty was unable to find within the Accounting Process Manual or the Policy and Procedures Manual (Exhibit I of the Services Agreement with AGSC) specific guidelines on how to charge time and expenses to guard against cross-subsidization from utility to non-utility Company. Generally utilities include such time reporting procedures as part of a cost allocation manual (*CAM*), which forms a single source of reference and procedures outlining cost allocation methods, time reporting, how to account for and differentiate between regulated and non-regulated transactions, and procedures to guard against cross subsidization. Liberty found, however, that the Company does not have a formal CAM. The Company considers the Accounting Process Manual and Policy and Procedures Manual to comprise the CAM; these documents and the Company's time reporting training documents contain some of the required elements for a CAM, but they are not sufficient to qualify as a formal CAM. Liberty recommended that the Company develop a new CAM that rectifies the deficiencies of the current documents and that the CAM be included in a filing for approval of the Services Agreement.

Liberty found AGSC's Accounting Process Manual to be a good source of accounting procedures and reference manual for processing allocation transactions and reports. It provides a good reference on the methods the Company uses for capturing costs and calculating cost factors, and describes the accounting procedures the Company uses to allocate and record costs to affiliates. Liberty found, however, that the Accounting Process Manual contains some out-of-date allocation process descriptions and recommended that the Company perform a complete review and audit of this manual.

AGLR maintains very detailed and comprehensive transaction path documentation of the flow of source information through the recording of the transaction costs to the appropriate general ledger accounts and department IDs within a business unit. The Services Agreement between AGSC and ETG provides that AGSC's methods and procedures are to directly charge, directly assign, distribute or allocate costs to AGLR system companies in various manners depending on the cost. Liberty found, however, that the Company does not have a written policy covering situations under which costs should be retained at the corporate level and not allocated to affiliates. Although Liberty did not find any activity of this type charged to ETG or other affiliates, the Company does not have a written policy as a guide for its employees to identify the costs that should be retained at corporate headquarters; Liberty recommended that the Company develop such a written policy. The policy should address costs incurred at both the AGLR Corporate level and at the affiliate utility level.

Liberty requested a description of how AGLR combined the resources of the NUI Service Company and AGSC to better understand the changes to the allocation methods and accounting of cost allocations before and after the acquisition. The Company indicated that one of the objectives related to the NUI merger and integration was to establish one service company to provide services to ETG and other affiliates to take advantage of economies of scale. AGLR's expectation of the merger was to produce efficiencies associated with more economical gas purchasing, information technology initiatives, improved transmission capacity and storage use,

and administrative expense reduction. Liberty concluded that the process the Company used to identify what roles and functions need to remain in ETG was reasonable, although the Company did not provide a project plan to Liberty.

Liberty reviewed the Company's time reporting process and procedures to ensure accurate reporting of employee time spent working on behalf of ETG and other affiliates. One of the purposes for testing of the payroll time reporting function is to ensure there is no cross-subsidization from a utility to a non-utility business unit. Liberty concluded that the Company has adequate time reporting procedures, including sufficient internal controls and flexibility to allow charging to multiple business units. The time reporting procedures are well documented and mechanized, which tends to minimize the chances for errors or inaccurate charges to business units. Liberty reviewed and saw evidence of time reporting controls that provide compliance to the schedule of authorization, level approvals and follow-up by managers for missing time sheets. However, Liberty recommended that the Company consider the use of the number of time sheets instead of the number of full-time-equivalent employees as a cost driver to allocate the cost of its payroll system.

The Company has not updated the capitalized engineering rate since 2006 and cannot locate the engineering time study to support the current rate. Without an updated engineering time study to capture expense and capital time reporting results, the Company is at risk of either charging too much or not enough capitalized engineering costs to ETG and other affiliates. Liberty recommended that the Company update the capitalized engineering study to determine if engineering expense and capital costs have changed from 2006 to present. Once the Company determines the updated rate, it should perform a comparison to the old rate and determine the materiality of the change. The Company should perform time studies and the rate calculation at least annually. The Company should monitor the mix between engineering capital and expense charges on a quarterly basis for changes in time reporting trends.

Although Liberty did not find any cases of cross-subsidization of costs through its review of the time reporting procedures, the Company does not have a formal written policy for employees to report time to utility or non-utility business units to help ensure that cross-subsidization does not occur. The Company explained how it accounts for the costs of sharing employees between utility and non-utilities, but the procedures are not documented and not all employees may be aware of the proper way to report or account for their time in such circumstances. Liberty recommended that the Company include in the CAM written policies and procedures that describe the circumstances in which costs (*e.g.,* payroll time reporting) would be charged to a utility or non-utility. The Company should include the time reporting procedures, specifically addressing protections against cross-subsidization, in the CAM as a reference and guide for employees. Liberty suggests that the Company develop a time reporting procedure that lists and identifies the utility and non-utility companies for time reporting purposes. It should include employee guidelines for charging time when working on a project affecting both a utility and a non-utility, and the ramifications for not reporting time properly. These procedures and guidelines will enhance employee time reporting and help guard against cross-subsidization.

Liberty reviewed the Asset Management Agreement between SEM and ETG to determine how the Company accounts for costs charged between SEM and ETG. The Company allocated gas

supply management costs to ETG as part of the monthly allocation process in 2005, 2006, and 2007. These cost allocations were in addition to costs charged to ETG based on the Asset Management Agreement in effect between SEM and ETG during 2005, 2006, and 2007. Therefore, Liberty determined there was duplication of costs charged to ETG from the cost allocation process and the costs resulting from the Asset Management Agreement, although the net impact on ETG was minor. Liberty concluded that the Company needs a thorough review of all the services provided and allocated to ETG based on the applicable service and asset management agreements. Liberty recommended that the Company review all services and charges allocated to ETG based on the AGSC/ETG Services Agreement and eliminate any duplicate charging for those provided under the Asset Management Agreement.

Liberty used sample ETG transactions and invoices for August 2008 for the detail transaction analyses and testing of costs and document flow. Liberty tested various transactions on site with the AGSC accounting personnel. The analysis included a review of selected document flows and analysis of journal entries, including time reporting, monthly billing of invoices, monthly reports, monthly settlement of charges, and snapshots of the general ledger for selected services billed and recorded. In general, Liberty was able to reconcile the transactions and invoices.

During the annual budgeting process, the Accounting department calculates standard benefits rates based on budgeted numbers. It updates these rates annually and reviews them quarterly for any adjustments. Accounting reviews the difference between actual benefit costs and the standard distributed amount quarterly and trues up distributed benefit costs if the differences are significant. If the budget-to-actual variance or true-up is significant in the period, the revised rate is abnormally inflated. Because of the inflated rate, AGSC charges to the current month prior-period costs that should have already been distributed. Liberty found this to be the case in the testing of the standard rate and true-up process performed for the benefits rate calculation for the fourth quarter 2008. Liberty recommended that the Company monitor the actual-to-budget activity on a monthly basis. More frequent reviews of actual-to-budget variances will minimize the need for a material benefits rate true-up at the end of the year.

Liberty found that the Company does not have specific written policies relating to transfer of assets between ETG and an affiliate. Liberty tested the asset transfer data for April, 2008 and found that several of the transferred assets were transferred with a negative book value. Liberty concluded that the Company does not have adequate procedures for asset transfers, transfer pricing and related plant accounting internal controls. Liberty recommended that the Company review and update procedures for asset transfer, transfer pricing and internal controls.

Liberty found that AGSC's methods for allocating costs to corporate headquarters, ETG and other affiliates are reasonable, in general. Liberty found an equitable distribution of costs to the corporate entity and its subsidiaries, including ETG, and no evidence that ETG is subsidizing non-utility affiliates to any significant extent. However, Liberty found some examples where the Company did not apply the methods appropriately or completely, such as the gas supply cost allocation and out-of-date capitalized engineering study and rate already mentioned.

Liberty found that AGSC's methods for reporting allocated costs to its affiliates are adequate. The Company produces reports that document AGSC's allocated costs, and show the costs at a

sufficient level of detail for affiliates to review them. The Company also provides comparative reporting of budget-to-actual costs on a month-to-date and year-to-date basis to aid in controlling costs. Liberty found, however, that the Company develops and produces regulatory reports manually from internal financial data adjusted for BPU-required rate making adjustments. Liberty recommended that the Company develop a mechanized regulatory reporting system.

F. Remediation Activities and Costs

For almost the first 100 years of its existence, ETG manufactured the gas that it distributed, rather than buying it for delivery to its city gates. The Company ceased gas manufacturing in the mid-1950s; subsequently residues from the old manufacturing processes were found to present public health risks. Agreements with the New Jersey Department of Environmental Protection (*NJ DEP*) cover ETG's conduct or sharing of responsibility for investigation and remediation activities at six sites in New Jersey: two in Elizabeth and one each in Rahway, Perth Amboy, Flemington, and Newton. ETG has responsibility for four of the six sites because it or its predecessor companies operated manufactured gas plants (*MGPs*) at them. Predecessor companies also operated MGPs at Flemington and Newton, but those were also owned by a predecessor of Jersey Central Power & Light Company. A 1993 agreement assigns ETG responsibility for 40 percent of MGP-related costs associated with those sites.

The controls environment for authorizing expenditures for ETG's MGP program warrants strengthening. Liberty found that the employee who conducts ETG's remediation program is very well qualified. He worked on environmental compliance and liability issues at NUI Corporation for nine years prior to its acquisition by AGLR, and has worked in ETG's MGP remediation program since NUI was acquired by AGLR. Liberty noted, however, that he essentially runs the program by himself. Liberty is concerned that expenditures of the magnitude that he authorizes require more oversight of the approval and authorization for the original MGP expenditures. Liberty recommended that the Company review the process for review and approval of program expenditures. Liberty suggested including a procedure to reference and cross check the approved MGP capital expenditure budget to ensure the project is part of the approved budget. This process should be reviewed with AGLR's Internal Audit group, and it should be done soon, as expenditures are scheduled to increase rapidly, beginning this year. A report regarding findings and recommendations from the review should be submitted with ETG's next Remediation Adjustment Clause (*RAC*) filing.

Dealing with MGP sites is a common problem for LDCs; Liberty's review of a number of them has found that the quality of efforts varies considerably. Development and administration of a remediation program can be complex and time-consuming. The solution is usually to increase the visibility of the program within the company. Liberty concluded that ETG's program has appropriate visibility. All AGLR's MGP programs report to a senior officer of the Company, who is responsible to the Board of Directors for their conduct.

The relatively slow pace of ETG's remediation program has meant that the most cost-effective way to proceed was with minimal internal staff resources, adding technical experts on a contract basis as needed. AGLR has brought experience with remediation in other states, and has managed this way successfully, calling on corporate resources to supplement program staff. Many of the consultants for ETG's sites have been in place for some time, and provide important

continuity in developing and conducting remedial investigations, and in designing remedial actions as that phase begins. Liberty did not find any formal evaluation of remediation contractor performance. AGLR's Supply Chain staff provides important assistance in identifying and hiring execution contractors, but someone must evaluate contractor performance if the program is to be managed effectively. Liberty could not identify who has that responsibility; therefore, we recommend that the function be formalized and assigned to someone.

2008 was ETG's first year of actual remediation activity, as opposed to investigations that lead to remediation. This is causing a significant increase in work associated with remediation. Liberty concluded that ETG will not be able to manage a program at the level it is now facing with the same staff and systems that it has managed until now. As its remediation activities increase in scale and scope, however, the Company will have to take a more proactive role in program management in order to ensure its effectiveness. Liberty recommended that Company develop a new approach that will require at least more active involvement of Company personnel in the development of each year's remediation program, and a much more intense program of budgeting and cost analysis. Liberty recommended that the Company look to experience in New Jersey in designing its approach. The other two gas-only distributors in New Jersey, New Jersey Natural and South Jersey Gas Company, have effective programs, and should provide experience that the Company can draw on.

