



**Audit of the Affiliated Transactions Between
South Jersey Gas Company and its Affiliates and a
Comprehensive Management Audit of
South Jersey Gas Company**

Submitted to:

New Jersey Board of Public Utilities

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Volume I

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1. EXECUTIVE SUMMARY AND BACKGROUND

Introduction

The Overland audit was generally supported by both SJI and SJG personnel. The Company provided dedicated personnel to support our discovery and audit task requirements. We appreciate the cooperation provided to us in the conduct of our review, which allowed the development and thorough consideration of most areas of corporate operations included in this report.

This report is organized in a manner that is generally consistent with the structure of the scope of effort requested by the New Jersey Board of Public Utilities (NJBPU) RFP guidelines. Our work was organized into two Phases – Phase I: Audit of Affiliate Transactions; and Phase II: Comprehensive Management Audit.

The primary period of analysis was the three-year period from January 1, 2009 to December 31, 2011. However, depending on the subject area, we also provided historical data prior to January 1, 2009. In other instances, we included 2012 and 2013 information regarding corporate operations. As with any corporate organization, SJI is continuously reviewing its corporate processes, and is subject to external events that may impact this analysis relative to present circumstances.

Overview of Audit Analysis and Summary of Key Findings and Recommendations

Our audit identifies a number of continuing challenges facing the Company. The following represents those recommendations that we believe have the greatest potential impact in terms of financial materiality, quality of service, or regulatory compliance.

- Apart from off-system sales of gas, most of the billings by SJG to affiliates during the audit period were to obtain reimbursement for payments SJG made to vendors on behalf of the affiliates. Overland understands there are efficiencies achieved by having a single affiliate pay for vendor services provided to multiple affiliates. However, the parent company, SJI, or the service company, SJIS, should fund these payments and seek reimbursement from subsidiaries, not the utility. (Chapter 2)
- SJI should immediately develop the reporting capability to show how costs incurred in the parent organization are incurred, by function (department) and cost type, how functional costs are directly charged and to what subsidiaries, which of the functional costs are pooled for allocation and how allocable costs by function are distributed to each subsidiary. (Chapter 3)
- Overland strongly recommends that SJIS develop (or be required to develop) reporting that shows the following on a monthly and an annual basis: 1) SJIS costs incurred by function and account, 2) how functional costs are classified for distribution by cost distribution method (i.e. the amounts, by function, directly charged or allocated using each allocation method), and 3) how these SJIS functional costs are distributed and billed to each affiliate. (Chapter 4)
- Until it is demonstrated that the growth in and level of SJI audit fees are reasonable, we recommend the Audit Committee either put the SJI financial statement audit up for competitive

bid in an environment in which all qualified firms have a reasonable expectation of being awarded the work or significantly curtail future increases in audit fees from the incumbent firm, Deloitte & Touche. (Chapter 6)

- All direct outside relationships that board members have in the markets in which SJI operates should be disclosed. Board members with such relationships should recuse themselves from board and committee discussions and decisions regarding such markets. (Chapter 6)
- The SJI Governance Committee and the entire board should consider candidates who possess accounting expertise, especially those with a CPA or with CFO experience, when next adding or replacing current members. (Chapter 6)
- Representatives of SJI and SJG should conduct meetings with the ratings agencies and BPU Staff to develop a plan to enhance current ring-fencing provisions to a level that ensures SJG's credit ratings are more reflective of SJG as a standalone company and negative influences from the activities of SJG's affiliates are minimized. (Chapter 9)
- SJG's Risk Management Committee should perform sensitivity and benchmarking analysis to test the effectiveness of its hedging program. This analysis should determine both how well SJG's hedging program has been executed, as well as how well it has been designed. (Chapter 11)
- SJG should adhere to the established protocol of its non-discretionary hedging strategy. (Chapter 11)
- SJG should establish written performance expectations for its hedging program. These performance expectations should be compared to actual results to evaluate how well SJG's hedging strategies have performed, and they should be reviewed by SJG's Risk Management Committee on an annual basis. (Chapter 11)
- SJG should consider significantly scaling down, or potentially even de-activating, its discretionary hedging program and utilizing alternative hedging strategies to achieve an adequate level of hedged gas supply. (Chapter 11)
- SJG should institute a policy to repair Grade B Leaks within twelve months of discovery. (Chapter 12)
- For executive compensation benchmarking, SJI should review its executive compensation peer group and choose companies that are relatively closer to SJI in size as well as other factors such as: utility vs. non-utility business, location, etc. (Chapter 15)
- Overland found that some balanced scorecards from 2009 – 2011 were not filled out completely and the results of the scorecards were discussed informally between the employee and the supervisor. We recommend that all exempt employees have balanced scorecards filled out in their entirety and retained electronically in the employee's file for future reference. (Chapter 15)
- The Legal Affairs group should employ a competitive bidding process when selecting the law firms it will use to provide SJI with outside legal counsel. (Chapter 17)
- Supply chain, fleet and facilities performance metrics, including the dollar value of all managed procurement, per-vehicle ownership, operations and maintenance costs and building-level facilities costs for owned space should be maintained. SJG should benchmark its supply chain,

fleet and facilities activities against other utilities and adopt best practices whenever feasible. (Chapter 17)

Aside from the above specific recommendations, we also observed another major of concern that we believe should be given a high priority at SJI. SJI utilizes the Balanced Scorecard (“BSC”) system of measuring relative performance. However, the implementation and effectiveness of BSC relative to other utilities is substandard at best. SJI should devote resources necessary to employ a more robust and more effective set of standards and procedures necessary to realize the potential benefits associated with this system of incenting and measuring management productivity. There are a number of more specific BSC recommendations various chapters within this report. They should be considered in the broader context of improving the BSC utilization throughout all corporate operations.

Finally, as identified in the recommendations above, we have made a recommendation to address and implement additional ring-fencing conditions to provide enhanced protection for SJG from the business and financial risks of its unregulated affiliates. SJI has material investments in unregulated operations that pose greater risks than its regulated gas operations at SJG. Given the relatively small market cap of this company, we believe that SJI is particularly vulnerable to adverse changes in market conditions with respect to these unregulated assets. While senior management and the Board of Directors may have the discretion to make such investments, regulators must manage the effects of these activities by minimizing potential negative impacts on the regulated utility. We recognize that the BPU has certain requirements imposed on New Jersey utilities designed to help protect utilities from the risks of their unregulated affiliates. However, we believe that the specific circumstances existing at SJI warrant company-specific scrutiny at this time.

Project Background and Scope of Audit

Request for Proposal

On June 15, 2011, the NJBPU Division of Audits issued a Request for Proposal to perform an affiliate transaction and management audit of SJI, SJG and its affiliates. Overland submitted its proposal on July 15, 2011, and was ultimately selected to conduct the audit pursuant to an agreement signed January 18, 2012. Substantive work commenced in March 2012.

Project Scope

The scope of the affiliate transaction and management audits as defined by the RFPs released by the Division of Audits has generally been consistent as applied to New Jersey utilities in recent years. The Overland work plan was developed consistent with the RFP released by the BPU. The position of SJI representatives regarding the scope of the Overland review limited our assessment of corporate operations with regard to the following areas of inquiry and analysis.

- Overland was restricted in our ability to analyze SJI’s unregulated operations, except to the extent that activities could be directly associated with SJG utility operations. Specifically, information was not provided regarding tax benefits from unregulated companies, and how those benefits were allocated in the consolidated tax return.

- Forecasted data was highly restricted, also greatly inhibiting our ability to assess corporate and financial planning.
- Even though requested in several different data requests, the Company did not provide any of the balanced scorecard objectives of senior management outside of what was disclosed in the proxy statements.

Overland has not encountered similar restrictions in management audits of other New Jersey utilities. However, we chose not to pursue a formal process to challenge these matters in the conduct of this review. However, we recommend that the BPU Staff and the auditors selected to perform the next BPU audit of SJI address and resolve these scope issues at the outset of the next audit. We believe that the authority of the BPU and its auditors to conduct a review across all corporate operations is well established. The next management audit of SJG and its affiliates should be allowed to conform with the scope of effort defined by the Division of Audits, consistent with the standard of review established in the conduct of other New Jersey utilities.

Approach to the Project

Initial Meeting with BPU Staff

Prior to finalizing our project workplans and commencing the technical analysis, Overland met with representatives of the BPU Staff. This meeting addressed various concerns about SJG that the parties felt were within the intended scope of our review. This meeting allowed Overland the opportunity to assure that our analysis would incorporate any legitimate issues that were of concern at the commencement of our work.

Conduct of Interviews

The audit review was facilitated by the conduct of informal interviews with company personnel, including subject matter experts, senior management and the SJI Board of Directors. These interviews were conducted on-site at the SJI headquarters in Folsom, New Jersey.

The interviews were considered “informal”, as they were not taken under oath and there was no transcript taken or recording made. In most instances, no attorneys were present. Aside from the Overland representative and the company interviewee, the company generally had one or two individuals present who were assigned to support the audit process. The primary purpose of the interviews was to gain an understanding of corporate operations, and to identify and clarify documents and reports available to support our technical analysis. To the extent possible, Overland did not rely directly on the information gathered in interviews. Written data requests were used as the primary basis for our analysis, findings and conclusions.

A complete list of the 46 interviews conducted by Overland is provided in Attachment 1-1.

Written Discovery

Overland developed written discovery requests as the primary basis for its technical analysis, which is relied upon in the development of this report. Over the course of our audit, Overland issued 776 data requests. Many of the documents produced were classified as confidential by the Company. Certain information was further classified as “Restricted” or “Restricted on-site only” material, which was provided under more limited conditions. Overland believes that the classification and limitations placed on the material produced was generally justified, and that the procedures agreed upon with regard to this material actually facilitated our work by providing reasonable access to highly sensitive material requested during the audit.

Other Sources of Material Relied Upon

Overland also reviewed documents from sources external to the written discovery and interview process described above. We have reviewed: financial material from various sources including investment services and rating agency publications, New Jersey BPU reports and Orders relevant to the SJG audit, and industry publications in the public domain. To the extent that this information was relied upon in our report, we have identified it in our footnoted references.

Review of Draft Report

Prior to the release of our report, an intense review process was imposed to ensure a complete, balanced and accurate presentation of our analysis. Aside from the internal review of the work product, Overland solicited and considered the comments of both BPU staff and SJI prior to the release of this final audit report. Overland made an independent determination of whether to modify our report based on the comments provided. The review and comment process involving SJI was focused on factual accuracy of the document. An exit conference with SJI was held upon a review of the final draft. This review process occurred over a six month period, culminating shortly before the report release.