Liberty found that the Company's methods of accounting for remediation costs are adequate. The Company appears to have adequate internal control procedures and processes in place once program invoices have been approved and coded to the proper account. However, Liberty questions whether the Company is prepared to provide effective review of program expenditures at the levels that are anticipated, given the dependence of the current approval process on a single individual, as mentioned above.

Liberty reviewed the time-reporting process for the MGP remediation program and found that, although the transactions are recorded properly, the process does not result in recording time directly to the business unit affected. Liberty recommended that the Company adjust the accounting process to charge payroll costs associated with the MGP remediation program directly to balance sheet accounts. This would allow direct assignment of such costs to ETG and other affiliates, and would also tend to simplify the quarterly accounting process.

Liberty found the Company's reporting and filing of MGP remediation costs through the RAC mechanism and the quarterly and annual filings to the BPU to be adequate. The accounting personnel are experienced and knowledgeable about the regulatory reporting requirements and how to capture the MGP remediation costs recorded in the general ledgers for reporting purposes. However, the Company and the BPU need to determine how to expedite the proposed RAC credit adjustment to allow customers of ETG the benefit of lower rates. Liberty recommended that the Company include as part of its internal controls, a process to reconcile all internal supporting schedules and worksheets to the final RAC report before it is filed with the BPU.

Liberty found that the Company's files of its correspondence with the NJ DEP and other government stakeholders are orderly and complete, and that the Company's relationships with

the NJ DEP reflect that agency's confidence in ETG's ability and willingness to accomplish the necessary steps in the remediation process. Liberty found that the Company's efforts at insurance recovery are sound; the Company has availed itself of adequate expertise in this area, and efforts at potential recovery are proceeding.

Liberty examined the Company's data and records retention process and found it to be adequate. The Company was able to find and produce all documents that Liberty requested. At present, all program records are hard copies, but that medium has sufficed to date. The Company is moving to electronic data storage which will increase efficiency in storing records and eliminate the need for paper copies.

G. EDECA

The BPU requested that Liberty audit ETG's compliance with the standards for affiliate relationships, transactions, and cost allocations between gas utilities and competitive business segments that the BPU adopted pursuant to EDECA. The last EDECA audit of ETG was performed in 2003, and the set of ETG affiliates and their relationship to ETG has changed significantly since 2003, partly because of actions taken by NUI after the last EDECA audit and partly because of the AGLR acquisition in 2004.

Liberty reviewed the status of the ETG and ETG affiliate operations and concluded that AGLR does not operate any related competitive business segments in New Jersey. All the affiliates identified in the 2003 EDECA Audit as related competitive business segment (*RCBSs*) or potential RCBSs are now either discontinued or have been sold. None of the existing affiliates has any customers in New Jersey, aside from ETG itself. Liberty concludes that there are currently no ETG or AGLR RCBSs in New Jersey. AGLR is seeking new business opportunities that may change that situation in the future, however.

III. Phase Two: Management and Operations Review

A. Governance

1. Board Membership and Structure

The AGLR board of directors currently has 14 members, divided into three classes, each with roughly one-third of the total membership, and serving overlapping three-year terms. All 14 current directors are outsiders, except for the AGLR chief executive officer (*CEO*). Beginning with the 2010 annual meeting, directors with expiring terms will be elected for one-year terms, the result being that by the 2012 annual meeting all multi-year terms will have expired and all directors will be elected annually. Liberty reviewed the board members' qualifications and experience and found them to be appropriate. The board has a sufficient range of senior experience and it compares existing and desired capabilities in considering potential new members. There has been a New Jersey member since the acquisition of NUI. Liberty found that there exists an appropriate program for introducing new directors to AGLR and its unique circumstance and needs. The board places appropriate emphasis on continuing education, and the directors have as a group participated adequately in continuing education activities.

Liberty concluded that the board operates with sufficient independence. AGLR takes effective measures to assure that board members do not have competing interests; AGLR has firm and comprehensive standards applicable to conflicts of interest, and requires all directors, as well as employees and officers, to confirm their compliance with them. Liberty concluded that the directors have a substantial opportunity to participate in agenda formation and they undertake substantial reviews of governance effectiveness in regular sessions among themselves. The post-meeting sessions among independent directors are consistently held, appropriately structured, communicative, and used to provide feedback to senior management.

AGLR rotates committee memberships and structures that membership essentially to place half of its members on the same two of four principal committees and the other half on the remaining two. Liberty did not find that any committee has been left with resource gaps because of the rotational policy. Moreover, gradual rotation should remain an effective element in considering committee assignments, in order to promote broad director understanding of the business as their tenures extend. AGLR needs, however, to assure that its consideration of committee assignments in the future makes rotational considerations secondary to assuring that committees retain expertise and stability, which are important in assuring that they provide optimally-informed and steady guidance from year to year.

AGLR's committee structure supports the implementation of controls necessary for overseeing the operational and financial separation of utility and non-utility operations. The board members understand the importance of that separation and address it in committee and board meetings. Liberty did conclude, however, that AGLR's understanding of what good utility practice requires by way of financial separation should be broadened. In terms of governance, however, Liberty found adequate board oversight in assuring the types of separation that the Company has found to be appropriate.

Liberty found a lack of a focus on LDC operations in the AGLR governance structure and concluded that this lack prevents the board from obtaining insight into ETG operations circumstances and needs at a level that Liberty has observed at other companies. Separate utility boards and operations committees represent some of the structures used by other holding companies to assure sufficient focus on utility operations matters. AGLR has made significant increases in New Jersey system investments. However, the presentations made to the board, the data sets regularly provided to the board, summaries of meetings, and the knowledge demonstrated by board members in interviews reflects greater attention on non-utility operations, despite their secondary size. Because the organization structure places the most senior ETG oversight at a geographic distance, it is very important to assure that the board does not see ETG principally as an undifferentiated part of a six-LDC business that operates primarily in the Southeast. Weather-based differences in gas usage, divergent economic growth patterns, and different labor characteristics represent some of the factors that make ETG different.

To improve LDC focus, Liberty recommended that AGLR create an LDC-operations-focused board committee and routinely distribute more detailed, focused, and LDC-specific data sets that provide quantitative measures of performance against clear, comprehensive metrics. AGLR should accompany this change with the development of a comprehensive set of performance metrics for reporting to the board each month, along with goals, quarterly and annual trends, and spotlights on areas of substandard performance and even standard-satisfying performance that is trending downward. Liberty recommended the New Jersey Natural Gas set of measures as a starting point. Liberty has found them to be quite comprehensive, yet presented in a way that facilitates ready comprehension and identification of potential areas of concern or questions for board members.

Liberty reviewed the documents used to govern the board's operations and committee structure and operations are found them to be sound and effective. They undergo annual review in conjunction with examinations of board and committee effectiveness. Committee members showed a thorough and consistent understanding of committee roles and activities particularly, and generally, the role of the board in promoting the creation of an effective controls environment.

Liberty found that the board and its committees undergo regular and sufficient annual evaluations. The evaluation forms used are notably comprehensive and they are faithfully used, and results are shared. However, the approach suggests acceptance of performance that is viewed as satisfactory. The documents that Liberty reviewed did not appear to focus on soliciting feedback that would improve performance already viewed as acceptable. Liberty recommended that use of these evaluations as tools improve board member performance.

2. Senior Executive Management

The chairman of AGLR is also the CEO. Liberty concluded that AGLR has adequately addressed the issues related to such a combination of roles. The particularly strong outside board member predominance on the board, the use of lead directors with long experience on the AGLR board, and the reliance that the board places on outside-director only sessions provides sufficient assurance that the board can and does exercise its responsibilities with sufficient vigor and independence.

Liberty found that the board is adequately involved in executive succession. It maintains a current identification of CEO candidates, should an unexpected need arise for a transition in the position. The board has also made its involvement in executive succession more broadly a specific goal.

3. Auditing, Ethics, and Compliance

Liberty found that the board's Audit Committee operates independently and effectively. The membership of this committee has sufficiently strong credentials for a company of the size and complexity of AGLR. Its membership is independent, conducts separate meetings with auditors and management, and actively participates in audit plan formation, status monitoring, and follow-up. It has sufficient control over the selection and performance of the independent accountants and it adequately controls the use of those accountants for additional work.

Liberty found that AGLR has given adequate attention to Sarbanes-Oxley (*SOX*) compliance. The independent accountants and Internal Audit, operating under Audit Committee guidance appropriately plan SOX work and take, in conjunction with the significant and appropriate self-examination role of management, a proper role in verification and independent testing activities. The Audit Committee collectively has substantial experience with SOX compliance at other large companies, and its members showed strong understanding of the importance of and means for assuring compliance. The board of directors has exercised leadership over compliance efforts, and has remained actively involved in monitoring the substance and the timing of actions as part of compliance plans. There exists an effective set of tools to assure that controls undergo comprehensive and timely evaluation, change, and certification.

Liberty concluded that AGLR has designed and conducted an effective program for assuring ethics and compliance. The board promotes and pays regular attention to the maintenance of effective guidelines, policies, and procedures. There exist adequate means for raising complaints and concerns. There is regular reporting to the board about ethics matters. AGLR has recently revised its code following a review of it by an outside consultant. Liberty does have a concern about where AGLR has located executive responsibility for ethics matters, and noted this as part of the organizational review summarized below.

Liberty concluded that there is not a formal process for soliciting proposals from independent accountants, although there is regular review of estimated costs of the independent accountants. The committee chair recognizes the value in considering rotation of independent accounting firms, and the Audit Committee charter requires consideration of change at least every three years. However, the policy does not require the use of formal solicitations of cost proposals. Liberty recommended the Audit Committee periodically solicit competitive proposals for providing outside audit services.

B. Organization

AGLR's breadth of operations gives it an advantage that smaller holding companies operations do not have. Liberty found that AGLR has performed well in taking advantage of this opportunity, and in ways that have brought to ETG an organization that is much improved form

the past and that is competitive with any that Liberty has seen in its work in the energy utility industry.

Liberty concluded that key utility operations functions have dedicated capable leadership. AGLR has provided for a New Jersey-based executive for ETG operations. He, the senior vice president to whom he reports, and the service company (AGSC) organizations provide a source of support adequately dedicated to utility operations. The organization structure at AGLR is more complex than one would find at some holding companies. This greater complexity results from the large number of jurisdictions in which AGLR operates. At the overall level, AGLR has created a structure that responds effectively to the needs imposed by its large operations footprint.

There exist appropriate missions, goals, and objectives for the organizations that conduct and support the provision of utility service in New Jersey. The benchmarking data used by AGLR shows effectiveness in acquiring a staff with competitive levels of tenure, using outside hires effectively, minimizing unexpected departures, preparing succession candidates, minimizing overtime, and applying a representative number of management layers and spans of control. In particular, Liberty views the relatively greater level of outsiders filling positions as a positive factor.

The two principal non-utility businesses, SEM and SouthStar operate largely independently in meeting their operations needs. AGLR's energy investments segment draws engineering and technical support from the same central group that supports the AGLR LDCs. There are appropriate controls and procedures in place to assure proper charges for that support. The work performed in support of energy investments is complementary to that performed by the LDCs; providing it through a common organization benefits the LDCs by bringing to bear the benefits of the experience gained through the performance of complementary work. Where appropriate, the service company organization has dedicated separate groups or individuals to LDC and to energy-investments work.

Liberty found that AGSC, the service company, comprises a notable strength of AGLR's organization and operations. It has been effectively designed to provide common services efficiently and effectively. The large number of LDCs it serves has provided an opportunity for centralizing a greater number of services. AGLR has done so, particularly in providing a greater level of engineering and technical services. The service company's functions operate under well-qualified and highly experienced leadership. The service groups exhibit a culture of "client service."

AGLR has a comparatively high number of officers, but their number is appropriate to the large and dispersed nature of AGLR's operations. This disparity is at least partially offset by comparatively lower numbers of managers, when measured similarly. While there does remain the potential for a very small further reduction in executives, there is not a basis for concluding that ETG suffers any measurable or material economic disadvantage.

AGLR compares favorably with other utilities generally and with New Jersey's other two LDC-only gas utilities in resource levels. AGLR does have size advantages that should translate into staffing competitiveness. The Company's benchmarking data and Liberty's review of staffing

numbers at the other two LDCs in New Jersey confirm that AGLR has used this advantage to produce staffing levels that are sufficiently competitive overall.

AGLR combines the position of General Counsel and Chief Ethics Officer. As noted in the Governance section, Liberty concluded that this combination does not fully promote the objectives of the ethics role. A lawyer has the responsibility to advise the client about what is lawful and not lawful. Combining the responsibilities of chief ethics compliance officer and chief legal officer may well obligate the person to whom management regularly turns for legal advice to apply two different standards. Moreover, it obligates the incumbent to take, as chief ethics compliance officer, potentially strong measures to prevent actions that he would, as a lawyer counsel, consider within the bounds of the law. Liberty recommended that AGLR provide for the eventual separation of the two roles of General Counsel and Chief Ethics Officer.

Overall, Liberty concluded that AGLR has generally managed the relationships among its utility and non-utility subsidiaries effectively and has appropriately balanced the allocation of resources and investment risks among them, but its energy-market operations will continue to require close observation and control. AGLR has managed its portfolio mix of utility and non-utility subsidiaries effectively in order to ensure that that the utilities, including ETG, have stable and sustainable growth and to minimize the financial failure risk on the utilities from the non-utilities affiliates. Energy-market operations, however, have for some time been viewed as a major source of financial risk. It will continue to be necessary for AGLR, while securing needed operational and financial separation, to maintain close senior executive oversight as those businesses continue, and to regularly re-examine their needs and risks as energy markets continue to change, and as those businesses grow.

C. Human Resources

1. Organization and Management

Senior executive direction of the Human Resources (*HR*) organization comes from an AGLR senior vice president located in Atlanta. Liberty concluded that the organization structure is effective and provides adequately for the needs of ETG. The organization presents a logical division of functions. It provides sufficient field representation to meet needs locally under commonly designed programs, policies and requirements. AGLR has recently restructured HR to meet needs better and more efficiently, including a restructuring of the training function.

HR's headcount has remained fairly stable in recent years; costs have fallen, due primarily to a reduction in the use of outside resources. AGLR benchmarking data show that its HR costs per employee are about twice the median level of a sample group, but that metric alone is not determinative, as such data does not recognize differences in where costs get assigned. Nevertheless, that factor and the fluid structure of HR in the recent past indicate the need for prompt development of a budget structure and cost-performance metrics that will provide assurance that staffing has reached an optimum level. Liberty recommended that HR promptly adopt a comprehensive new budget structure and a series of cost performance metrics at the sub-group level. Work on this matter was underway during Liberty's audit field work. The recent reorganization and HR's recent cost history indicate significant attention to HR's effectiveness and efficiency. Completing the development of a budget structure that can be supported by

performance metrics at the functional level within HR will help to assure that cost performance is optimized.

Liberty concluded that AGLR employs corporate-level resource controls that are commensurate with what Liberty has seen at other, similarly situated companies. The Company controls staffing growth and the assignment of salary grades through focused measures that operate with sufficient visibility and rigor. The controls over the filling of open positions are particularly strong.

Liberty found that AGLR has made an appropriate commitment to doing business with minority, women-owned, and other disadvantaged businesses, and has succeeding in producing steady and notable increases in the level of business it does with such firms. The Company uses specific goals and reports progress against them regularly. It has made significant gains in the level of business it does with such firms and it has substantially broadened the areas in which it does business. AGLR now engages in a variety of technical and operations business relationships with such firms. Some of those agreements include very substantial dollar commitments. AGLR reports progress at the state level as well.

2. Workforce Management

AGLR produced large gains in efficiency at the time of the NUI acquisition through reductions in staffing; reductions have continued at moderate levels since the acquisition. It is clear that the leverage AGLR can apply by virtue of its large LDC operations has been used to make major staffing reductions from the level that NUI had been applying.

ETG has the advantage of a very experienced work force, but the Company faces the aging-workforce issue that confronts utilities nationally. The data does not show a more acute problem at ETG (versus the remainder of AGLR), and it is clear to the Company that skills maintenance is an issue. The Company, however, has not adopted a formal approach or processes for identifying areas that will permit it to identify the extent and timing of particular skills needs it faces. Liberty recommended that the Company develop such an approach. With some estimates indicating that as much as half of the utility workers (professional and others) in the U.S. may retire in five to ten years, it seems surprising that there remains no recognized standard or set of measures to which utility HR groups can turn. However, the lack of a developed approach to the problem does not obviate the need for active measures. Developing more comprehensive data that can be used to forecast the skills that will be most in need is certainly a key starting point that AGLR can address now. This information can then be used to concentrate efforts to identify unique and valuable expertise and to identify formal and informal means for its transfer from more senior employees to more junior ones. With a comprehensive re-examination of training now underway, AGLR has perhaps a unique opportunity to tailor its training and development efforts to assure that the wealth of operational and institutional knowledge its workers have and that it takes to optimize performance remains strong and vibrant.

Liberty found that AGLR has adopted and communicated an effective commitment to diversity in its employee population, and supports that commitment with appropriate affirmative action planning. The Company has a focused and comprehensive approach; the plan sets specific goals annually, and reports progress against them. Benchmarking data shows that AGLR compares

favorably overall with other companies. The data shows, however, that AGLR has had comparatively less success in meeting placement goals at ETG in 2008. The most recent presentation to the board of directors on diversity did not focus on gaps or plans specific to closing the gaps in New Jersey; it showed new hires on an AGLR-consolidated basis. Liberty recommended that the Company make the satisfaction of EEO/AA placement goals in New Jersey a priority at both the local and headquarters level.

Liberty found that AGLR uses an effective and economical organization for conducting labor relations. Both grievances and arbitrations have fallen since the NUI acquisition, and are at a level comparable to what Liberty has seen at New Jersey's other LDCs. Liberty also found that AGLR prepared appropriately for the 2009 end of its current labor agreement; the Company began early to assemble a team, identify matters likely to be in issue, and survey terms and conditions of other New Jersey utility and regional labor agreements. Liberty concluded, however, that running the labor relations operation from Atlanta keeps it far from the workers affected. Only New Jersey and Virginia employees now work under labor agreements, although agreements existed in other AGLR LDCs until recently. Locating the director in Atlanta had more support when most LDCs had bargaining units than doing so now does. Liberty recommended that the Company establish a goal of moving management responsibility for labor relations to the Mid-Atlantic region.

Liberty concluded that the number of salary grades AGLR maintains is competitive. AGLR regularly adjusts them, and uses a consultant to provide market information to support those adjustments. AGLR has moved ETG salary grades closer to those of the remainder of the Company, but retains a premium of about 7 percent for comparably graded ETG positions. Liberty found that AGLR applies a structured, comprehensive process for conducting employee performance evaluations, and effectively ties results to compensation. A common, electronic form applies to all evaluations, with commonly derived categories and measurement bases, which have been adjusted to reflect the differing kinds of contributions that employees at different levels make to company success. While the performance evaluation process is sound and effectively administered overall, Liberty found that it does not give local management a formal opportunity to contribute to evaluations of AGSC personnel assigned to local operations. Liberty recommended that AGLR provide for New Jersey or Mid-Atlantic input to the AGSC managers, allowing local or regional managers to input the same information into the goal setting and evaluation system, for review by the AGSC manager prior to finalization of the manager's entries.

Liberty concluded that AGLR has an appropriate safety organization, which operates effectively to promote safety and measure performance. Separating environmental responsibilities from safety responsibilities, and moving responsibility for safety upward to a managing director's position has raised safety's position and focus in the AGLR organization. Safety performance has been effective at AGLR overall. At ETG in particular, safety performance has improved, and is at present comparable to that of AGLR's other LDC operations. Safety is comparable to what Liberty has observed at other companies.

AGLR takes the pulse of its New Jersey employees frequently. It solicits feedback on a broad range of issues. The Company response to the results has not always been clear and decisive,

however. The action-plan documents to respond to what were clear indications of broad discontent within the ETG workforce in 2007 were not specific. ETG employee general attitudes have improved since that survey, as recent survey work confirms; AGLR has made important progress in promoting positive employee attitudes, which are necessary to assuring that service delivery remains strong and effective in New Jersey. The action plans after the 2007 survey, however, did not focus clearly on the magnitude of the gaps shown, set closure targets, define clear and specific actions to close each gap, assign responsibility to the full range of managers and executives involved, produce objective measures of success, or generate documented reports of results obtained and needs remaining. Liberty recommended that the Company continue regular surveying of New Jersey employee attitudes and require definitive analyses and action plans subsequent to each. AGLR should require detailed, objective, quantified analysis of survey results, and an identification of the nature, size, and root causes of all "gaps" that exist. For each gap identified at each survey, the group identified above should establish objective "closure" goals (quantified wherever possible), specific actions, assigned responsibilities (including local, regional, and Atlanta operations, supervision, and management, rather than just HR personnel), similarly objective and quantified success measures, and regular results reporting. Comprehensive surveying should not extend beyond intervals of, at most, two years.

3. Training

The Company undertook a detailed and focused look at its training needs, organization, and offerings in 2009. Liberty concluded that the resulting reorganization of training represents a strong step forward by AGLR; the reorganization has created a much sounder platform for needs identification, program and offering design, delivery, and results measurement. The new organization reports to a higher management level, which separates it from an HR department with an already large portfolio of responsibilities and roster functions, and set of activities. The new organization focuses specifically on training design, which, if effectively implemented should allow for content improvement and sharper decisions on the costs and benefits of internally versus externally provided solutions. The reorganization eliminates the former decentralized approach to finding training sources and time availability, which can both reduce costs and improve results.

The Company lacks new-hire training and recognizes this as an issue, but has not yet subjected to the issue a firm development plan and schedule. The aging work-force issue heightens the need for such training in the current and coming environment. Formal programs have already been developed and implemented by LDCs recognizing that the time it takes for worker knowledge to mature through an apprentice-type, "on-the-job" approach may not be sufficient. Liberty recommended that the Company make the development of a new-hire training program a priority, and set a firm plan and schedule for implementing it. ETG's region has already witnessed important advances in the area, with major gas LDCs (including ConEdison and National Grid) as active participants. Cooperation with local educational institutions presents a particularly exciting opportunity, providing not only a training solution, but recruitment assistance as well. The metropolitan New York region already has at least one community college offering courses.

Liberty found that AGLR has had and maintains a broad range of offerings and communicates their availability. The roster appears typical. AGLR has used typical means to stress the

importance of development generally and to allow employees to steer their development through the use of identified offerings that meet specified needs and criteria. Nevertheless, AGLR was not able to produce for Liberty information that showed substantial knowledge and analysis of how effective its training has been, and what drives its costs at a detailed level. There has been some benchmarking of overall performance (hours and costs), but problems with AGLR's data make use of those metrics, which are fairly general in any event, very limited. Liberty recommended that the Company establish a robust training budget structure, cost reporting system, performance reporting and metrics, and benchmarking program to assure that training is producing appropriate results cost effectively.