SJI and Business Unit Overview

SJI’s corporate history dates back to 1910 when the Atlantic City Gas and Water Company merged with Atlantic City Gas Company. This began a series of acquisitions that eventually led to the creation of South Jersey Gas Company in 1948. During the 1950s and 1960s, SJG continued to acquire smaller New Jersey gas companies in the surrounding regions. In 1969 the SJG board of directors decided to pursue non-regulated activities, and establish South Jersey Industries, Inc. (SJI) as a holding company in the state of New Jersey. Its principal businesses include:

- Gas Utility Operations - consists primarily of natural gas distribution to residential, commercial and industrial customers.
- Wholesale Energy Operations – include SJRG’s and SJEX’s activities.
- The Retail Energy Operations caption includes Retail Gas and Other, Retail Electric, On-Site Energy Production and Appliance Service Operations. SJE is involved in both retail gas and retail electric activities.

- Retail Gas and Other Operations include natural gas acquisition and transportation service business lines.
- Retail Electric Operations consist of electricity and transportation to commercial and industrial customers.
- On-Site Energy production consists of Marina’s thermal energy facility and other energy-related projects.
- Appliance Service Operations includes SJESP’s servicing of appliances under warranty via a subcontractors arrangement as well as on a time and material basis.

Table 1 -1 – SJI Operating Revenue

SJI Operating Revenue (in thousands)			
Segment	2009	2010	2011
Utility	484,376	475,982	412,449
Wholesale	97,475	88,729	68,370
Retail	278,951	379,985	364,374
Corporate & Services	19,948	22,468	25,325
SJI Total	880,750	967,164	870,518
Source: SEC Form 10K, 2011			

Affiliate Overview (Chapter 2)

South Jersey Energy Solutions (Holding Company for Non-Regulated Subsidiaries)

South Jersey Energy Solutions (SJES) is the holding company for SJI’s non-regulated businesses. The significant non-regulated businesses include South Jersey Energy (SJE), South Jersey Resources Group (SJRG), South Jersey Energy Services Plus (SJESP) and Marina Energy. During the audit period, with the exception of SJE, the employees of the non-regulated businesses worked for and received their paychecks from SJES. SJE’s employees became part of SJES beginning in 2013. The number of employees in SJES grew from 41 at the end of 2008 to 76 in August, 2012. Open Flow Energy (OFE) is a department within SJES and a division of the SJE legal entity. Its employees run a separate retail gas products “book of business” in Pennsylvania. (2-11)

During the review period SJES charged minor amounts of employee time to SJG. Amounts charged were \$0 in 2009, \$31,404 in 2010 and \$48,615 in 2011. SJG charged SJES to obtain reimbursement of payments made on its behalf, including payments for SJES employee health insurance, prescription drug coverage and credit union payroll deductions, facilities rents, and employee time. Amounts charged were \$900,109 in 2009, \$1,120,031 in 2010 and \$1,745,012 in 2011. (2-14)

Marina Energy

Marina Energy develops and operates energy-related projects that use natural gas. It is a co-owner of Energenic, a business that develops landfill gas-to-electric projects. It provides gas-fired heating and cooling for the Borgata casino in Atlantic City, and through its 50% interest in LVE Partners, it helps operate energy projects in Las Vegas. Although a separate legal entity, Marina operates as a department of SJES. Employees increased from six in 2009 to nine in August, 2012. (2-15)

In 2010 SJG entered into a 15 year contract with Marina under which Marina provides solar electricity to SJG at 6 cents per Kwh plus escalation based on the CPI. Initially SJG issued an RFP to purchase solar panels. After Marina was awarded the bid to supply the panels, the transaction was restructured so that Marina kept the panels and sold the electricity to SJG. The restructuring effectively nullified the competitive bidding component of the transaction. (2-15)

During the three year review period from 2009 through 2011, net income to Marina from the solar transaction with SJG was approximately \$1.5 million, including renewable solar energy credits and investment tax credits, sales of electricity to SJG, and subtracting depreciation and minor amounts of other expenses. In contrast, the benefit of the transaction to SJG during the same three-year period was approximately \$180,000 in electricity savings and revenue from leasing space to Marina for the panels. (2-16)

South Jersey Energy (Non-Regulated Sales to Retail Customers)

South Jersey Energy (SJE) buys electricity and gas in the wholesale markets and sells to retail commercial and industrial customers. It also offers energy management services. During the review period electricity accounted for about two-thirds of total sales. SJE's employee force increased from six at the beginning of 2009 to 10 as of August, 2012. It includes sales, energy analyst and operations management positions. (2-17)

During the audit period, sales by SJE to SJG were limited to a new chiller that SJE supplied to provide heating and cooling to the Folsom headquarters building. Although SJE billed SJG, SJE's parent company, SJES, actually hired a design team consisting of engineering, mechanical and electrical firms to install the chiller. There were no competitive bids. It is not clear whether, or by how much, SJE and SJES profited from the chiller or why SJG could not have purchased the chiller and contracted for its design and installation. It is also unclear why SJE charged SJG for the chiller when SJES appears to have hired the contractors to design and install it. The actual amount billed by SJE to SJG for the chiller was \$613,954, while the price quoted by SJES had a "final installed price" of \$490,100. Without competitive bidding, and because the final price was higher than the proposal-quoted price, it does not appear that the price SJG paid was market-based. (2-18 to 2-19)

Transactions between SJG and SJE also included charges by SJG to obtain reimbursement of payments made on SJE's behalf, including payments for SJE's employee health insurance, prescription drug

coverage and employee time. SJG provided bill processing services for SJE's customers and charged SJE for the services. Total amounts charged were \$236,121 in 2009, \$244,492 in 2010 and \$326,979 in 2011. (2-19)

South Jersey Resources Group (Non-Regulated Pipeline Capacity, Storage and Risk Management)

South Jersey Resources Group (SJRG) provides a variety of services in the wholesale (pipeline and storage) markets, including gas trading and sales, storage management, peaking services, transportation capacity, producer services, portfolio management and commodity risk management. Customers include energy marketers, utilities and gas producers. As of 2012, SJRG was divided into Texas and New Jersey marketing groups, each of which report to separate Vice Presidents. The Texas group concentrates on the Gulf Coast market, while the New Jersey group concentrates mainly on the east coast markets and the Marcellus production region in Pennsylvania. (2- 19 to 2-20)

Organizationally, SJRG operates as a department within SJES. It grew from 9 employees at the beginning of 2009 to 16 employees in August 2012. Positions include gas traders, dispatchers and schedulers, and, for Texas operations, three gas accountants. During the review period SJRG sold gas to SJG. According to SJRG, all gas purchased by SJG was obtained at market through a Nymex broker in arms-length transactions. Net gas commodity sales to SJG were \$86.9 million, \$44.5 million and \$40.5 million in 2009, 2010 and 2011, respectively. Sales to SJG represented a small percentage of SJRG's revenue. SJG also made \$3.7 million, \$6.2 million and \$6.6 million in off-system sales to SJRG in 2009, 2010 and 2011, respectively. (2-20 to 2-21)

South Jersey Energy Services Plus (SJESP) and SJESP Plumbing

SJESP is a subsidiary of SJES. It installs residential and small commercial heating and air conditioning systems, provides plumbing services and provides appliance services under warranty through a subcontractor arrangement. SJESP Plumbing (Plumbing) is a wholly-owned subsidiary of SJESP, set up to provide plumbing services to SJESP. (2-21)

SJESP sold its service contracts for appliance warranty repairs to HomeServeUSA Corp. (HomeServe) on March 8, 2011. The purpose of the sale was to allow SJESP to focus on performing the repairs and maintenance for the service contracts while outsourcing the marketing and customer service responsibilities. (2-22 to 2-23)

[Begin Confidential]

[End Confidential]

Millennium Account Services, LLC (MAS)

MAS is a joint venture of South Jersey Industries (SJI), the holding company for South Jersey Gas (SJG), and Conectiv Solutions, owned by Conectiv, the holding company for Atlantic City Electric (ACE). SJI and Conectiv Solutions are equal owners of MAS and share equally in its profits. MAS' primary business purpose is to read meters for ACE and SJG, which it has been doing since its inception in January 1999. MAS has been reviewed in previous NJBPU audits. Its operations have not changed significantly since its inception. (2-28 to 2-29)

There have been several updates of the original Services Agreement between MAS, ACE and SJG since 1999. However, since the beginning of 2009, there have only been extensions to the agreement for each year. The terms of the extension that was to end on January 31, 2012 was extended on a month-to-month basis, while ACE and SJG conducted a competitive bid process for joint meter reading services. (2-29)

In 2012 ACE and SJG sent out an RFP to provide joint meter reading service. Four companies (including MAS) provided initial responses with cost proposals to the RFP. The estimated annual meter costs from the four bidders ranged from **[Begin Confidential]** **[End Confidential]**. MAS's bid under the 2012 RFP was **[Begin Confidential]** **[End Confidential]**. The low bidder was Accu-Read, with a bid of **[Begin Confidential]** **[End Confidential]**. ACE and SJG asked Accu-Read and MAS to resubmit their bids. Accu-Read declined; however, MAS submitted a second bid that showed estimated annual meter costs of \$5,340 below the initial low bid submitted by Accu-Read. MAS's price bid was limited to the first three years of the five year contract. As a result of Accu-Read declining to submit a second bid, the new meter reading services contract, which became effective January 1, 2013, was awarded to MAS. (2-30 to 2-31)

It has been recommended in several audits that MAS be classified as an RCBS for the purpose of applying the EDECA affiliate rules. SJG has agreed with the recommendation, though it continues not to be listed as an RCBS in the most recent version of the SJG Compliance Plan. Overland found MAS to appear to be in violation of the EDECA Standards in the following areas: transfer pricing, transfer of risk, potential cross-subsidization by utility of MAS's employee benefits, and marketing and promotion. (2-33 to 2-34)

Key Recommendations:

- Payments by SJG on Behalf of Affiliates – Apart from off-system sales of gas, most of the billings by SJG to affiliates during the audit period were to obtain reimbursement for payments SJG made to vendors on behalf of the affiliates. Overland understands there are efficiencies achieved by having a single affiliate pay for vendor services provided to multiple affiliates. However, the parent company, SJI, or the service company, SJIS, should fund these payments and seek reimbursement from subsidiaries, not the utility.