D. Strategic Planning

The Company does not perform a specific long-term strategic planning process or develop a "corporate strategic plan." AGLR has strategic visions and long-term financial targets; however, the Company does not prepare any single, seminal strategic planning document that is used by management as a platform for conducting medium-term and shorter-term planning. The heads of different business units have responsibility for individual strategies. These strategies tie together conceptually at the holding company level, under the overall direction of the CEO and chief financial officer (*CFO*), with the input of an eight-person "policy committee" consisting of the most senior AGLR executives. The AGLR board of directors receives a "strategic outlook" presentation each year. The Company derives its strategic outlook presentation from a five-year financial plan and forecast that it calls the "base plan."

AGLR's vision and mission is focused on the natural gas "value chain." The value chain extends from pipelines to storage assets to local distribution companies. The Company is interested in potential value creation opportunities within this chain. AGLR's vision for its six regulated utilities is to focus on stable and sustainable growth. The vision for the AGLR non-utility businesses is to grow these businesses, but not too rapidly. Liberty concluded that the AGLR vision is appropriate and consistent with ETG's needs.

AGLR is targeting a strategic mix of LDC and non-utility businesses that limits earnings from the non-utility businesses to about 30 percent of the holding company total. This is a long-term target that is understood by investors to require flexibility on a year-to-year basis, recognizing market volatility. Liberty concluded that this policy appropriately limits financial failure risk to ETG to acceptable levels. Restricting the non-utility contribution to earnings creates boundaries on the size of these businesses, which inherently limits the impact of business failures on the LDCs. AGLR's recent performance and five-year forecast are generally consistent with the strategic mix target.

AGLR's strategic plan, as defined in its five-year forecast, includes the Company's base plans and targets for the LDCs and specific strategic overlays for major projects and investments. The AGLR staff also develops shorter-term financial targets for the holding company, Pivotal and ETG. Mid-Atlantic Operations, of which ETG is a part, and ETG develop goals for their operations based on the corporate goals and budget targets. Liberty concluded that AGLR and Mid-Atlantic Operations plans, processes and business unit goals and objectives tie to and appropriately support the ETG utility business and initiatives; the annual budgeting processes for ETG and MAOPS set sufficiently detailed targets for the most important financial goals and

objectives. Liberty also concluded that ETG and Mid-Atlantic Operations business planning and budget processes include planning and programs to meet the requirements and priorities of its customers.

The AGLR budgeting processes and procedures and the response to New Jersey economic development programs have provided for significant increases in capital and management resources for ETG. Actual capital spending has been more than budgeted amounts in three of the four years. ETG has increased its budgeted and spending significantly in the "mandatory projects" and the "business support projects" categories. Liberty concludes that ETG has received substantially increased and sufficient capital authorizations in its normal budget process, and that the capital budget is appropriately funded. The funding for the strategic initiatives will be accomplished through specific tariff riders requested by the Company.

The Company measures ETG's management performance primarily in monthly reviews of financial and operating performance for each of the three operating utilities in Mid-Atlantic Operations, and for Mid-Atlantic Operations in total. Liberty examined the process the Company uses to analyze, track, measure, and report ETG performance against budget, and concluded that this process is effective.

ETG has its own management team and business office to support its planning and management reporting operations. Liberty concluded ETG management spends virtually all of its time and energies on achieving reasonable goals and objectives for the New Jersey LDC, and their focus is not diverted by other needs of the AGLR holding company.

AGLR uses an approach known as "enterprise risk management," which represents a new and growing approach to identifying and managing risk. Taking a very broad view of risk, enterprise risk management strives to help an enterprise determine how much risk it is taking, how much it should accept, and what measures exist to bring actual and acceptable risk into line. AGLR's approach received favorable reviews from Standard & Poor's and an outside consultant hired by the Board of Directors' Audit Committee. Liberty concluded that this approach is developing an effective process for risk identification and mitigation, but found inconsistencies in the 2008 ratings across the Company to be too large for the combined risk assessment to be of high value on a company-wide basis. Liberty recommended that the scoring of risks should be upgraded to provide more consistency on a company-wide basis.

AGLR's tax allocation policies provide for ETG's federal tax liability to be calculated and paid as if ETG were a stand-alone entity and not part of a consolidated tax return. The Company's tax allocation spreadsheets, quarterly tax provisions and actual payments and true-ups support this underlying principle. Liberty concluded that ETG is charged and pays for its share of federal income taxes as calculated by an allocation method that is in accordance with SEC and IRS regulations. However, we emphasize that these tax allocations and payments are proper for tax and accounting purposes, but do not suggest the appropriate regulatory treatment of consolidated taxes. The BPU and other state commissions have made tax savings adjustments to the "stand alone" treatment in rate case proceedings.

E. Finance and Cash Management

1. Financial Policies, Credit Ratings, and Pension Plans

Liberty found that AGLR has set reasonable financial policies and targets for the holding company and ETG, and has effectively managed to those targets; ETG dividends and equity levels have also been effectively managed to result in reasonable funding costs. AGLR's long-term goal is to grow earnings per share in a range that averages 4 to 6 percent per year. Half of this growth may come from Distribution Operations (the core utility business of the LDCs) should they be able to achieve 1.5 to 2 percent annual customer growth rates. Overall growth levels above this range have been attained in some previous years; however, AGLR believes that these growth levels may not be sustainable in the long term, especially considering the current economic and financial market climate. Liberty considers the utility earnings targets that result to be reasonable for ETG. Recapitalizations have been performed for ETG at June 30 and December 31 since the end of 2005 to reset the utility capital structures per books to be in line with target capitalizations, causing a consistently fine-tuned capital structure to support the utility's operations.

The AGLR utilities generally have a credit rating target of "A," and the holding company has a target of "BBB+." AGLR recognizes that its non-utility businesses and its acquisitions of smaller utilities causes the holding company credit profile and rating to be somewhat weaker than that of its utility subsidiaries. The "A" level target, and the cash flow ranges that are required to attain it, are appropriate for ETG to provide the foundation for reasonable funding costs.

The limit AGLR places on non-regulated contributions to earnings (30 percent) is designed to manage the holding company's risk profile, especially in the eyes of equity analysts and the credit rating agencies. Liberty finds that this diversification limit also has the related benefit of limiting the risk that the non-utility businesses pose to ETG and on AGLR's other LDC operations. As a result, the risk of negative financial results of the unregulated businesses affecting the utilities is being adequately controlled. This earnings limit does not, however, mitigate the potential risk that non-utility businesses may place on the utility's financial market access and liquidity.

The ETG legacy pension plan suffered serious losses in its investment assets during 2008; however, it started the year with a funding level of about 103 percent. Liberty concludes that the plan will not require large capital contributions or increases in pension expense due to 2008 asset investment losses.

2. Debt Financing

Gas facility revenue bonds issued by Pivotal through the New Jersey Economic Development Authority form a major portion of ETG's outstanding long-term debt. ETG has historically benefited greatly from the use of this tax-exempt, floating rate financing vehicle. However, problems in the credit markets caused failed auctions of the revenue bonds, which threatened this inexpensive financing source in early 2008. The Company took effective action to repurchase the floating-rate bonds and restructure the credit support backing them which allowed ETG to

maintain the substantial benefits of the floating-rate instruments. As of December 31, 2008, the interest rate on the floating-rate bonds was around 1 percent.

The other major portion of long-term debt for ETG comes in the form of a promissory note with a financing affiliate called AGL Capital Corp. (*AGLCC*). The holding company and subsidiaries use AGLCC as a central and common financing entity. AGLCC obtains longer-term funding by issuing long-term debt securities. It then allocates the funds to utility and non-utility subsidiaries, as needed, in the form of additions or adjustments to the principal amount of existing affiliate promissory notes. ETG has authorization from the BPU to use the AGLCC promissory notes to meet its incremental long-term borrowing needs and to adjust its capital structure as necessary.

Liberty found that AGLR is not following the BPU order or AGLCC promissory note provisions in calculating long-term debt interest for ETG. Liberty recommended that the Company recalculate all of the interest charges on the promissory notes since the ETG merger to be in compliance with the BPU financing order that governs this transaction. We also recommend that the Company inform its financial auditors of these mistakes and request that the auditors re-verify interest expenses for ETG.

Liberty concluded that the use of AGLCC to provide all long-term debt financing has conflicting efficiency and credit rating effects, and does not maximize benefits to ETG. AGLCC provides long-term financing for AGLR's utility and non-utility units, but the long-term financing requirements of the non-utility units are extremely limited. AGLR service company financial management seeks to optimize benefits to all of the holding company entities through using one large financing entity to issue debt securities. The concept behind this approach is that the economies of scale are substantial, especially for the smaller utilities that would have difficulty accessing capital markets with small debt issuances. Combining the needs of the AGLR utilities for long-term debt capital allowed AGLCC to offer larger senior note packages, which produces a wider range of interested institutional investors. ETG and other smaller AGLR utilities have benefited from the improved market access and somewhat lower rates provided by the holding company's use of these economies of scale through AGLCC financings. Despite this advantage, AGLCC carries a debt rating lower than that of the parent and its utility subsidiaries; the negative credit effect of combining utility and non-utility units in common financial packages amounts to one ratings notch. This difference recognizes that non-utility businesses carry more risk than that of AGLR's LDCs. The effect of differences in credit strength between the AGLR utilities and non-utility units has been greatly magnified by the turmoil in global financial markets during the past year or two. Given these considerations, Liberty recommended that AGLR set up a financing entity that raises long-term capital for only AGLR utility subsidiaries.

Liberty reviewed the underwriting agreements for long-term debt issuances of AGL Capital Corp. and the Pivotal loan agreements through New Jersey Economic Development Authority. Liberty also reviewed the credit agreements for the AGLCC $1 billion credit facility and an additional $140 million credit facility. Liberty did not find any restrictive or potentially harmful lien or collateral clauses in the agreements, nor did we find any material adverse change or cross-default clauses that are unduly dangerous to ETG. The AGLCC financings are guaranteed by AGLR, making more restrictive security provisions unnecessary to be attractive to debt investors.

3. Money Pool and Cash Management

Liberty concluded that AGLR has not properly segregated the cash management operations and funds of ETG from that of the non-regulated affiliates and the holding company. The BPU merger order authorized ETG to participate in a utility money pool at AGLR, but subject to a number of specific requirements. The order required separate bank accounts for the utility money pool to be established, and it required separate accounting for money pool activities. AGLR did establish separate utility money pool bank accounts; they consolidate into a single bank account for the utilities. The establishment of separate accounts conforms to a narrow reading of the BPU order, but AGLR has missed what Liberty views as the core intent. The specific problem with the AGLR structure is that the bank accounts of the utility money pool and the bank accounts of SEM, SouthStar, the holding company and other non-utility businesses get consolidated into one bank concentration account. The AGLR cash manager may issue commercial paper to meet those daily requirements, or may invest funds with a single daily cash target and set of funding sources to meet this consolidated need. The consolidation and joint funding of the utility and non-regulated bank accounts results in inter-company loans among all participants.

The severe NUI financial problems that profoundly affected ETG five years ago provide the historical context for examining the goal of money pool separation. ETG's distress resulted not from utility problems, but from: (a) banking, cash management, and accounting systems that allowed co-mingling of funds among the utility and NUI's financially troubled non-utility entities, and (b) undocumented intercompany loans among affiliates. Liberty thus views precluding the co-mingling of funds and intercompany loans as an important objective. The cash management operations at AGLR do not take place under a structure and controls that provide ETG with appropriate cash segregation or that prevent loans involving non-utility affiliates.

Liberty recommended as a first step in segregating utility funds, cash management and intercompany lending from that of unregulated diversified activities that the Company establish separate bank concentration accounts for the utility money pool and all other cash management activities. Setting up separate accounts would allow for the segregation of the funds so that they are not co-mingled in the cash management system and so that intercompany loans would not be a by-product of the current account consolidation in a central concentration account. These segregated accounts should be held separate and not merged for joint funding purposes.