- Competitive Bidding – MAS – Given the circumstances under which MAS obtained its most recent contract to provide meter reading to SJG and Atlantic City Electric (ACE), we recommend the BPU do the following: 1) Enforce the “re-bid” price per read, which essentially represents MAS’ match of a lower initial bid by competitor Accu-Read, and ensure that it has not been adjusted to a higher price since the contract went into effect. 2) Prohibit MAS from “negotiating” with SJG to raise its price at the end of year three of the five year contract in order to recoup the revenue lost by having to resubmit its initial bid at a lower price. 3) Given the inherent conflict of interest between MAS and its utility customers created by common ownership, monitor all future MAS contract bid processes to ensure that they are competitive and impartial, or limit the amount of meter reading expense incurred from MAS that SJG records in above-the-line (regulated) accounts to either a) a price based on cost plus a regulated investment return or b) the inflation-adjusted amounts in the re-bid price-per-read submitted in the current contract.
- EDECA Compliance and Competitive Bidding – Millennium Account Services - EDECA Section 14:4-3.5(t)(6) requires that “transfers of services [to a utility] not produced, purchased or developed for sale on the open market” be priced at “the lower of fully allocated cost or fair market value.” Through ACE and SJG’s process of soliciting competitive bids in 2012, MAS adjusted the rates charged to the two utilities for meter reading services to reflect current fair market value. However, in order to fully comply with the EDECA regulation in this section, Overland recommends that MAS determine what its fully allocated cost would be to provide meter reading services to SJG and charge the utility the lower of fully allocated cost or fair market value, ensuring compliance with this EDECA standard. If MAS is unable to comply with the standard, Overland further recommends that the NJBPU prevent amounts charged to SJG that exceed the lower of fully allocated costs or fair market value from being passed on to SJG’s ratepayers by requiring SJG to record the excess charges below-the-line.

Compliance with EDECA Standards

South Jersey Gas maintains a Compliance Plan for the EDECA Standards. The Compliance Plan has been reviewed and updated every three years with the most recent updates being in 2011, 2008 and 2005. Going forward, SJG plans to review the Compliance Plan every year and also throughout the year after significant changes to the Standards. SJI provides education to its employees on affiliate standards and rules compliance by using memoranda, in-person training sessions, and web-based training sessions. (2-35)

During the audit period, the utility awarded three major projects to SJI affiliates. The Cooling Tower Replacement project appeared to be in compliance with EDECA Standards. The Solar Panel Installation project appeared to be in compliance with EDECA Standards; however, utility ratepayers were not able to take advantage of the all of the savings achieved through the tax credits and renewable credits originating from the power generated through the solar panels as Marina retained ownership of the panels. The Chiller Replacement project appears to be in violation of the EDECA Standards on nondiscrimination as preference was given to SJES to do the installation due to the utility’s compressed

timeframe and on transfer pricing as it appears the utility was billed for an amount that was greater than the proposed fair market value of the products and services associated with the installation of the chiller. (2-36 to 2-38)

Prior EDECA Audit Recommendations

In the prior EDECA audit of SJG in 2005, there were 136 recommendations. SJG agreed to take action to implement 118 of the recommendations, accepted 15 recommendations with some level of qualification, and respectfully disagreed with three of the recommendations. SJG disagrees that Marina should be considered a related competitive business segment (RCBS) as defined in the EDECA Standards. The utility disagrees with the scope of operations and activities that falls under the Standard's definitions of "competitive services" and "retail services". SJG also disagrees that a threshold for the level for business dealings between SJI entities and companies associated with SJI's Board members that is lower than the independence standards set by the New York Stock Exchange is necessary. (2-40 to 2-43)

SJI Corporation Cost Distribution (Chapter 3)

SJI, through its parent organization, effectively acts as a second service company, providing primarily corporate-type services to SJG and other subsidiaries. Among the functions performed during the 2009-2011 review period were strategic and financial planning, shareholder services, treasury and cash management, internal auditing, legal and executive management, corporate accounting and risk management, investor relations, insurance and environmental affairs. During this time the parent also had cost responsibility for corporate directors' fees and expenses, corporate bank interest, corporate-level consulting and audit fees, certain employee benefit costs, corporate charitable contributions and certain public and media relations costs incurred from external service providers. (3-4 to 3-5)

The parent organization grew by more than 50% between the end of 2008 and the middle of 2012, from 31 employees to 47 employees. Incurred costs (the functional costs for which it has budget responsibility) grew from \$11.6 million in 2009 to \$13.4 million in 2010 and to \$20.5 million in 2011. Although some of the increase was due to growth in the employee organization, a fairly significant portion of the increase between 2010 and 2011 reflected an increase in net intercompany and bank interest expense. In addition to the costs incurred by the parent organization, SJI makes payments of various costs incurred by its subsidiaries on their behalf, including pension contributions, bank fees, insurance, contributions to employee 401K accounts and various other subsidiary costs. (3-5 to 3-7)

SJI does not have a reporting process that can effectively summarize the costs it incurs and distributes to its subsidiaries by function (cost center or department), cost type and cost distribution methodology. A significant percentage of the costs incurred by the parent company organization are classified as part of the Management Service Fee (MSF) and are distributed using an "unattributable" three factor formula. The formula is based on three arbitrarily selected measures of corporate size: assets, "margin" and payroll. These size-based statistics are drawn from the accounting system and financial reports. During the years 2009-2011, roughly 75% of costs distributed through the MSF were allocated to SJG.

SJI makes various assumptions and adjustments in calculating the three-factor formula that affect the percentages distributed between SJG and its non-regulated affiliates. It is not obvious that all of these are theoretically justified. For example, in calculating the “margin” component, various adjustments are made to non-regulated affiliates’ revenues. The adjustments and various assumptions on which the three-factor formula is based are not described or explained in the Cost Allocation Manual. Review of the spreadsheets supporting the three factor formula allocator used to distribute MSF costs revealed two calculation problems, which are described in detail in Chapter 3. (3-23 to 3-26)

Among the costs distributed through the MSF are corporate donations to civic and charitable organizations. Approximately 75% of these costs were distributed to SJG, which yields a corporate contributions distribution to SJG of approximately \$1.1 million during the years 2009 through 2011. SJG recorded the costs “above the line” in account 923 – Outside Services Expense. Corporate contributions are normally not funded by regulated utility customers, and are properly recorded on the utility’s books “below-the-line” in FERC USOA Account 426.1 – Donations Expense

Key Recommendations:

- SJI should immediately develop the reporting capability to show how costs incurred in the parent organization are incurred, by function (department) and cost type, how functional costs are directly charged and to what subsidiaries, which of the functional costs are pooled for allocation and how allocable costs by function are distributed to each subsidiary.
- SJI should update and improve its Cost Allocation Manual to provide a complete description of the various steps involved in calculating the three-factor formula which is used to distribute a majority of the costs it incurs.
- SJI should correct the template used to calculate the payroll component of the three-factor formula to prevent assigning payroll from unregulated holding company South Jersey Energy Services to the payroll component factor used to distribute costs to SJG.

SJI Services Cost Distribution (Chapter 4)

SJIS provides administrative services to SJG and its affiliates in the areas of information technology, human resources, facilities management, procurement, materials management and communications. SJIS is one of two entities within SJI providing shared services. The other is the parent organization, which provides various corporate and executive services. SJIS grew from 40 employees at the end of 2008 to 49 employees in August, 2012. As of 2012, almost half of SJIS’ total employees worked in the information technology function. Slightly less than one-third worked in the human resources function. The remaining employees were split among the communications, facilities management, procurement and materials management functions. (4-4 to 4-5)

During the review period SJIS incurred costs averaging approximately \$7.5 million annually. Approximately 80% of the costs incurred and charged during the years 2009 through 2011 period, including costs initially charged to the parent organization and reallocated, were ultimately charged to SJG. Costs consisted primarily of labor and labor-related costs incurred by employees providing shared

services in the functions noted above. In addition to labor, some SJIS functions incurred costs for outside services. SJIS also had an “overheads” cost center through which costs including depreciation, general office expenses such as telecommunications, pension costs, certain outside services and charges from other affiliates were collected for distribution based on a rate applied to functional costs. (4-6 to 4-7)

As a shared services entity, SJIS costs are fully charged out to affiliates and affiliate billings are produced on a monthly basis. A majority of SJIS costs (approximately 70% during the review period) appear to have been directly charged. SJIS costs not directly charged during the review period were allocated to affiliates using factors that include measures of relative operational size, including metrics such as the number of personal computer and number of employees.

Unlike most utility service companies, SJIS does not have the ability to summarize the costs it incurs and distributes to affiliates by function, cost type, cost distribution methodology and affiliate cost objective. The inability to summarize the cost collection and distribution process appears to be a result of the present process, in which disconnected systems are used to gather and price incurred costs and to bill affiliates. According to the company, this is due to the inflexibility of the Lawson accounting system and its inability to handle the entire shared services transfer price and cost distribution process. The SJIS cost collection and distribution process is a “black box” that is not auditable in any practical sense. Although significant billing errors appear unlikely, it is not apparent that affiliates receiving cost distributions from SJIS can have confidence that their individual bills are correct. (4-17 to 4-19)

Key Recommendations:

- Overland strongly recommends that SJIS develop (or be required to develop) reporting that shows the following on a monthly and an annual basis: 1) SJIS costs incurred by function and account, 2) how functional costs are classified for distribution by cost distribution method (i.e. the amounts, by function, directly charged or allocated using each allocation method), and 3) how these SJIS functional costs are distributed and billed to each affiliate.
- SJIS should improve support for allocation factors to include 1) support for current year (as opposed to previous years’) factors for all allocators and 2) the input data used to calculate each affiliates share of all allocators.
- SJI should improve Cost Allocation Manual documentation of the SJIS allocation process. Specifically, documentation in the CAM should be expanded to include the following:
 - A description of the functions performed by SJIS at least equivalent to the descriptions contained in this report.
 - An end-to-end description of the process by which SJIS incurs costs, identifies them for direct charging or pools them for distribution, and distributes and bills them to affiliates, including the basis for various allocators used to distribute “billable to multiple clients” costs.