The remainder of any solution to segregating the funds of the utilities from other activities is to arrange for separate funding sources, including separate credit facilities and commercial paper programs. Liberty concluded that the trading operations of SEM cause AGLR and all of its subsidiaries to be subject to liquidity stress considerations and adequacy questions. Energy trading operations require large amounts of credit capacity and access to liquidity sources. Changes in market energy prices routinely trigger collateral calls from trading counterparties as the value of contractual commitments increases to threshold levels. Reductions in credit ratings can also trigger contractual collateral calls, especially if a contract participant falls below the investment grade level. These considerations require immediate access to liquidity sources to satisfy the cash collateral requirements that are standard in the energy trading business. Liberty found that the SEM trading operations have the capability to use all of the available liquidity sources within the AGLR holding company under market or credit stress events. Such events could leave ETG and other utility subsidiaries without adequate liquidity to fund operational

requirements, which is unacceptable for a utility with service obligations. ETG should not be subjected to such liquidity risks by the AGLR unregulated businesses. To address this issue, Liberty recommended that the Company add specific borrowing limits to the Utility Money Pool Agreement and to any non-utility money pool agreement that ensures constant access to borrowing capacity and liquidity for ETG and other AGLR utility subsidiaries.

Liberty found that AGLR does not have in place a functional utility money pool agreement that follows the NJBPU merger order requirements for ETG. The current Utility Money Pool Agreement, dated December 8, 2003, precedes the NUI acquisition. ETG is not a party to this agreement, nor is AGLCC, each of which should be. There is no utility money pool agreement that meets the requirements of the BPU in accordance with the merger order. Liberty recommended that the Company draft and execute a new Utility Money Pool Agreement that requires cash management segregation of bank accounts and funding sources.

Moreover, Liberty found that AGLR has not been strictly adhering to the terms of the money pool agreement that it provided. Specifically, AGLR's calculation of ETG money pool interest does not use the appropriate daily loan or investment balance information, does not match loan balances to interest charges, and has, through calculation error, mischarged ETG. Liberty's review of the actual ETG interest booked and the Company money pool interest recalculations demonstrated significant error in calculating ETG money pool interest expense and income from 2005 through 2008. The recalculations indicate a net overcharge to ETG on the GAAP accounting books of $998,540 in these years. This amount could be substantially greater for regulatory accounting purposes. The amount of overcharge to ETG could be considered to be $2.9 million greater if one recognizes that interest charges related to goodwill accounting are not the responsibility of the ETG regulated utility, although they may be charged to ETG under GAAP and FASB accounting rules. Liberty recommended that the Company re-calculate ETG's money pool interest since 2005 and have financial auditors re-examine the ETG financial statements for 2008 and prior years to determine if restatements are required.

AGLCC commercial paper funds the money pool, which provides a low-cost source of operating funding for ETG. Commercial paper provides significantly lower interest costs than borrowing from bank lines of credit. AGLCC's $1 billion line of credit that backs the commercial paper program was negotiated when the pricing of such facilities was at historically low levels. The good fortune produced by that timing also continues to bring advantage to ETG, along with all of AGLR's other borrowing units. The extreme changes in capital markets since the time of those negotiations have brought reduced availability and much higher estimated pricing of 3 to 4 percent in increased net borrowing costs. ETG and all other AGLR units would have to use significantly more expensive bank borrowing in the absence of a centralized commercial paper program. However, the LDCs together (*i.e.*, excluding the non-utility affiliates) would have the ability to participate effectively in a centralized program.

Liberty also found that the Company's use of a common revolving line of credit for AGLR's utilities and non-regulated affiliates does not adequately protect ETG's liquidity and access to funds. The AGLCC revolving credit facility was supplemented by an additional $140 million one-year credit facility in September 2008. The credit limits of these facilities mean that the AGLR companies may have commercial paper borrowings (backed by the credit facilities) and

loans outstanding under the credit facilities that total no more than $1.14 billion at any point in time. This credit capacity is available to any AGLR subsidiary through borrowing from the money pool vehicle or directly from AGLCC. The credit facility does not employ sub-limits, which serve the purpose of limiting the borrowing of individual companies to specified levels. Consequently, there exist no legal or contractual limits to protect ETG's access to liquidity. In distressed conditions, ETG could find itself without economic access to necessary liquidity support due to high liquidity demands from other AGLR units.

Liberty recommended that the AGLCC short-term funding vehicles, including the commercial paper program and credit facility, should be kept in place until the scheduled termination date of the line of credit in August 2011. Liberty also recommended that separate utility and unregulated/holding company commercial paper programs and backing lines of credit be solicited and arranged for September 2011 and thereafter. It is clear that the inclusion of the non-utility entities would impose significant additional costs when it does come time to negotiate new credit facilities. Moreover, it is equally clear that the combined facility has provided benefit to AGLR's non-utility borrowers. That benefit has grown to extraordinary levels in the aftermath of the turmoil in the financial markets. We recommend that a utility-only line of credit and commercial paper program be established that would minimize borrowing costs for ETG and the other utilities in the future.

F. Accounting and Property Records

Liberty reviewed the Company's accounting policies, procedures and practices to ensure the books and records are maintained properly in accordance with accounting standards and regulatory requirements. Liberty reviewed and evaluated the major accounting systems and process flows, the settlements and payments among affiliates and with vendors to ensure consistent handling and processing, and the internal controls that affect the reliability of the Company's records and financial reports.

Liberty concluded that the Company's accounting systems, procedures and controls are adequate to ensure accurate recording and reporting of affiliate and property transactions. AGLR, AGSC, ETG and other affiliates maintain a separate set of books and general ledgers for company-specific recording of transactions and reporting of results. The integrated accounting system records affiliate transactions in separate business units and inter-company accounts within the general ledger. AGSC uses the inter-company accounts for affiliate transactions and settlements between ETG and other affiliates, including AGSC. The accounting and finance group personnel reconcile affiliate transactions to verify accuracy of the recorded transactions, and the Company appears to settle its inter-company transactions promptly and according to the requirements of the Service Agreements. The Company records property transactions and processes the work order activities properly and in accordance with official Company practices. The Company appears to have reasonably comprehensive accounting control procedures and processes in place. Liberty found the Company's procedures used to guide and control the month-end closing process to be adequate.

Liberty concluded that the Company's internal audit process, risk assessment documentation and Sarbanes-Oxley compliance is adequate. The Company contracted for an outside and independent review of its internal audit function by the Institute of Internal Auditors, which

found the overall Company internal audit function and internal controls to be adequate. Liberty notes, however, that the Company has not performed an internal audit for the accounting cost allocation process and specifically of the Accounting Process Manual, which documents the accounting procedures for the allocation of costs. Liberty recommended that the Company conduct a formal, comprehensive and timely internal audit and compliance testing of this process.

Liberty examined the Company's process of accounting for and recording the transfer of asset costs to ETG and the other LDCs from the development of the Customer Information System, a new billing system used to provide billing services to retail customers. The Company uses end user customer counts as a basis for the asset cost allocation; Liberty agrees that this process is adequate and consistent with the Company's cost allocation methods. However, Liberty recommended that the Company review this allocation method to verify that it is equitable and based on the most current data.

G. Customer Service

ETG provides customer services (*i.e.*, customer contact, billing, credit and collection, and meter reading) through services provided by AGSC, and through field and face-to-face services provided by ETG employees in New Jersey. ETG's more than 274,000 customers account annually for more than 400,000 customer calls and more than 2.6 million customer payments.

1. Customer Satisfaction and Call Center Performance

ETG measures customer satisfaction quarterly, through recent-contact transactional surveys. Liberty found that customer satisfaction as measured in these surveys has declined significantly since 2006. ETG also participates in J.D. Power and Associates Gas Utility Residential Customer Satisfaction studies annually. ETG ranked above average, overall, but ranked near the bottom of the New Jersey utilities.

The decline in customer satisfaction has been accompanied by deterioration in measured customer service performance. Service level (percentage of calls handled by the call center in 60 seconds) provides the clearest indication of what callers to the Company's call center are experiencing. The Company's call center vendor, Wipro, which provides service based in India, failed to meet the target service level of 80 percent within 60 seconds for most months from April 2007 through January 2009; the Company increased this target to 80 percent within 30 seconds in May 2009. In addition to service level performance challenges, Wipro had difficulty meeting ETG's quality standards for handling calls: Wipro did not meet call quality goals during 10 of 22 months. Wipro also was not able to handle all the ETG calls it receives; an average of 20 percent of customer calls are transferred to AGSC escalation and support teams in Georgia for various reasons. Such transferred calls can create dissatisfaction among callers.

Another source of customer dissatisfaction is transferred calls from business office lobby phones. ETG's business offices are geared to handle customer payments, not all customer service transactions. Walk-in-customers are generally referred to the lobby customer service phones for anything other than a payment, especially during busy times. The lobby phones are routed to the India call centers, just like all general customer service inquiries. However, representatives in India are not allowed to handle payment arrangements or extensions; so, most of these calls are

transferred to the escalation team in Georgia, once the customers indicate the reason for their calls.

In response to these challenges, ETG decided to move the handling of customer inquiries to a new call center located in Union, New Jersey. This center was under construction during the period of Liberty's audit and was scheduled to begin operations on December 7, 2009. The Company planned to staff approximately the center and its support with 60 employees (53 ETG employees and 7 back office billing and collections support representatives directly responsible for ETG in AGSC). ETG also planned to continue to use the Lead Escalation team in Atlanta to support the new call center, and provide the same assistance that it currently provides to the outsourcing provider. This approach represents an effective strategy for making a quick transition; however, Liberty recommended that ETG's customer call center should assume responsibility for escalated calls as soon as possible in order to minimize call transfers. The AGSC call center teams should be available as contingency resources in the case of a disaster or temporary shut-down of the New Jersey center. Ultimately, representatives in ETG's New Jersey call center should answer the business center lobby phones to eliminate unnecessary transfers and delays for customers. However, until the New Jersey center is operational later this year, Liberty recommended that these calls be immediately routed to the escalation team in Georgia.

2. Billing and Collections

ETG reads meters on a monthly schedule, primarily through automated meter reading technology. As a result, ETG has significantly improved its meter reading accuracy and timeliness since January 2005. However, ETG's large indoor meter population makes it difficult to physically visit the meter for other needs, such as safety inspections, collections enforcement, and routine start or stop of service. While automated meter reading has improved billing accuracy and efficiency, it has eliminated a frequent physical visit to the meter, making it less likely that employees will observe meter tampering or diversion.

ETG's billing performance has improved significantly over the past three years, partly as a result of the introduction of automated meter reading. More customers are receiving timely and accurate bills each month, and estimated readings have declined steadily. ETG has also focused efforts on reducing the number of unbilled accounts each month and has reduced the number of such accounts significantly. Liberty found, however, that ETG is inappropriately charging a convenience fee for in-person payment of utility bills by credit card in violation of VISA's merchant rules. Liberty recommended that ETG immediately discontinue this practice.

Liberty concluded that ETG's collections performance is declining. ETG is not effectively advising customers of the availability of financial assistance through the BPU's Winter Termination Program or working to establish payment arrangements to bring accounts current prior to winter. Many customers that would qualify for assistance do not apply, while many other customers apply for assistance near the end of the winter protection program (after they receive a shut-off notice). As a result, customers facing the threat of disconnection in late March or early April have to scramble to pay the balance that has accrued over the winter. Additionally, ETG is not enforcing the guidelines of the Winter Termination Program; instead, ETG has significantly reduced its field collection efforts during the winter protection period, effectively giving all customers the benefits of the program. The lack of field enforcement during the moratorium

teaches customers they do not have to make a payment until the disconnect notice arrives in March; it also delays the requests for energy assistance. ETG's collection effectiveness, as defined by the percentage of trips that resulted in a field action of either collection or disconnection, has also been trending down since 2004, with the winter months becoming less and less effective. ETG's write-off performance has worsened considerably since 2004, with write-offs doubling from 2007 to 2008. Liberty recommended that ETG develop a promotional campaign to encourage customers to sign up for energy assistance early in the winter and work delinquent accounts more actively during the winter.

Liberty concluded that ETG is not adequately pursuing revenue protection. Very few theft of service or tampering cases have been identified over the past three years. ETG has taken a passive approach, relying on employees or customers to report the problem. While the Company introduced a web application to manage and track theft of service incidents that has improved communication and tracking of incidents, ETG has done little to communicate its theft of service program to employees or customers. Liberty recommended that ETG pursue a more proactive and aggressive revenue protection program. This program should be focused within the Customer Service organization, with clear responsibilities defined.

H. External Affairs

Liberty concluded that the structure, staffing, and operation of the regulatory and governmental affairs groups and of communications functions are appropriate. Government and regulatory relations fall under the Atlanta-based Senior Vice President, Government and Regulatory Affairs, whose organization has separate regulatory affairs, government affairs, regulatory compliance and regulatory markets analysis groups. ETG's regulatory affairs fall under the responsibility of a Director, Regulatory Affairs assigned specifically to New Jersey. The government affairs group has responsibility for federal and state legislative matters across AGLR. As part of a mid-2009 reorganization, AGLR combined the corporate communications function, which was formerly the responsibility of the recently-retired Executive Vice President-External Affairs, with marketing. Liberty found that AGLR has structured the organizations to take advantage of its size, while retaining sufficient local roles to ensure that New Jersey needs get met adequately. The organizations have had fairly stable or declining costs, and their limited use of outside resources promotes economy of operation.

AGLR has refocused and reduced its sales and marketing organizations, most recently as part of a mid-2009 reorganization, as continuing economic conditions have greatly diminished new customer growth opportunities. Liberty concluded that the recent mid-2009 changes in sales and marketing focus realistically on market opportunities. The changes have reduced staffing, focused on differences in the needs of different customer groups, and, most importantly, emphasize customer retention in a period of significantly reduced growth opportunities. The mid-2009 reorganization reduced the sales and marketing staff for ETG by a net of three persons. This reduced ETG staff size is proportionate in size with the resources assigned to the other AGLR jurisdictions. The changes have been made with specific consideration of New Jersey needs and opportunities, and the organization and staffing support ETG appropriately.

I. Support Services

AGLR provides or coordinates centralized services to ETG and other AGLR utilities as well as to non-utility subsidiaries through AGSC. AGSC provides most aspects of these functions to ETG, either directly or through vendors. ETG, however, self-provides some key functions, such as significant portions of fleet and materials management and infrastructure security.

1. Insurance and Claims

AGLR's Director, Risk Management has responsibility for claims and risk management, who reports to the General Counsel & Ethics & Compliance Executive Vice President. Liberty concluded that this organization's approach to insurance and claims represents a notable strength in AGLR's operations; the overall approach has been effective in providing for a well-defined identification of risk and a very cost competitive approach to mitigating those risks. AGLR has moved aggressively into alternative approaches, using a captive insurer to address many risks. AGLR's continuing search for effective ways to use its captive insurer has generated sizeable large cost savings, particularly for ETG following the NUI acquisition. Risk Management performs effectively with a small, centralized staff, which further promotes economy, while also allowing for optimum coordination with programs for returning employees with claims back to work. AGLR is, for a utility company, a leader in providing for effective insurance and claims management.

2. Legal Operations

AGSC employs all of the AGLR's in-house legal resources. They operate under the overall direction of the General Counsel & Ethics & Compliance Executive Vice President. AGLR has taken advantage of its size to build a large internal staff that performs many of the services that outside counsel do for smaller utilities. The alignment and size of the internal staff is appropriate for meeting utility needs, including those of ETG. AGLR has created a largely separate staff for the performance of non-utility legal work, which facilitates specialization in services offered and proper separation of costs between utility and non-utility resources. The level of legal resources committed on ETG's behalf, combining inside and outside counsel is competitive with what the other two New Jersey-only LDCs have seen, and is comparable to what Liberty has seen at other energy utilities. The number of outside firms, the types of matters on which they reported working, and the levels of effort committed to those matters did not appear unusual. Liberty concluded that AGLR's legal resources structure, internal staffing, inside/outside resources balance, overall expenditure levels, and cost allocation and assignment are appropriate.

The alignment of outside counsel matches current and emerging needs. Billing is strictly by matter, and is controlled by an effective web-based system that produces uniform billings, requires inside lawyer approval, and promotes visibility of work efforts and costs to all levels of legal department management. The in-house lawyers responsible for overseeing the work of outside counsel use an array of informal methods; there exists an adequate system for assuring senior legal department management control over outside counsel retention and for maintaining at that level an awareness of outside service costs, including rates. However, Liberty found that there is not a policy calling for periodic solicitations to verify periodically more informal sources of market information about costs; there is also no formal policy calling for evaluations of outside counsel performance. Liberty recommended that AGLR bring more formality to current

legal-service quality and cost control methods by conducting periodic solicitations and by requiring formal outside counsel performance reviews.

Liberty's review of time charges generally showed that those attorneys most likely to be involved in generally applicable functions had the highest percentages of time charged to AGSC, and thus passed along ultimately to ETG through a general allocator. Some lawyers, however, charged extremely high percentages of time to the service company. Interviews, even among supervising lawyers, indicated that self-discipline, rather than a formal process, served to control time reporting to specific beneficiaries as frequently as possible. Liberty concluded that AGLR has adopted a structure that promotes proper separation of utility and non-utility legal costs. It has not, however, sufficiently emphasized the need for time charges to keep to a minimum the use of charge numbers that result in the assignment of costs to ETG through a general allocator. Liberty recommended that the Company use the regular goal setting and performance review process with each Atlanta-based attorney to establish individual targets for time assignment, and generally track performance against those targets and that supervising attorneys should conduct quarterly or more frequent reviews of time assignments by those they supervise.

3. Facilities Management

ETG maintains several facilities in each of its two regions (Union and Northwest) and at main offices in Berkeley Heights, NJ. No dedicated New Jersey personnel support these functions. AGSC provides support for facility management and planning through centralized resources located in Atlanta. However, this group has had no clear location within the organization, having migrated recently among various AGSC organizations: IT, controller, and human resources. Two of the four positions in the group are open, and these are the highest-level positions.

The centralized facilities organization and other relevant centralized AGLR support organizations work collaboratively with local ETG management to manage the facilities, plan facility enhancements, and acquire new facilities. The successful process used to develop the new call center in Union illustrates this approach. The one significant facility acquisition decision that occurred after the change of ownership was the leasing of the Berkeley Heights building, which succeeded in significantly reducing ETG's lease costs. On the other hand, a very large portion (88 percent) of ETG's facility space is owned rather than leased, which the Company attributes to "inheritance" from the NUI acquisition rather than strategic decisions by AGLR. The Company does not have any guideline documentation and no internal measurements specific to facilities management and planning.

Liberty concluded that the facilities management and planning process is satisfactory, but could be improved with greater strategic focus. The Company lacks rigor and strategic focus in facilities planning and management. Although the evidence indicates that the Company makes reasonable facility decisions when prompted to do so by circumstances, the Company does not otherwise actively engage in the strategic planning of its facilities portfolio. Liberty recommended that the Company find leadership for and determine the appropriate staffing and the best organizational location for this group as soon as possible. In addition to considering the most efficient and cost effective approach, the Company should consider how best to improve the strategic focus for facilities planning and management in making these decisions.

4. Procurement and Materials Management

AGSC's centralized Supply Chain department in Atlanta provides procurement and materials management support and related functions, including fleet management. Liberty found that this organization is effectively managed and that its approach to procurement and materials management provides notable advantages for ETG. The organization's approach provides a strategic focus to procurement and materials management that takes effective advantage of AGLR's scale while at the same time tailoring the corporation-wide approaches to ETG's specific needs. Supply Chain generally relies heavily on outsourcing to reduce costs, but has modified its approach to conform to ETG's constraints. The Company has made notable improvements in inventory levels, cycle count variances, and operational efficiency, and Supply Chain continues to seek operational improvements. The Company has applied effective controls to ensure compliance with the processes and policies. A recent mid-2009 reorganization to further consolidate direction and support of supply chain management into the Supply Chain department should provide further improvements.

Although the Company is doing a good job of materials management, Liberty concluded that Supply Chain could use additional formal approaches to the tracking supply chain management performance to improve results further. As examples, Liberty recommended more formalized use of performance targets, comparison of performance results to industry benchmarks, and use of internal satisfaction surveys. The recent reorganization that has brought increased focus and additional analytical resources to supply chain management provides a good opportunity to review and enhance supply chain performance tracking.

5. Fleet Management

The AGSC Supply Chain organization includes a Fleet Services group. Before the mid-2009 reorganization, the Fleet Services group was responsible for both support of fleet operations for all of AGLR's operations (acquisition, management and disposal of vehicles and equipment used to support operations) and specific management of the Georgia operations. The mid-2009 reorganization separated the southern fleet operations from Supply Chain and Fleet Services, and consolidated contract negotiations into the Supply Chain Transaction Services Group. This change leaves a smaller Fleet Services group, which now focuses on support of fleet operations throughout the AGLR footprint, including ETG. These support functions include setting policies, managing budgets, developing forecasts, performing analysis, and managing other administrative needs. An organization located in Union has responsibility for ETG's in-house maintenance.

Liberty concluded that AGLR has reasonably balanced corporate strategies and goals with local needs and constraints in the management of the ETG fleet operations. AGLR's overall corporate fleet management strategy is to outsource fleet maintenance, repair, and fueling. ETG's collective bargaining agreement constrains the Company's ability to do so, leading to a mix of in-sourcing and outsourcing to accomplish these functions. AGLR has adapted its fleet support and planning activities to accommodate this unique mix for ETG. At least in the case of fuel costs, there is some evidence that the mix worked to ETG's advantage during the period of volatile fuel prices in 2008, when purchasing fuel in bulk for the on-site fueling stations led to lower average cost per gallon as compared to use of fuel cards. AGLR's Fleet Management organization has effectively managed vehicle acquisition based on input from local ETG

management. Fleet Management has also championed greater vehicle operation safety practices; ETG's accident rate has declined.

Liberty concluded that although Liberty found the Company is doing a generally effective job of fleet management, Fleet Management, like the rest of Supply Chain, could use more formal approaches to tracking performance. Liberty recommended that Fleet Management adopt the more formalized approaches recommended generally for Supply Chain.

6. Land Management and Real Estate

ETG's current land management and real estate requirements are limited. ETG has not needed to make any rights-of-way or land acquisitions for many years, given the limited growth in its service area. Recent related activities have been confined to the granting of easements. No single organization coordinates land management and real estate activities. At the local level, the ETG Engineering Services group supports right-of-way or easement acquisition. For major pipeline projects, AGSC provides support through right-of-way agents. The Legal Department has a real estate attorney to provide support in executing legal documents. Given the low growth in the area ETG serves, Liberty concluded that the Company's staffing and processes are appropriate to the modest level of easement activity.

7. Information Technology

AGSC provides support for ETG's information technology needs through the information Services organization, led by the Chief Information Officer, who reports to the Executive Vice-President, Chief Financial Officer. Liberty concluded that AGSC's Information Services department is well organized and managed. The department supports a modern suite of applications and uses up-to-date tools to support the Company's requirements. It effectively balances in-house and contract resources to meet the changing needs of the business. The department is sensitive to the needs of its users. The Company maintains standing user groups with representation from across the corporation, including ETG, to identify and prioritize system development and enhancement requirements. The department's process involves ETG's and other user organizations' business leads and subject matter experts in identifying project goals, requirements, risks, constraints, assumptions, timelines, and funding. It involves user teams in defining specifications, building test scenarios, and performing user acceptance testing. The department has developed service level agreement requirements with client organizations to monitor its performance.