Organizational Structure (Chapter 5)

SJI conducts its operations primarily through two wholly owned subsidiaries: SJG and SJES. SJES was created for the purpose of holding SJI's interest in non-regulated businesses. SJI is also the direct parent of a service company, SJIS that provides support to SJI affiliates. (5-1)

The net income attributable to SJI's non-utility subsidiaries increased during each year of our audit. As a percentage of total SJI net income, the percentage attributable to SJG declined from 67.5% in 2009 to 59.2% in 2011. (5-2) The percentage of SJI personnel employed by SJG increased slightly during our audit period, from 64% to 66%. (5-4)

Prior to organizational changes occurring in April 2012, the President and CEO of SJI was also the President and CEO of SJG. These organizational changes resulted in the promotion of the SJG COO to the position of President of SJG and it also removed the CFO position from the Gas Company. (5-5 and 5-6)

Executive Management and Corporate Governance (Chapter 6)

The governing bodies of SJI's regulated (SJG) and non-regulated (SJES) businesses are currently composed of members of the parent's board of directors with two major exceptions. The SJG president serves on the SJG board, and the SJES president serves on the SJES executive committee. Neither of these individuals serves on the SJI board of directors, and no SJI board member serves concurrently on both subsidiary governing bodies. (6-4)

The responsibilities of SJI Chairman and CEO have been consolidated with one person. That same individual is also the Chairman of the SJG board. The leadership structure is complemented by the contributions of an experienced Lead Independent Director. (6-23) Other than the Chairman and CEO and two subsidiary presidents, all SJI board members have internally been determined to be "independent". (6-7) However, several of these SJI board members have relationships with SJI customers and/or competitors. (6-6 to 6-7)

Although it has no term limits, SJI's board has a mandatory retirement age of 72 unless extenuating circumstances exist. The SJI board follows a formal process for adding and replacing members with an emphasis on attaining needed skill sets and achieving diversity. (6-4 to 6-5) SJI board members have long identified accounting expertise as a key skill set that was lacking on the board but have nonetheless chosen to focus on other competencies to support the company's strategic vision. (6-7 to 6-8)

SJI employs tablet computers to communicate with its board members. We view this as a particularly effective and practical approach to providing timely and comprehensive information to its board. (6-15)

Other notable findings include:

- Many board members meet their continuing education requirement by attending in-house training arranged by the company (6-15 to 6-16);
- The reasonableness of outside director compensation is assessed by comparing SJI pay to that of companies significantly larger than SJI (6-20 to 6-21);
- Unlike its peers, SJI audit fees have grown substantially in the past several years (6-24 to 6-25); and
- SJI provides employees and third parties a number of different ways to communicate ethical concerns to the appropriate level of management. (6-29)

Key Recommendations:

- All direct outside relationships that board members have in the markets in which SJI operates should be disclosed. Board members with such relationships should recuse themselves from board and committee discussions and decisions regarding such markets.
- The SJI Governance Committee and the entire board should consider candidates who possess accounting expertise, especially those with a CPA designation or with CFO experience, when next adding or replacing current members.
- At a minimum, every other year, each SJI director should attend one external continuing education seminar, class, and/or conference on the topic of corporate governance and/or the utility industry. No more than two members should be given credit for attending any particular continuing education offering so as to encourage as much diversity of training as possible.
- Until it is demonstrated that the growth in and level of SJI audit fees are reasonable, we recommend the Audit Committee either put the SJI financial statement audit up for competitive bid in an environment in which all qualified firms have a reasonable expectation of being awarded the work or significantly curtail future increases in audit fees from the incumbent firm, Deloitte & Touche.

Strategic Planning (Chapter 7)

The purpose of the Strategic Planning Group is to help the business units of SJI to plan their operational activities and develop financial forecasts. The primary output of the strategic planning process and the Financial Planning group is the five-year Strategic Plan. Included in the Strategic Plan are financial forecasts, capital expenditure forecast, discussion of major projects, and an environmental review based on the current economy. (7-3 to 7-4)

SJI has a broad vision statement where it states the Company's desire to become an industry leader in several areas including: growth, innovation, service, energy efficiency, one-stop energy shopping, entrepreneurial leadership, strategic alliances, empowered employee base, and green energy expertise. The mission statement is appropriately aligned with the vision statement, but should include how the Company will serve its employees as described in the vision statement. The Company also has a values statement that guides its behavior and decision making process. (7-4 to 7-5)

Developing and communicating the Strategic Plan is a year-long process. This process begins in March when the Research and Corporate Development group presents to the Board of Directors topics to be covered with the SJI Executive Team during the Strategy Summit. The Strategy Summit is held in June when executives and other key SJI associates hold a two-day Annual Strategic Planning Session to discuss the inputs for the five-year Strategic Plan. The Strategy Summit often has on its agenda internal and external presentations. The remainder of the year involves gathering information, developing the five-year Strategic Plan document, receiving feedback on the document, and obtaining final approval from the Board and SJI executives. Overland observed that the utility portion of the Strategic Plan did not contain much forward-looking information. Typically, this would include information such as the timeframe for the next rate case filing and any other anticipated regulatory actions by the utility. (7-6 to 7-7)

SJI considers itself to have an “Always On” philosophy when assessing potential mergers and acquisitions. The Company uses external consultants to provide a market overview for mergers and acquisitions. The Board as well as high level executives at SJI evaluate and consider the relevant findings in these presentations (7-9)

The Marcellus Shale represents one of the most important aspects of the Strategic Plan at SJI, especially for the non-regulated affiliates. SJI has formed various alliances in order to take advantage of business opportunities in the Marcellus region. However, a decrease in wholesale natural gas prices towards the end of the audit period decreased the value of SJI’s transportation and storage assets in the Marcellus region. This has forced the Company to shed some of these assets and focus more on becoming a major retail market aggregator with significant producer services. (7-10 to 7-11)

Key Recommendations:

- The SJI five-year strategic plan should include more of a forward looking view of how the utility will operate for the five years covered by the 2011 – 2015 Strategic Plan. Included in this view should be a more detailed assessment of any anticipated regulatory filings (e.g. rate case filings) and financial metrics as they relate to credit ratings.

External Relations (Chapter 8)

The External Relations function is the responsibility of the Government Relations and Regulatory Affairs (GRA) department. GRA provides strategic regulatory support, legislative and rulemaking monitoring and advocacy, municipal government relations, and helps with regulatory compliance. GRA is responsible for interfacing with the New Jersey BPU and the Ratepayer Advocate. GRA’s Regulatory Affairs component was part of the Rate department prior to 2011. GRA was moved from SJI Services to SJG in 2012. (8-5 to 8-6)

GRA is responsible for oversight of corporate donations. During the 2009-2011 review period, approximately three-fourths of corporate donations, amounting to approximately \$380,000 annually, was allocated to SJG. Although the FERC's Uniform System of Account rules dictate that donations should be recorded "below-the-line," in account 426.1 -Donations Expense, SJG recorded allocated corporate donations "above-the-line," in account 923 - Outside Services Expense. (8-2 to 8-3)

Information provided by SJI showed very small amounts, averaging approximately \$6,000 annually, were paid to outside lobbyists during the 2009-2011 review periods. The GRA department uses project codes to track the employee costs related to monitoring legislation and overseeing corporate donations and lobbying. In 2011 these costs totaled approximately \$112,000, a majority of which was allocated or charged to SJG. Amounts charged to SJG were recorded "above-the-line," in account 920- General and Administrative Salaries Expense. (8-4)

Key Recommendations:

- SJG should record its share of corporate donations in below-the-line account 426.1, Donations Expense, instead of account 923, Outside Services Expense.
- The "government" component of GRA, headed by the General Manager, Government and Community Relations, is a corporate function performed on behalf of SJI and all of its subsidiaries. SJI should consider incorporating this function in its parent organization or in SJI Services, instead of in SJG.
- The BPU should determine whether the costs incurred by employees in conducting legislative analysis, advocacy and "social investment" activities should be funded by ratepayers or by shareholders. To the extent the BPU determines that any of these activities should be funded by shareholders, SJG should record its share of the activities "below-the-line," in FERC account 426.4 – Expenditures for Certain Civic, Political and Related Activities.

Finance, Risk Management, and Cash Management (Chapter 9)

Finance

Credit Ratings and Equity Analyst Views

The South Jersey Gas S&P rating of BBB+/Stable has been for some time. Consistent with SJG ratings, South Jersey Industries received an initial rating of BBB+/Stable as of June 17, 2011. SJG's first mortgage bonds are rated 'A' by S&P, which is two notches higher than the corporate credit rating, reflecting collateral coverage for these securities. (9-6 to 9-7)

The current Moody's rating on SJG first mortgage bonds is A-1, also reflecting a two notch spread over its issuer ratings of A-3. The Moody's issuer rating for SJG is Baa1, with an outlook that changed from positive to stable in March 2011, largely due to an increasing exposure to SJI unregulated businesses held in SJES. In August 2012, Moody's increased the utility's ratings one notch for the senior secured, senior unsecured and corporate ratings, citing improved financial performance and credit metrics that aligned more with the lower range of the A-rating category. (9-7)

Overland reviewed the reports from these equity analysts from early 2012 and found most of the views of SJI to be similar. Almost all of the analysts gave SJI stock a “Buy” rating. Only one of the listed equity analysts above did not consider SJI stock to be a strong buy, instead giving them a “Neutral” rating. In recent years, industry analysts have viewed SJI favorably to its peers. This is driven by the company’s record of earnings and dividend performance; its strong financial position, which are reflected in strong credit ratings; and a positive view of management performance. (9-19 to 9-20)

Both SJI and SJG have issued debt during the audit period. Approximately 38% of SJG’s debt is scheduled to mature within ten years. The utility issues debt through its Medium Term Note Program and SJI issues its debt through private offerings. Both SJI and SJG have revolving credit facilities to fund capital requirements and any other short-term financing needs. (9-16 to 9-17)

Ring-Fencing

SJI’s non-utility operations during the audit period were substantial and are likely to become even more significant in the future. (9-9 to 9-10) The two rating agencies that issue credit ratings for SJG (Moody’s and Standard and Poor’s) have made clear their view that SJI’s unregulated businesses are riskier from a credit perspective than SJG. Moody’s and Standard and Poor’s reports clearly indicate that SJG’s association with these non-regulated businesses is having a negative impact on the perceived creditworthiness of SJG. (9-11 to 9-13)

Cash Management

SJG does not participate in any formal money pool arrangements with its affiliates. (9-34) SJG utilizes a variety of different credit facilities to meet its capital requirements. During the audit period, SJG altered its liquidity profile by establishing a commercial paper program to replace other expiring SJG credit facilities. Under this program, SJG may issue up to \$200 million of unsecured notes to qualified investors. This program is backstopped by a \$200 million revolving credit facility that provides protection in the event that SJG is not able to find buyers for its commercial paper.

Risk Management

SJI uses a qualitative methodology in assessing and managing its business risks as opposed to a quantitative approach. To identify and monitor significant business risks and set limits and guidelines for the management of these risks, SJI has established an Enterprise Risk Management Framework. The framework provides a bottom-up approach to managing risk, where the business unit leaders “own” the risks and the processes of mitigating them. The Risk Management Department is responsible for carrying out the Framework. The utility also has a Risk Management Committee to enforce the Risk Management Policy and Procedures and monitor the gas purchasing process at SJG. (9-23 to 9-24)

The Risk Management function of SJI has evolved from primarily managing credit risks to an enterprise wide function that manages the following risks: marketplace, earnings, cash flow, financial reporting,

operational, political, reputation, environmental, and strategic risks. The Risk Management Department has developed a risk inventory that is a compilation of approximately 200 events that could prevent SJI from achieving its business objectives. SJI assesses each risk based on the probability of occurrence and its potential impact to SJI. Each risk parameter is given a score of one to five, so that the total overall score, considering both parameters, is between two and ten. A higher number means a higher risk to SJI. (9-25 to 9-26)

Key Recommendations:

- Representatives of SJI and SJG should conduct meetings with the ratings agencies and BPU Staff to develop a plan to enhance current ring-fencing provisions to a level that ensures SJG's credit ratings are more reflective of SJG as a standalone company and negative influences from the activities of SJG's affiliates are minimized.

Accounting and Property Records (Chapter 10)

Both SJI and SJG's year-end financial statements received an unqualified or "clean" opinion from its external auditors for each year of our audit period. (10-7) The external audit firm also found that SJI maintained effective internal controls over financial reporting during the audit period. Even so, the number of internal control deficiencies discovered at SJI increased sharply during the audit period, with the majority of these deficiencies being identified by the Company's external auditors. In 2009 only two control deficiencies were identified by SJI's external auditors. This number then approximately doubled in 2010 to five (including one significant deficiency) and then nearly tripled to thirteen in 2011. The dramatic increase in deficiencies identified by SJI's external auditors and the recurring nature of some of these control deficiencies indicate that SJI's Internal Audit Department may not be effectively identifying and remediating internal control issues. (10-13 to 10-15) Fixed asset accounting, specifically asset retirements, was one area in particular that had recurring internal control issues. (10-4 to 10-5)

SJI's Internal Audit Department has recently completed a significant project to document many of the Company's key controls through flowcharts. These provide a helpful illustration of the different control processes in place at SJI. (10-9 to 10-10)

Time budgets for internal audits were generally inaccurate and not reflective of the actual level of effort necessary to complete the required tasks. In 2010, only 15% of internal audits were completed within +/- 20% of budgeted hours, and in 2011 only 26% of internal audits were completed within this range. (10-12 to 10-13)

The Company's capitalization policy is written at an extremely high level. This policy appears too general to provide meaningful guidance to Company personnel. (10-16)

Key Recommendations:

- Internal Audit should perform a focused review of the SJG Property, Plant and Equipment internal control procedures, particularly in regards to the retirement of SJG assets, to ensure that these controls are effectively designed and are being adequately followed.
- The SJI Internal Audit department should make a concerted effort to develop more accurate budgets and it should regularly report the budget-to-actual variance of its audits to members of management.

Gas Procurement and Supply (Chapter 11)

During the audit period, an outside consultant developed an enhanced approach to forecasting SJG's gas supply demands. The enhanced forecasting methodology appears sound and predictive. (11-5 to 11-7)

SJG's Gas Supply Department has performed reasonably well minimizing pipeline imbalance charges. With the exception of one atypical month in 2010, imbalance charges during the audit period were negligible. (11-7 to 11-8)

Energy efficiency programs have significantly decreased design day demand requirements. Without these programs, the Company's design day forecasts showed an increase of roughly 15% from the 2012-2013 winter season to the 2020-2021 winter season. Incorporating the impacts of energy efficiency programs decreased the projected design day growth to 8.5% over this time period. (11-8)

SJG has recently entered into an agreement with Columbia Gas Transmission to substantially increase its firm transportation capacity entitlements. Beginning in September 2015, this agreement increases SJG's firm transportation capacity entitlements by 50 thousand Dths/day. It will then increase by increments of five thousand Dths/day each year until reaching 70 thousand Dths/day in 2019. (11-12)

Third party marketer activity increased in SJG's service territory during the audit period. Third party marketers provided almost 27 million dekatherms of gas supply to residential, commercial and industrial SJG customers. This was an increase from 2009 of roughly 3.3 million dekatherms. SJG's retail marketer affiliate is a major, but not dominant, participant in this market. Information on the Company's website regarding New Jersey's Energy Choice program is considerably less extensive than the information provided by the other three New Jersey LDCs. (11-14 to 11-16)

During the audit period, SJG began using an online auction to purchase its gas commodity. These auctions allow each potential supplier to see the other bids in real time and adjust its bid accordingly. The participation and bid data for these auctions generally indicate a healthy degree of participation. (11-19 to 11-21)

In an effort to maximize the value of its capacity entitlements, SJG began utilizing South Jersey Resources Group as its asset manager to market 90 thousand Dths/day of SJG's firm transportation capacity. (11-22) South Jersey Resources Group is the only SJG affiliate that SJG conducted Off-System Sales and/or Capacity Release transactions with during the audit period. SJG is a major supplier of both pipeline capacity and gas commodity to SJRG. This relationship presents incentives for SJG to maintain a larger portfolio of gas supply assets than is necessary for the regulated utility. However, we found no examples of SJG providing preferential treatment to South Jersey Resources Group. (11-24 to 11-26)

The Company was fined \$950 thousand and forced to return \$120 thousand in unjust profits by the FERC because of rules violations conducted by SJG and SJRG. SJG has since implemented enhanced controls to prevent further violations that appear adequate, but the effectiveness of these controls has not been tested. (11-27 to 11-30)

SJG's hedging program appears adequately designed, but there are some areas of concern. SJG's hedging program includes both non-discretionary and discretionary components. (11-31 to 11-32) Regarding the non-discretionary hedging component, we found multiple instances of non-compliance with the purchasing procedures of this program. Also, the Company consistently fell short of its stated objective to hedge 20% of its commodity supply through the non-discretionary hedging program. (11-33 to 11-34) Regarding the discretionary hedging component, we found the lack of written procedures and supporting documentation to be a major shortcoming. (11-36 to 11-37)

SJG's hedging program lacks performance goals, and no benchmarking studies were performed over SJG's hedging program during the audit period. (11-38)

Key Recommendations:

- SJG should develop, and make available on its website, a comprehensive manual that could be downloaded by third party marketers interested in providing service to customers in SJG's service territory.
- When conducting online auctions to enter into wholesale natural gas contracts, SJG should require a minimum of two bidders before awarding the contract to an affiliate.
- SJG should adhere to the established protocol of its non-discretionary hedging strategy.
- SJG should establish written performance expectations for its hedging program. These performance expectations should be compared to actual results to evaluate how well SJG's hedging strategies have performed, and they should be reviewed by SJG's Risk Management Committee on an annual basis.
- SJG should establish documentation requirements for its discretionary hedging program. At a minimum, these documentation requirements should fully explain the Company's basis for entering into the hedge.
- SJG should consider significantly scaling down, or potentially even de-activating, its discretionary hedging program and utilizing alternative hedging strategies to achieve an adequate level of hedged gas supply.

- SJG's Risk Management Committee should perform sensitivity and benchmarking analysis to test the effectiveness of its hedging program. This analysis should determine both how well SJG's hedging program has been executed, as well as how well it has been designed.

Gas Delivery and Operations Management (Chapter 12)

SJG has recently upgraded its Supervisory Control and Data Acquisition (SCADA) system. The new system provider is widely used by other gas distribution companies. (12-4)

SJG has met or exceeded all requirements under the Pipeline Integrity Management Program. (12-5 to 12-6)

The top threat identified through SJG's Distribution Integrity Management Program is corrosion due to the large amount of unprotected bare steel in SJG's distribution system. (12-6) Corrosion was the predominant cause of leaks on SJG's mains, causing between 77% to 86% of the leaks on SJG's main on an annual basis for the five year period from 2007 through 2011. (12-15)

When all non-modern materials are combined and compared to the national average, the miles of main as a percentage of the distribution system composed of non-modern materials are over twice that of the national average (19.8% versus 9.2%). (12-9) SJG has been proactive in the past few years of proposing methods to accelerate the replacement of this pipe beyond the requirements of its own internal replacement program. (12-6 to 12-7) As a result, SJG has significantly increased the rate at which it is replacing non-modern pipe, but this increase has come at a significant cost. While the rate of main replacement has more than doubled since SJG began its accelerated infrastructure replacement programs, spending on these programs has nearly quadrupled. (12-12 to 12-13)

SJG substantially reduced the number of leaks in its backlog. SJG reduced the backlog for the leaks classified as Grade A by 42% and Grade B by 89%. (12-15 to 12-18) However, some of the open leaks have been outstanding for many years. (12-18)

Key Recommendations:

- SJG should institute a policy to repair Grade B Leaks within twelve months of discovery.
- SJG should integrate industry benchmark statistics into their performance targeting and should set performance targets at "stretch" (aspirational) levels.

Contractor Performance and Damage Prevention (Chapter 13)

Construction and Maintenance

SJG outsources engineering design, construction, mark-out (pre-excavation facilities location) and leak survey activities. Approximately 220 SJG employees perform most of the maintenance on the gas distribution system, and manage and administer all construction, maintenance and operations activities.

Construction activities have increased significantly since 2009, when SJG began a BPU-approved accelerated replacement program for gas mains and services. The programs have permitted SJG to recover replacement costs in rates (through rate base treatment) as soon as they are completed and placed into service. (13-3)

Excavation Damage Prevention

SJG is a member of the Common Ground Alliance, a national group focused on the protection, safe construction and safe operation of underground infrastructure. SJG's written procedures include a pipeline mark-out procedure and a damage prevention program operating procedure. The procedures appear adequate. (13-9)

SJG's key damage prevention metric, damages per 1,000 markout requests, has improved steadily. After peaking at 7.4 damages per thousand in 2007, it has declined each year since, and was as low as 4.87 for the 10 months ending October 31, 2012. However, though trending downward, SJG's damages rate appears to be higher than the median in a peer group of 30 utilities, which had a rate of 3.69 per 1,000 excavations in 2008. (13-12)

Excavation markouts are currently performed by contractor Utiliquest. SJG recently signed a five-year contract with Utiliquest that includes a termination clause in case Utiliquest fails to meet performance requirements. SJG has a procedure under which it audits approximately 1,000 Utiliquest markouts annually. The "failed audit" percentage has dropped from 15% in 2008 (the earliest year for which statistics were made available), to 2% for 2011. The number of damages attributed to locator error dropped from 262 in 2007 to 126 for the first 10 months of 2012 (representing an annualized rate of 151 for 2012). (13-12)

Key Recommendations:

- SJG's key damage prevention metric is damages per 1,000 markout requests. We recommend that a goal to improve this statistic to "best in class" levels be reflected in the performance evaluations for employees directly responsible for damage prevention, including the Director of Work and Process Management and the Markout Coordinator.
- The division of gas system construction and maintenance functions between employees and contractors has remained constant for at least the last 12 years. SJG has not conducted any studies of the costs and benefits of using employees vs. contractors since at least 2009. At least for the excavation location (markout) function, which is and has been handled by a contractor, the use of employees can be considered to be a best practice because it tends to provide better control over the process. Although it may be that the status quo continues to represent SJG's least-cost alternative, we recommend that SJG perform a high-level computation of the costs and benefits of each construction and maintenance function at least once every five years.
- Balanced Scorecards do not directly reflect contractor performance objectives relating to leak survey performance or damage prevention. Performance objectives directly tied to these

metrics; in particular, damages per 1,000 locates, should be included in the scorecards of all employees with responsibility for contractor safety procedures, especially employees with direct responsibility for overseeing the leak survey and damage prevention processes.