Liberty concluded that Information Services provides good support to ETG. AGLR has replaced the applications supporting ETG's operations with systems providing better automation and control. Information Services has been sensitive to the ETG's specific needs and requirements, and appropriately includes ETG management and employees in developing requirements, specifications, and testing of new applications and application enhancements. Performance reports indicate that the department has provided good service to the users, particularly recently.

Liberty found that AGLR has initiated a comprehensive approach to information security that provides significant benefits. The Company hired a manager with considerable experience in the field to develop and implement the program. The broadened focus allows the Company to address more aspects of information protection and additional approaches to information

security. Such an approach gives the Company greater ability to achieve security of its key information resources and to protect employee and customer data. AGLR has also developed a well considered and documented information technology disaster recovery program. It provides the capability for the Company to protect its key data and applications in the event of a disaster and to bring key computing resources back on-line in a short period of time.

Liberty concluded that although Information Services provides good value to AGLR and ETG, the department could benefit from the use of additional tools to measure its performance. The department does not currently use internal user surveys or industry benchmarking. These additional tools could assist Information Services in measuring its performance and planning for performance and organizational enhancement. Liberty recommended use of internal user satisfaction surveys to provide additional information to the department in judging how well it is meeting user needs. Industry benchmarking can provide another means for Information Services to judge its performance and consider ways to enhance it.

8. Records Management

Prior to June 2008, AGLR a records retention policy and retention schedule, but there was no one in place to enforce them. At that time, AGLR hired a professional records manager with considerable experience in the field to direct the Company's Records and Information Management program. Liberty concluded that the new manager has effectively introduced enhancements to the Company's records management programs that should provided benefits to ETG, by improving the records management policies and documentation, increasing records management awareness, and identifying resources throughout the corporation to help institutionalize the records management program.

9. Infrastructure Security

AGLR's Corporate Security Department in Atlanta, which is in the General Counsel's office, provides support and oversight for facility and personal safety and security of all AGLR organizations. Since 2000, an ETG Operations Supervisor has managed security activities through ETG's operations territory. The ETG Operations Supervisor works with Corporate Security in conducting security and safety investigations, making equipment and policy recommendations, conducting security surveys, and providing critical facility security training. He also acts as contract facilitator for the guard services and alarm monitoring contractors. His duties include management of SCADA operations, monthly alarm checks at the Elizabeth and Perth Amboy payment facilities, card access readers and timed door access controls, identification badges, and building access control.

Liberty concluded that ETG provides appropriate security and safety for its facilities and employees. The Company has assigned appropriate personnel to manage security and safety. The security employees regularly inspect ETG's facilities for security and safety and work with state and federal agencies to ensure the Company's compliance with security and safety requirements. The Company provides appropriate training to employees.

J. Contractor Performance

ETG uses a number of contractors to install all new mains and services and most of the replacement mains and services. ETG uses in-house crews for small jobs when such crews have available time. The decision to use contractors was based on manpower requirements and cost issues. ETG employs other contractors for specialized tasks, such as leak surveying, locating services, LNG services, automation and controls for the SCADA system, environmental services, corrosion services, and engineering services. ETG hires most of these contractors using specific bids, and the assistance period can vary from days to years.

ETG contracts for all outside leak-survey work. The current contractor also does leak surveys for most of the AGLR distribution companies. ETG operations personnel generally agreed that the contractor has been doing a good job. Over the last several years the number and percentage of leaks found by the leak-survey contractor has increased, while those reported by the public have decreased; the overall number of leaks has remained nearly constant. Because of the large number of inside meter sets in the Union territory, customer-reported leaks will probably always comprise the majority. Liberty concluded that the drop-off in customer- and public-reported leaks indicates a need for a public awareness program. Some of the decrease could be attributed to better leak surveying, but some of the drop off may because the general public and customers may not be fully aware of the leak hazard and is reporting all leaks (odors) that they discover. Liberty recommended that the Company review and improve its programs for customer and public awareness of the hazards of natural gas.

Liberty found that ETG is retaining good records on contractor cost and performance. ETG construction inspectors are able to keep detailed and accurate records of contractor performance using PDAs and associated software that mandates evaluation of a checklist of items each time an inspector visits a contractor job site. This information is uploaded nightly into the computer and available the next day. In addition, the Company also tightly monitors the costs of construction jobs, thereby providing good estimates on the total cost. Liberty concluded that this combination of on-job evaluation and cost monitoring is sufficient to ensure that construction jobs are well monitored from both a performance and cost standpoint for well-established contractors, but not for new contractors.

Liberty concluded, however, that the number of personnel assigned and actually performing construction oversight for outside contractors is not sufficient based upon the current and future projections for new and replacement mains and services. Since 2004, the number of construction inspectors has been cut in half while the value of the construction by contractors has increased by almost 80 percent and will continue to increase. These inspectors have new technology which helps, but visiting every job site every day is an important method of keeping track of the contractors and maintaining contractor quality and performance. That frequency is not possible with the current work load and inspection force. Liberty recommended that the Company increase the number of construction inspectors.

ETG has used no-bid construction jobs to keep several contractors busy during lull periods and for good job continuation. Liberty found that the documentation of the reasons for these practices is insufficient. Several of the no-bid contracts awarded in 2008 have high dollar values. In order for ETG to show that it has awarded these contracts prudently, it should always have significant

justification for each such action. Such awards may not only be prudent but also cost-effective and provide more value to the ETG customers than bid contracts. Liberty recommended that ETG, as part of its contracting procedures, have documentation prepared for all no-bid contracts over a certain dollar value.

ETG also does not formally audit or check the quality of its contractors' work. ETG believes that its construction inspectors perform this duty using the pre-programmed PDA that applies a series of questions. Additionally, ETG holds contractors responsible for the quality of work and for following ETG's construction standards. This approach is sufficient for well-established contractors, but ETG is also attempting to increase its contractor base in order to promote completion and to be able to perform all of the necessary construction work in the mandated or agreed upon time frames. Current quality-assurance and quality-control processes are not sufficient to assure the work of new contractors. Liberty recommended that the Company establish a multifaceted or tiered approach to Quality Assurance and Quality Control.

ETG relies on a locate contractor and its own employees to identify and mark its underground facilities. Liberty found that ETG's improved locating contractor oversight and contract management have reduced third-party damages. ETG's third-party damages have declined significantly since 2005. ETG's field audits are providing a higher degree of contractor oversight, strengthening ETG's underground locating processes and damage prevention performance. The linkage of audit performance to contractor payment has also strengthened contractor commitment. Nevertheless, Liberty recommended that the Company continue to emphasize the importance of the New Jersey One Call notification system with contractors and customers, because every third-party damage incident is a potentially serious public safety issue.

K. System Operations and Maintenance

Liberty concluded that ETG employs appropriate processes for system planning and design. The Company performs system planning using flow simulation with network analysis computer models, which is the method used throughout the distribution segment of the gas industry. ETG's combination of this tool with performance tracking is a good way to ensure the modeling exercises are appropriately connected to system performance. Engineering's incorporation of market intelligence from marketing and sales organizations into its network-simulation exercises is also sensible and useful. That intelligence should facilitate multi-year horizons for project configuration and prioritization, which should produce efficiencies in project execution.

Neither the gas meters nor the automated meter reading devices are completely accurate. Both need to be checked for accuracy periodically; otherwise, the customers may be receiving incorrect bills. Liberty found that ETG does not have a process to verify the readings obtained from the automated meter reading devices and the actual mechanical index on the meter at prescribed intervals. Most utilities have instituted a procedure to visit each of the automated meter reading devices on a periodic basis and to check the reading against the mechanical dials. Liberty recommended that ETG institute such a process as soon as possible.

Liberty found that ETG does not have a Quality Assurance and Quality Control program for all of its operations and maintenance activities. Thus, the Company needs to do more to ensure that these activities are being performance in accordance with BPU and U.S. Department of

Transportation rules and regulations. Liberty recommended that the Company initiate such a program.

Since 2004 the operating workforce within ETG has been drastically reduced, in some groups by as much as 50 percent for both management and union/hourly workers as of 2008. AGLR did improve the technology so everyone could become more efficient. Such an improvement in efficiency did compensate for some of the reduction but in many areas this was not sufficient and overtime rates have become very high. In other areas the workload has also increased and thus the workload per remaining employee has also increased to greater degree than can be compensated by technology innovations. Another area of concern is the aging of the work forces, especially in some of specialty areas such as pressure control, corrosion control, and leak repair. These two dynamics will or have already affected how well ETG can meet its mandated programs in the future and needs to be addressed now. It can take several years to qualify and train a new instrument technician or regulator mechanic. Liberty recommended that the Company add specialized workers to address increasing work load and the age of its existing employees in several key operations and maintenance groups.

Liberty concluded that ETG is falling behind on leak repairs relative to leaks reported. Leak repair only becomes more expensive when postponed. If the Company waits too long, the number of open leaks and new leaks can overwhelm an organization and cause it to make expensive repairs, such as call-outs, overtime and weekend work. Both public and customer safety could be affected if the number of leaks becomes excessive and the amount of gas escaping is large. Liberty recommended the Company work to increase leak repair rates.

Because ETG service territory is in a congested area, the Company sustains considerable third-party damage each year. Liberty found that ETG's outreach to other stakeholders regarding such damage is not as effective as it should be. The Company's locating and mapping to minimize damage to the gas system also is not effective. Liberty recommended that the Company improved its outreach program. ETG needs to make sure that it reaching all of the stakeholders and that a multi-lingual approach may be necessary given the population of the territory and excavator population. Another area that ETG should explore is the quality of its locate contractors and whether they are doing everything needed to reduce the number of damages.

ETG currently has an excellent emergency plan and training program. The transmission drill that is performed yearly has resulted in some significant improvements via the lessons learned. However, Liberty found that ETG's simulated transmission emergency does not include the actual participation of outside responders. Liberty recommended that ETG involve outside responders in the annual transmission drill. Incorporating outside responders in this drill may provide additional lessons learned which will move the validation of their training to the next level and will fully comply with both BPU and U.S. Department of Transportation regulations.

Liberty found that ETG is using a robust geographic information system (*GIS*) for mapping in its Northwest territory but has not yet fully digitized the Union territory. The Union territory has the bulk of the customers, is the most congested and has the majority of issues since the distribution system there is considerably older than the Northwest territory. A fully active and updated GIS will assist the locate contractors with better and more up-to-date maps, will assist in plotting

leaking mains that need replacement, will assist the corrosion control group in identifying active corrosion areas, and will assist developing a comprehensive main replacement program that may be required under the soon-to-be-released distribution integrity regulations. The GIS mapping will assist ETG in meeting or exceeding its internal goals, the goals that the BPU has established, and the requirements under the U.S. Department of Transportation regulations. Liberty recommended that the Company make instituting the GIS system throughout its service territory a priority.

Liberty found that ETG currently has a large backlog of inside meter sets that need inspections, meter reading verification, and safety checks. To perform the inspections, ETG uses first responders or other trained individuals to go to the customer during normal business hours. If this fails, the Company tries post cards and then escalates to additional methods to contact the customer to set up an appointment either through phone contact or letters. The methods do not appear to be working effectively. This problem is not unique to ETG and many urban gas utilities have addressed this in different methods. Some utilities where there is considerable safety implication, such as a service-affecting corrosion control problem, have terminated the service and cut off the service line, but this is an extreme example. Liberty recommended that ETG contact other local urban utilities to determine what their respective methods are and what seems to work the best. They should try these other methods and determine if they are yielding sufficient results to make them permanent.