Customer Service and Meter Reading (Chapter 14)

Information Systems and Telephony – During the audit period SJG relied on a 1970s-era Customer Information System (CIS) to maintain its customer accounting and billing processes. The system had significant limitations in terms of flexibility, reliance on paper-driven processes and ability to interface with other SJG systems. SJG began to evaluate options to replace the legacy CIS in 2010 and management approved the acquisition of a new system in 2011. (14-6)

At the time our report was prepared, SJG was completing a new CIS, based on an Oracle platform, which is expected to provide improvements such as real-time information, customer-based (rather than meter-based) financial information, web-based customer self-service, better flexibility to incorporate rate and other changes, and improved capture of performance metrics. The new system was budgeted at \$22 million (about \$63 per customer). Its final cost was not known at the time of our report. (14-6)

SJG replaced its call center phone system in 2010. The new phone system includes an automatic call direction (ACD) sub-system that interfaces with the CIS through an interactive voice response (IVR) system, which was upgraded when the new phone system was installed. The new system can direct customer calls to service representatives based on skill designations. Customers can also obtain payment and other information from the system without waiting to talk with a service representative. SJG uses its Automated Dispatch System (ADS) to dispatch customer service orders to the field. The ADS is a web-based system that dispatches orders and collects service order results data in the field. It links with the legacy CIS to schedule appointments and provide Customer Service Representatives with the ability to view service call information. (14-7 to 14-8)

Customer Service Performance – SJG measures customer satisfaction relative to other gas utilities using surveys conducted by J.D. Power. SJG's overall customer satisfaction was above the average of its peer group (mid-sized, eastern region gas utilities) in three of the four years from 2009 through 2012. In addition to customer satisfaction, performance metrics include inbound call answering, meter reading and billing, gas leak response, service appointment performance, customer complaints, and customer interaction. The current set of metrics and targets were negotiated during the 2010 rate case. Most metrics reported by SJG showed improvement between 2009 and 2012; however, some of the performance targets established in the rate case had not been met as of 2012. (14-8)

Credit and Collections – SJG's late-payment collection and disconnection activities are determined by customer credit scoring using a proprietary scoring process owned by Total Solutions, Inc. Credit scores resulting from this process drive collection procedures and efforts. Collection activities include sending late payment and shut off notices, making outbound "last attempt to collect" phone calls, physical

disconnection at the meter or curb valve, and post-disconnection attempts to collect by outside agencies. (14-11 to 4-13)

SJG's bad debts as a percentage of revenue more than doubled between 2009 and 2012, from 0.41% to 0.90%. SJG attributed the increase to "the financial market crash of 2008 and its subsequent impact on the local economy." We question the causal link that SJG draws between the 2008 financial crisis and an increase in the bad debt rate between 2011 and 2012. To the extent the increase in 2012 is not simply a "catch up" of amounts that should have been expensed before 2012, it could be the product of either less-than-aggressive collection efforts or sub-par efforts to ensure that as many customers as possible who are eligible for energy assistance receive the assistance. For example, while the bad debt rate increased in 2012, SJG's percentage of customers disconnected declined from 1.6% in October, 2010 to 1.2% in October, 2011. At 1.2%, SJG's disconnection rate was one-third the average rate of 3.6% for gas utilities in the mid-Atlantic region, according to statistics compiled by the AGA in its fall 2011 survey. (14-13 to 14-15)

The effectiveness of external collection agencies, as measured by the average rate of recovery of amounts sent for outside collection, decreased from 8.5% in 2010 to 4.1% in 2012. During this time, the number of accounts sent for collection increased from 34,133 to 48,931; however, the amounts recovered by outside agencies declined from \$867,000 in 2010 to \$554,000 in 2012. (14-16)

Metering – SJG's meters are read by affiliate Millennium Account Services (MAS). The Joint Agreement between MAS and SJG defines acceptable performance as obtaining actual reads (by Millennium or the customer) of at least 91% of total SJG meters. With the exception of a few individual months impacted by snow events, MAS met the 91% standard throughout the review period, with an average gas meter read rate of slightly less than 95%. (14-16 to 14-17)

Meter testing is outsourced to Measurement Controls, Inc., located in North Carolina. SJG tests a 5% sample of all new meters purchased and continuously conducts testing on a sample of "small" meters (under 500 c.f. / hour capacity) in accordance with BPU requirements. Meters with capacities above 500 c.f./hour are scrapped after 10 years. To pass a test, a meter must be within +0.5% and -1.0% for both "open" and "check rate" tests, with a spread of no more than 1.0% between the tests. Meters found to be out-of-tolerance may be subject to billing adjustments. A Fast Meter Refund is calculated and issued if a meter is found to be registering fast by more than two percent. Billing adjustments are not processed for slow meters unless SJG finds evidence of tampering or the meter fails to register consumption. When a non-registering meter is adjusted, the customer may spread the additional amount owed over the same amount of time that the meter determined not to have been registering usage. (14-18 to 14-19)

Key Recommendations:

- SJG should consider adding automated dialing and collection capability to its new phone and CIS system to enable it to initiate active collection efforts on past due amounts at an earlier stage in the account aging process.
- SJG should add performance targets for the following credit and collection statistics and add them to the balanced scorecard for the Manager, Customer Accounting and Billing: 1) arrearages over 60 and 90 days; 2) bad debts as a percentage of revenue; and 3) percentage of revenue recovered for accounts turned over to outside collection agencies.
- Balanced scorecards for managers in the Customer Service function do not currently include performance targets for important department metrics. Assuming it is the responsibility of Customer Service managers to meet these targets, we recommend including them in the balanced scorecards for the Managers, Customer Service and Dispatch and Customer Accounting and Billing. Specifically, call answering, gas leak response, first call resolution, service appointments met and service representative courteousness and knowledgeable targets should be included in the balanced scorecard for the Manager, Customer Service and Dispatch. Targets for bad debts as a percentage of revenue, 60 and 90 day arrearage as a percentage of total outstanding accounts receivable, field collector productivity and percentage of revenues recovered by collection agencies should be added to the balanced scorecard for the Manager, Customer Accounting and Billing.
- SJG should investigate the reasons that its disconnection rates are lower than its peers during a time when its bad debts as a percentage of revenue have been increasing. SJG should determine whether its procedures for identifying and disconnecting non-pay accounts are appropriately aggressive. To the extent SJG's reliance on credit scoring may be causing it to leave non-pay accounts connected beyond the age that such accounts are disconnected by peer companies, SJG should adjust its procedures and perhaps increase the aggressiveness of its shut-off activities.

Human Resources (Chapter 15)

The head of the Human Resources department at SJI changed hands during 2013. During the audit period, Sharon Pennington, Senior Vice President and Chief Human Resources Officer, was reassigned to the position of Associate Vice President – Labor and Business Relations. Kathleen McEndy was hired by SJI on March 22, 2013 to be the Vice President of Human Resources at SJI. (15-5)

SJI's vision is to be The Energy Company of First Choice for Employees. The Company created an Organizational Development group in 2009 to help achieve this vision. This group is tasked with increasing the role of employee development from an ad-hoc activity to a more permanent program of activities which include succession planning, talent management, individual development, planning, performance management, and training. The goal of the group is to help SJI employ the right people with the right skills in the right place at the right time. In the future, the Organizational Development

will focus on workforce planning, succession planning as well as compensation and recognition programs. (15-6)

SJI performs virtually all of the staffing functions in-house. SJI has had an increasing percentage of open positions filled internally from 2009 through 2012. In 2012, the Company took an average of 38 days from the time a new position is created to the time the new employee fills the position. (15-8 to 15-10)

SJI uses job description forms to document the duties and responsibilities of each position within the Company. The SJI job descriptions are reviewed approximately every three years, with one-third of them reviewed each year. However, Overland found that only 75% of the positions at SJI had existing and up-to-date job descriptions. This percentage fell short of the Company's estimate that 99% of the company's positions have up-to-date job descriptions. (15-10 to 15-11)

The goal of SJI's Executive Compensation Programs is "to advance the Company's strategic plan and corporate mission, which are rooted in shareholder value, while attracting and retaining highly qualified executive management to carry out the Company's work and goals." The Company targets the market median (50th percentile) for the compensation of its executives and manages executive compensation to within +/- 20% of the median. Using an external compensation consultant, SJI reviews their executive compensation program on an annual basis, using a peer group with which to compare the executive compensation at SJI to other utilities. SJI is one of the smallest utilities in the peer group used to benchmark executive compensation. As such, SJI's executive compensation proved to be significantly less than the peer group median and market survey data median provided by the compensation consultant. SJI executive compensation fell below the 20% less than the median threshold that the Company targets for managing executive compensation. Since SJI is one of the smallest utilities in its peer group, it is reasonable that the Company's executive compensation is significantly below the median when compared to the peer group companies. (15-12 to 15-20)

For non-executive compensation, SJI targets base salary for their employees at the 50th percentile with a tolerance of +/- 20%, based on market surveys. The salary structure for non-executive employees is reviewed annually by the Internal Compensation Committee. (15-23 to 15-24)

SJI calls its employee performance evaluation process The Strategic Performance Management Program. The Company uses the balanced scorecard as a tool to evaluate the performance of its employees. The balanced scorecard has four areas that contain objectives on which the employee's performance is assessed: Financial, Customer, Process, and Development. Represented employees are not subject to the Strategic Performance Management Program. Instead, these employees have their performance evaluated after their first 180 days of employment. After this probationary period, the performance of the represented employee is governed by the collective bargaining agreement. (15-28 to 15-30)

SJI has placed a high priority on succession planning due to the fact that 45% of SJI's employees in 2012 could have been eligible for retirement in 2016. In 2011, SJI contracted with Right Management Group

to develop an emergency/interim succession plan for the CEO and Chairman of SJI and an executive talent overview. Through the talent assessment of the executives and their immediate subordinates, the consultant and SJI were able to identify potential replacements for the seven key positions at SJI: CEO, CFO, General Counsel, VP Corporate Research and Development, Chief HR Officer, COO of SJG and COO of SJES. SJI has developed a succession planning tool for non-executive employees. This tool measures the employee's retirement risk and how critical the position is for the Company. These two measures combined to help SJI gauge the likelihood and business risk of employee turnover for a specific position. SJI then uses this information to determine the level of effort and urgency necessary to find a replacement for that position and train the employee for that position's responsibilities. (15-33 to 15-34)

SJI has generally good constructive relationships with its unions. The two unions that are employed at SJI and its affiliates are the Local 1293 of the International Brotherhood of Electrical Workers (IBEW) that had approximately 44 members as of August 2012 and the Local 76 and 95 of the International Association of Machinists and Aerospace Workers (IAMAW) that had approximately 280 members as of August 2012. The Local 1293 is under contract through February 28, 2017. The Local 76 and 95 is under contract through August 31, 2014. (15-35 to 15-36)

Although SJI has a generally good relationship with its unions, the Company's interactions with the Local 76 and 95 IAMAW unions have been more difficult, especially concerning bargaining agreements and process improvements. SJG filed an unfair labor practices charge against the Local 76 and 95 in 2009 and SJESP filed an unfair labor practices charge against the union in 2012. In both cases the judge found in favor of the SJI affiliate. (15-36 to 15-37)

SJI has a very structured procedure for handling grievances from the union members. The procedures vary slightly from one union to the other. From 2009 to 2011, the SJI affiliates averaged 34 grievances per year with just a few of them going to arbitration. (15-37)

SJI has an Affirmative Action policy in its HR Manual and represents that it is an equal opportunity employer. Although SJI has devoted a considerable amount of resources to promote and improve the diversity of employees with the organization, we found that SJI has not been able to reach its goal of reflecting the diversity of its service area in the Company's workforce and organizational culture. Women and Hispanics are the most underrepresented minority groups in its workforce. In addition, the Office of Federal Contract Compliance Programs (OFCCP) found two violations in SJESP's equal employment opportunity policies in 2011. (15-39 to 15-41)

Key Recommendations:

- SJI should ensure that each position in the Company from the CEO to full-time entry level employees has an up-to-date job description documented and retained by Human Resources.

- For executive compensation benchmarking, SJI should review its executive compensation peer group and choose companies that are relatively closer to SJI in size as well as other factors such as: utility vs. non-utility business, location, etc.
- Overland found that some balanced scorecards from 2009 – 2011 were not filled out completely and the results of the scorecards were discussed informally between the employee and the supervisor. We recommend that all exempt employees have balanced scorecards filled out in their entirety and retained electronically in the employee's file for future reference.
- In general, SJI Human Resources should obtain, and more extensively utilize, benchmarking data in order to improve the effectiveness and efficiency of the HR function.
- SJI should strive to improve its relationship with the Local 76. Improving the relationship with the Local 76 might be achieved through consistent monthly meetings with the union as well as soliciting the help of outside facilitators to conduct relationship building workshops with the Company and the union.

Remediation Costs (Chapter 16)

SJG is directly responsible for the clean-up of 12 active manufacturing gas plant sites. As of the end of our audit period, cost estimates to complete environmental remediation activities at these sites ranged from \$90 million to \$217.2 million. (16-2) SJG performs a variety of internal control procedures regarding remediation costs. These include utilizing a competitive bid process to award contracts to environmental remediation contractors, and reviewing/authorizing invoices on a periodic basis. (16-4 to 16-5)

Until recently, SJG's remediation activities were directly overseen by the New Jersey Department of Environmental Protection. As a result of the 2009 Site Remediation Act, Licensed Site Remediation Professionals now have direct oversight for these sites. (16-5)

SJG has reached the limit of its environmental remediation insurance coverage. With the removal of the insurance carriers from SJG's environmental remediation process, the Company has lost a third-party uniquely interested in cost containment. (16-6)

Support Services (Chapter 17)

Materials and Procurement

SJG's Materials Procurement and Management function is performed by Administrative Services employees in SJI Services (SJIS). SJG purchased approximately \$38 million in gas materials during the three year review period (2009 through 2011).

SJG outsourced the procurement of most gas materials and the management of its storerooms to McJunkin Redman Corp. (McJunkin) in 2006. McJunkin maintains inventories of gas materials in SJG warehouses on consignment and SJG pays for the materials as they are used. McJunkin also supplies project-specific materials outside of the consignment process. (17-9)

The relationship between SJG and McJunkin is governed primarily by a consignment sales Supply Agreement. McJunkin's minimum prices to SJG are based on a return on sales which was not documented in the original Supply Agreement because it was "verbally negotiated" between McJunkin and a former SJG Administrative Services Vice President. The minimum prices were later documented in a contract amendment. The services provided by McJunkin under the Supply Agreement have not been subjected to competitive bidding since McJunkin was awarded the initial supply contract in 2006. (17-10) McJunkin also sources and sells materials to SJG on a project-specific basis beyond the consignment sales covered by the Supply Agreement.

Fleet Management

During the review period the SJI fleet had approximately 500 units of rolling stock, of which approximately 435 units (85%) belonged to SJG. SJI outsourced the fleet maintenance function in 1999. Since then, the contract has been reviewed and consideration has been given to issuing a new request for proposals for maintenance services every three years. As a result of the most recent review, in 2011, SJI switched from Penske to First Vehicle Services. (17-14 to 17-18)

In 2011 SJI began a program to convert the fleet from gasoline to compressed natural gas. SJG completed a CNG fuel station at its Glassboro Operations Center in 2012 and had plans to complete two additional stations in 2013. The Glassboro facility is also open to other companies with CNG vehicles. As of November, 2012 SJG had purchased 31 CNG vehicles at an average of about \$25,000 above the cost of a gasoline equivalent vehicle. At present fuel prices, the payback period for the additional cost of a CNG vehicle appears to be as high as 10 years (depending on SJG's actual cost of natural gas and the price of gasoline). 10 years is the approximate useful life of an SJG utility vehicle. (17-19 to 17-23)

Unlike many, if not most other utilities, SJG does not maintain per-vehicle operating or ownership cost statistics and it does not benchmark its fleet operating efficiency or costs against other utilities. Many of the utilities that track fleet costs and efficiency benchmark themselves against other fleets using a specific vendor that specializes in utility fleet benchmarking. SJG also stated it was not tracking the ownership or operating costs per vehicle for the CNG fleet, which means it is also not comparing the per-vehicle costs of CNG and gasoline. (17-23)

Facilities Management

SJG owns most of the space occupied by employees of SJG and some which is also occupied by other SJI companies. SJG charges its affiliates SJI and SJI Services (SJIS) for their use of space in SJG's Folsom General Office building based on a "market proxy" rate for Class A office space in the Philadelphia area plus the cost of energy. SJG does not charge affiliates for the Folsom building based on the "higher of cost or market," as required by Electric Discount and Energy Competition Act (EDECA) rules. Although the rate SJG charged affiliates was a few cents higher per-square foot than a cost-per square foot calculation produced in response to an audit inquiry, the cost calculation failed to include return on invested capital and related income tax. (17-25 to 17-27)

Neither SJI nor SJG maintain facilities-based ownership and operating cost statistics on buildings. A calculation of the 2011 cost of the Folsom building was prepared in response to our audit inquiry, but is not a calculation that is regularly prepared or compared year to year. SJG does not participate in the International Facilities Management Association's (IFMA's) regular facilities benchmarking surveys and does not benchmark its facilities costs, even though SJG's Facilities Manager is a member of the IFMA. (17-29)

In 2011 SJI hired U.S. Facilities (USF) to manage its facilities contractors and projects and provide "mailroom services." USF charges SJI approximately \$20,000 monthly plus a 5% fee on the billings of contractors it manages. SJI did not quantify or describe any savings or productivity improvements associated with hiring USF; however, it appears USF may replace employees responsible for "mailroom operations" and could replace SJG's current Facilities Manager in the future. (17-24 to 17-25)

Legal Affairs

SJI's Legal Affairs group is housed within the Executive Department of the parent company and reports up to the Corporate Counsel & Secretary of SJI. Most of the work performed in this group relates to review and drafting of contracts, resolving minor litigation matters, and handling disputes with 3rd parties, and regulatory filings. Major litigation matters are outsourced. SJI spent \$3.0 million, \$2.6 million, and \$3.5 million in external legal fees in 2009, 2010, and 2011, respectively. The utility was responsible for over half of the external fees billed to SJI during those three years. SJI was billed 52% of its external legal fees from 2009 to 2011 from one law firm. This dependence on one law firm for the majority of the company's external legal counsel suggests that there is a relationship between the legal firm and SJI that is not subjected to a rigorous competitive bidding process, which is inconsistent with best practices. (17-29 to 17-36)

Insurance and Claims

Insurance and Claims is a function within the Risk Management department of SJI's parent organization. The Insurance and Claims group has the overall responsibility to identify, assess, and transfer risk from any of the SJI affiliates through whatever means possible including: insurance policies, contracts, indemnification provisions, etc. and to handle all third party liability claims. The department processes on average 70 to 100 claims per year, most of which result in minor rewards of \$1,000 or less. The most frequently processed claims are vegetation claims and small property claims. (17-36 to 17-37)

The insurance policies at SJI are adequate, containing a wide array of insurance policies that mitigate the company's risk relating to employees, property, environment, and the general public. The total costs for the premiums of the insurance coverage in place as of June 1, 2011 was \$9,844,334, with the utility being responsible for \$4,876,743 of that amount. (17-38 to 17-39)

In 2011, SJI developed an Insurance Risk Analysis Report highlighting: risks that were underinsured, risks that might need to be insured by a third party that were self-insured at the time of the report, and risks

that were uninsured where the company should obtain insurance quotes and consider purchasing a policy to mitigate. Based on the recommendations from this report, SJI purchased Director & Officer Side “A” coverage for \$15 million and obtained an additional \$25 million of umbrella insurance coverage on June 1, 2013. (17-39 to 17-40)

The Insurance and Claims department participates in a few benchmarking surveys. In the American Gas Association’s (AGA) Risk Survey Report, SJI is one of the smaller utilities participating in the survey for the 2011. Despite being one of the smaller utilities, SJG paid premiums that were above the median in the survey for worker’s compensation, employment practices coverage, and pollution/environmental coverage. The utility’s coverage limits for each of the different of insurance types presented in the survey were at or below the median. (17-40 to 17-43)

Records Management

Within the Administrative Services department there is a Records Management function. Records Management is tasked with: submitting and retrieving records internally and from the external records storage management company; ensuring the security of the records maintained at SJI; and verifying that records retention guidelines are met. The governing document for the Records Management function at SJI is the Records Retention and Destruction Manual, which was last updated in April 2011 and made available to all SJI employees via the company’s intranet. SJI uses Iron Mountain for long-term record storage and any short-term record storage that is not able to be kept on-site at the Folsom storage area. (17-44 to 17-45)

Key Recommendations:

- Supply chain, fleet and facilities performance metrics, including the dollar value of all managed procurement, per-vehicle ownership, operations and maintenance costs and building-level facilities costs for owned space should be maintained. SJG should benchmark its supply chain, fleet and facilities activities against other utilities and adopt best practices whenever feasible.
- SJG should evaluate vendors providing services similar to those provided under the McJunkin under its gas materials Supply Agreement and the prices they charge. The McJunkin contract, which has been in place since 2006, should be put up for bid, similar to what was done with the Penske fleet maintenance contract in 2011.
- Affiliate pricing for space in SJG’s Folsom General Office building should be reviewed annually. A fully distributed cost-based price, including return on investment and income tax components, should be calculated annually, and compared with market-based pricing, which should also be updated annually. In accordance with EDECA rules, affiliates SJI and SJIS should pay SJG the *higher* of the building’s cost or market rate per square foot.
- The Legal Affairs group should employ a competitive bidding process when selecting the law firms it will use to provide SJI with outside legal counsel.