L. Compensation and Benefits

AGLR's compensation philosophy is to keep total compensation competitive with a peer group, about whom the board of directors' compensation consultant provides detailed compensation data. Liberty concluded that AGLR has designed its compensation program for executives and management around an appropriate structure, and applies it objectively, and with reference to sound, comprehensive data. The Company use of a mix of base, short-term, and long-term compensation amounts is appropriate and AGLR regularly compares total compensation and each of the three components against a range of peer-group information. Liberty also found that the board of directors is actively and appropriately involved in establishing and administering executive compensation.

Liberty found that AGLR targets a higher level of compensation than do New Jersey's other two gas LDC holding companies by targeting the third quartile of energy services companies. Liberty concluded that this distinction is appropriate, in that AGLR operates over such a larger footprint, and operates a much more substantial support organization. This organization provides significant economies for the LDCs (ETG among them), but makes the organizations and senior executive oversight of them more challenging. Compensation levels have been much more moderate generally in the utilities industry and AGLR is no exception. Nevertheless, utilities are not wholly isolated from general industry trends. At this critical juncture, when there has been more scrutiny in all industries on executive compensation, it will be important for the board to pay particular attention to what concepts, concerns, risks, and opportunities leading edge companies are reflecting in their compensation changes. The board has done well in choosing and using compensation consultants. Those consultants have already begun to provide notice that compensation thinking overall and compensation elements in particular may be changing. Liberty recommended that the board use its relationships with professionals who are at the

leading edge of the business to bring added perspective that should come in the form of extended discussion of how more aggressive, thought-leading companies are responding to the much more visible subject of executive compensation and to the opportunities that the current marketplace may present.

A review of the individual performance objectives for the two executives most responsible for ETG (the ETG Vice President and General Manager and the Senior Vice President of Mid-Atlantic Operations) shows a detailed listing of individual performance factors, many of which relate directly to the operational effectiveness and efficiency of New Jersey operations. Liberty found, however, that the incentive program hinges too little of incentive compensation on such performance, does not appear to operate in a transparently objective manner, and (for the Senior Vice President of Mid-Atlantic Operations) contain an inappropriate incentive for extending the asset management agreement between SEM, an LDC affiliate of ETG. There is a large amount of direct and indirect overlap among the measurement components of the annual incentive plan and a component of the long-term incentive plan. Their net effect is to underemphasize ETG operational performance in the awards to the executive leadership at the local and regional levels. AGLR needs to increase the weight given to ETG operational performance in the annual incentive plan for those at the New Jersey and Mid-Atlantic levels. Liberty recommended that the Company restructure the annual incentive plan to increase the weight that local and regional operations have on compensation and assure that extension of the SEM asset management agreement is not a contributor to compensation anywhere outside SEM itself.

Liberty concluded that AGLR has adopted and closely monitors and faithfully applies an appropriate long-term incentive program. AGLR has recognized that incorporating a long-term element into its incentive compensation program encourages the production of lasting shareowner value. The board has adopted and altered a program that is reasonably competitive in the industry, thus serving to attract capable personnel at a reasonable cost. The board has regularly monitored the program for consistency with peers, and administered the program rigorously, in order to assure satisfaction of performance targets.

Liberty concluded that AGLR provides for effective, competitive, and economical benefits. AGLR has undertaken commendable measures to control health care costs, while seeking to gauge and respond to employee views. AGLR has been aggressive in recent years in changing its health care programs, using employee input, and emphasizing wellness programs. The use of the captive insurer has provided cost-effective options, as AGLR has sought available means to mitigate the rise in costs without transferring costs unduly to employees. Despite these efforts, AGLR finds itself, as do employers across the country that it continues to face health care cost increases that far outpace inflation. The AGLR pension program provides competitive levels of benefits, and is administered in a manner that is commensurate with industry standards.

Appendix A:

Recommendations Summary

Volume One: Affiliate Transactions Review

I. Procurement and Purchasing

1. Bring arm's-length bargaining to gas-supply relationships.
2. Ensure that AGLR's organizational units providing essential inputs to regulatory filings continue to afford those filings sufficient priority.
3. Complete process documentation.
4. Develop documentation requirements for supply-portfolio decisions that require selections from among alternatives.
5. Planning and Forecasting should use a shorter time period for its use-per-customer regressions.
6. Require that Gas Supply and Capacity Planning bring more analysis to its selection of key parameters for capacity-requirements forecasting.
7. Restrict the addition of gas-supply capacity until ETG has worked off its current excess.
8. Work with pipeline suppliers to further diversify ETG's sources of supply.
9. Determine the causes of the increase in ETG's LAUF rate.

II. Affiliate Relationships

1. Put ETG's asset-management arrangements out for bid when the current arrangements expire.
2. Keep records of ETG's costs before and after the delivery-point shifts requested by SEM.
3. Ensure that upcoming examination of the operation of SEM's agreements with ETG examines how optimization transactions get assigned to ETG, and how the transactions get valued.
4. Prohibit SEM from participating in competitions to provide peaking supplies to ETG.
5. Develop an improved process for seeking spot-market gas supplies.
6. Make reducing ETG's gas costs an explicit objective for AGLR's Gas Supply and Capacity Planning department.
7. Ensure independent examination of any SEM violations of the FERC's capacity-release rules involving ETG's assets.

III. Market Conditions

1. Develop procedures for estimating supplier volumes, creditworthiness review and periodic review of existing suppliers.

2. Post the active supplier list to the ETG web site, with a clearly visible tab on the home page.

3. ETG should consider initiating a dialogue with the BPU regarding its vision, goals and objectives for competition in the retail residential market.

IV. Recommendations and Review of Previous Audit

None.

V. Cost Allocation Methods

1. Develop a new CAM that rectifies the deficiencies of the current documents.

2. Make a formal filing seeking NJ BPU review and approval of Services Agreement.

3. Develop a written policy identifying the types of costs the Company should retain at the corporate level.

4. Develop a written time reporting procedure and include it in the CAM.

5. Review all services and charges allocated to ETG based on the AGSC/ETG Services Agreement and eliminate any duplicate charging for those provided under the Asset Management Agreement.

6. Perform a complete review and audit of the Allocation Process Manual.

7. Update the engineering time study and capitalized engineering rate to more accurately represent engineering costs to be capitalized over large and general construction work.

8. Consider the use of the number of timesheets instead of full-time equivalent employees as the cost driver for allocating payroll costs.

9. Review and update procedures for asset transfer, transfer pricing and internal controls.

10. Review and monitor benefits true-up calculation more frequently.

11. Develop a mechanized regulatory reporting system.

VI. Remediation Activities and Costs

1. Review the controls environment for ETG's MGP program.

2. Develop a program for evaluating contractor performance in ETG's MGP program.

3. Develop a more active approach to MGP program management.

4. Adjust the accounting process to charge payroll costs associated with the MGP remediation program directly to balance sheet accounts.

5. Reconcile internal MGP remediation expenditure reports supporting the annual RAC filings to the actual reports filed with the BPU.

VII. EDECA

None.

Volume Two: Management & Operations Review

I. Governance

1. Create an LDC-operations-focused board committee and routinely distribute more detailed, focused, and LDC-specific data sets that provide quantitative measures of performance against clear, comprehensive metrics.

2. Periodically solicit competitive proposals for providing outside audit services.

3. Emphasize the use of board and committee evaluations as improvement tools.

II. Organization

1. Provide for the eventual separation of the roles of General Counsel and Chief Ethics Officer.

III. Human Resources

1. Promptly adopt a comprehensive new budget structure and a series of cost performance metrics at the sub-group level.

2. Develop a more structured approach to addressing ETG's aging workforce.

3. Make the satisfaction of EEO/AA placement goals in New Jersey a priority at both the local and headquarters level.

4. Establish the goal of moving management responsibility for labor relations to the Mid-Atlantic region.

5. Provide for a formal contribution by local and regional management in the setting and measuring of performance against the individual goals of AGSC personnel assigned to New Jersey operations.

6. Continue regular surveying of New Jersey employee attitudes and require definitive analyses and action plans subsequent to each.

7. Make the development of a new-hire training program a priority, and set a firm plan and schedule for implementing it.

8. Establish a robust training budget structure, cost reporting system, performance reporting and metrics, and benchmarking program to assure that training is producing appropriate results cost effectively.

IV. Strategic Planning and Budgeting

1. Make the scoring of ERM risks more consistent on a companywide basis.

V. Finance and Cash Management

1. Establish separate bank concentration accounts for the utility money pool and all other cash management activities.

2. Draft and execute a new Utility Money Pool Agreement that requires cash management segregation of bank accounts and funding sources.

3. Re-calculate ETG's money pool interest for 2005 - 2008 and to date in 2009. The ETG financial statements for 2008 and prior years should be re-examined by financial auditors to determine if restatements are required.

4. Replace the AGLCC commercial paper program and revolving credit facility with utility-only programs and separate non-utility business facilities after the termination of the current credit facility.

5. Add specific borrowing limits to the Utility Money Pool Agreement and to any non-utility money pool agreement that ensures constant access to borrowing capacity and liquidity for ETG and other AGLR utility subsidiaries.

6. Recalculate interest charges on the AGLCC promissory notes and request verification from financial auditors; draft and execute between AGLCC and ETG a new promissory note that conforms to the NJBPU financing order.

7. Set up a financing entity that raises long-term capital for only AGLR utility subsidiaries.

VI. Accounting and Property Records

1. Conduct a complete review and internal audit of the Allocation Process Manual.

2. Determine the transfer price of the CIS assets and review the allocation method used to allocate assets to the utilities.

VII. Customer Service

1. Fully Staff NJ-based Customer Care Center.

2. Route the customer service lobby phones to the Lead Escalation Team until the New Jersey call center is operational.

3. Discontinue charging a convenience fee for in-person payment of utility bills by credit card.

4. Develop promotional campaign to encourage customers to sign up for energy assistance early in the winter.

5. Work delinquent accounts more actively during the winter.

6. Pursue a more aggressive revenue protection program.

VIII. External Affairs

None.

IX. Support Services

1. Bring more formality to current legal-service quality and cost control methods by conducting periodic solicitations and by requiring formal outside counsel performance reviews.

2. Provide a review process for assuring that inside lawyers charge the maximum amount of time properly allocable to individual AGLR entities.

3. Bring more strategic focus to facilities planning and management.

4. Use additional methods to track supply chain management performance.

5. Use additional methods to track information technology performance.

X. Contractor Performance

1. Review programs for customer and public awareness of the hazards of natural gas.

2. Increase the number of construction inspectors.

3. Provide additional documentation for no-bid contracts that have a significant dollar value.

4. Establish a Quality Assurance (QA) and Quality Control (QC) program.

5. Continue to emphasize the importance of the New Jersey One Call notification system with contractors and customers.

XI. System Operations and Maintenance

1. Perform for all AMR devices a periodic ‘true up’ to confirm and validate that the readings are accurate.

2. Start a robust and comprehensive Quality Assurance and Quality Control (QA/QC) program for all O&M activities and tasks.

3. Add specialized workers to address increasing work load and the age of its existing employees in several key O&M groups.

4. Increase leak repair rates to keep the open-leak count down, improve public and customer safety, and minimize future O&M costs.

5. Provide for all stakeholders additional outreach for ETG’s TPD and outside-force program.

6. Involve outside responders in the annual transmission drill.

7. Make instituting a GIS mapping system across the entire service territory a priority.

8. Change the methods and approaches for gaining access to inside meter sets to perform inspections and to conduct accuracy checks (true up).

XII. Compensation and Benefits

1. Task the board's compensation consultants with providing a focused analysis on new directions in executive and management compensation and on new developments by individual companies that may be at the leading edge of change.

2. Restructure the AIP to increase the weight that local and regional operations have on compensation and assure that extension of the SEM asset management agreement is not a contributor to compensation anywhere outside SEM itself.