Information Technology (Chapter 18)

The Information Technology (IT) department at SJI is divided into five components: Infrastructure & Network Services; Application Services; CIS CC&B System; Enterprise Design Authority and Client Relations/Planning; and Project Management Office (PMO). The department provides strategic planning and technical support to SJI affiliates, identifies opportunities where technology can assist and improve current and future business processes, coordinates with SJI stakeholders all design and implementation requirements of SJI's technology mission and objectives, and reports on the status of IT projects to the Executive IT Steering Committee. (18-2 to 18-3)

The IT department is planning upgrades to some of the larger IT systems used by SJI and its affiliates. The new Customer Care and Billing system is expected to be implemented in the first quarter of 2014. The Enterprise Work & Asset Management System came online in January 2013. Finally, the trading platform and risk management software is being rolled out to SJI affiliates during 2013 and 2014. (18-5)

Overland obtained benchmarking data for the IT department. The Company prepared its own benchmarking survey comparing the department's fully allocated cost of providing service to SJI and its affiliates versus outsourcing the IT department's functions. The costs that the IT department charged to SJI affiliates in 2012 were less in five of the six categories of IT services than the outside vendors that were included in survey. The only service where SJI's IT charged more than the outside vendor average is Helpdesk Support. This is likely because of the costs associated with implementing the new work request system, Altiris. Overland also obtained the Gartner 2012 IT Benchmarking Survey. This survey showed that the SJI has a lean IT department compared to other participants in the survey. Because the IT function at SJI is investing heavily in new technology, the Company is shown to employ more consultants and spend more financial resources on capital projects than the benchmark in this survey. (18-9 to 18-10)

Significant Subsequent Events

SJI Announced Executive Promotions and an addition to the Executive Team

On November 20, 2012, Edward J. Graham, Chairman, President and CEO of South Jersey Industries announced, on behalf of the board of directors, several organizational changes effective January 1, 2013 as follow:

- Michael J. Renna was appointed Senior Vice President of SJI.
- Jeffery E. DuBois was appointed Senior Vice President of SJI.
- David A. Kindlick was appointed Senior Vice President and CFO.
- Stephen H. Clark was appointed Vice President, Finance and Regulatory Affairs.
- Kenneth A. Lynch was appointed as Chief Accounting Officer.
- Christine Mari Mazzola was appointed Assistant Vice President.

On March 22, 2013 SJI announced that Kathleen A. McEndy was elected Vice President, Human Resources by the SJI Board of Directors.

SJG filed a Petition to Implement an Accelerated Infrastructure Replacement Program to Replace the Annual Capital Investment Tracker.

On July 2012, SJG filed a petition to implement a five-year, \$250 million Accelerated Infrastructure Replacement Program (AIRP) to replace the annual Capital investment recovery Tracker CIRT. In February 2013, the NJBPU and SJG executed an agreement for incremental capital spending under the AIRP of \$35.3 million per year for the next four years, totaling \$141.2 million.

Moody's Upgrades the Rating of SJG

On August 14, 2012, Moody's Investor Service upgraded by one notch the senior secured and senior unsecured ratings of its subsidiary, South Jersey Gas, to A1 and A3, respectively. See Chapter 9 – Finance, Risk Management, and Cash Management for more detail.

SJI Amended its Credit Facility

In February 2013, SJI amended its revolving credit facility with a syndicate of banks to increase the available credit by an aggregate \$100.0 million, to a total of \$400.0 million. The maturity was also extended to five years from effective date of the amendment, to February 2018.

SJI Interview List

Date	Interviewer Name	Interviewee Name	Interviewee Title	Subject Matter
9/24/2012	Howard Lubow / Ryan Pfaff	Lynda Truitt	Manager Gas Supply & Transportation Services	Gas Supply
9/24/2012	Robert Welchlin / Chadwick Epps	Mike Halter	Vice President - SJESP	Appliance Services
9/25/2012	Chadwick Epps	Steven Cocchi	Director, Rates and Revenue Requirements	Legal Services, EDECA Standards, and Affiliate Relationships
9/25/2012	Robert Welchlin	Stephen Rulis	Manager - Facilities	Facilities and building services
9/26/2012	Howard Lubow / Gregory Oetting	Thomas Bracken	Chairperson of SJI Board's Corporate Responsibility Committee	Operation of the SJI Board and Committee, Government Relations, and Code of Ethics.
9/26/2012	Howard Lubow / Gregory Oetting /Chadwick Epps	Keith Campbell	Chairperson of SJI Board's Compensation Committee	Executive Compensation and Board Member Relationships
9/26/2012	Robert Welchlin	Marie Schaffer	Manager - Administrative Services	Purchasing, materials management and fleet services
9/27/2012	Howard Lubow / Gregory Oetting	Sheila Hartnett- Devlin	Chairperson of SJI Board's Audit Committee	Audit and Finance - related Matters
9/27/2012	Howard Lubow / Ryan Pfaff	Tim Rundall	Director Gas Supply & Allocation	Gas Supply & Off-System Sales
9/27/2012	Robert Welchlin	Thomas Kavanaugh	Controller	Services provided by SJG to affiliates, service company and parent company charges to SJG; general affiliate transactions accounting and payment issues.
10/9/2012	Robert Welchlin	Paul Zuccarino	Director, Construction Services	Construction and operating activities, contract performance
11/13/2012	Ryan Pfaff	Peter Parillo	Director Internal Audit	Internal Audit & Sarbanes-Oxley
11/13/2012	Chadwick Epps	Sharon Pennington	Vice President and Chief HR Officer	Executive Compensation, Organizational Structure of HR, Union Negotiations
11/13/2012	Robert Welchlin	Louis DeCicco	General Manager - SJ Energy	South Jersey Energy operations and transactions with affiliates
11/13/2012	Robert Welchlin	Thomas Kavanaugh	Controller	Working session - Service company accounting and allocation issues.
11/13/2012	Robert Welchlin	Michael Palogruto	Staff Accountant	Working session - Service company accounting and allocation issues.
11/13/2012	Robert Welchlin	Shawn Denz	IT Enterprise Architect	Working session - Service company accounting and allocation issues.
11/14/2012	Ryan Pfaff	Mike Halter	Director Environmental Affairs Department	Environmental Remediation
11/14/2012	Ryan Pfaff	Steve Clark	Treasurer - SJI & SJG	Finance
11/14/2012	Robert Welchlin	Greg Nuzzo	Vice President - SJ Energy Solutions	South Jersey Resources operations and transactions with affiliates
11/15/2012	Gregory Oetting	Walter Higgins III	SJI Lead Independent Director and the Chairperson of SJI Board's Governance Committee	Corporate Governance; Board member Selection and Assignment
11/15/2012	Chadwick Epps	Kathy Carl	Director - Human Resources	Corporate Organizational Structure, Employee Performance & Development (non-union)
11/15/2012	Chadwick Epps	Kathy Casella	General Manager - Compensation & Benefits	Allocation of HR services, employee compensation, incentives & benefits
11/15/2012	Robert Welchlin	Anthony Pezzulo	Director - Work and Process Management	Excavation damage prevention
11/16/2012	Chadwick Epps	Kristy Calo	Manager - Diversity & Recruitment	Recruiting, hiring, transfers, diversity, etc.
11/29/2012	Howard Lubow / Ryan Pfaff	Tim Rundall	Director Gas Supply & Allocation	Gas Supply & Off-System Sales (continuation of September 27 interview)
1/8/2013	Robert Welchlin	Joseph Rodio	Director, Customer Service	Customer service organization, operations, activities and costs
1/9/2013	Howard Lubow/ Ryan Pfaff	Joe Schneider	SJG General Manager, System Engineering & Planning	Gas System Constraints, Engineering Standards
1/9/2013	Howard Lubow/ Ryan Pfaff	Christian Castronova	SJG Director, System Integrity	Integrity Management Programs
1/10/2013	Howard Lubow/ Ryan Pfaff	Charles Dippo	SJG Senior Vice President , Engineering Services & Systems Integrity	Gas System Design, Gas System Planning
1/10/2013	Ryan Pfaff	Thomas Kavanaugh	SJG Controller; SJI Services Treasurer	Accounting and Property Records
1/22/2013	Chadwick Epps/Howard Lubow	David Kindlick	Senior Vice President and Chief Financial Officer	Finance Officer Responsibilities, Credit Ratings, Equity Analysts, Dividends, Earnings Performance, Rate Regulation
1/22/2013	Chadwick Epps/Ken Tatum	Kathy Casella/Kathy Carl/Kristy Calo	GM Comp & Benefits, Director of HR, Mgr. - Diversity and Recruitment	Allocation of Compensation Expense to Affiliates, Employee Training, Employee Benefits
1/22/2013	Chadwick Epps/Howard Lubow	Kevin Patrick	Vice President - Research and Corporate Development	Mergers & Acquisitions, Marcellus Shale, Compressed Natural Gas, Non-Regulated Activities
1/23/2013	Chadwick Epps	Thomas Hewitt	Manager - Insurance	Insurance Policies, Benchmarking
1/23/2013	Chadwick Epps	Robert Kimble	President of the Local 1293	Union Relationship with SJI and Affiliates
1/23/2013	Chadwick Epps	Laurence Powell	President of the Local 76	Union Relationship with SJI and Affiliates
1/23/2013	Chadwick Epps	Kris Smith	Director - Information Technology	IT Systems, Disaster Recovery, Help Desk Function
1/24/2013	Robert Welchlin	John Stanzola	Director, Regulatory Affairs	External (government and regulatory) affairs activities
3/4/2013	Robert Welchlin	Billie Jo Berry	Manager, Customer Accounting, Billing, and collection	Customer billing and collection
3/27/2013	Ryan Pfaff	Kenneth Lynch	SJI Chief Accounting Officer and the Chairman of SJI Risk Management Committee	Accounting, Risk Management
3/27/2013	Howard Lubow / Gregory Oetting	Edward Graham	Chairman, President and CEO of SJI	Corporate Governance, Executive Management, and Strategic Planning
3/28/2013	Ryan Pfaff	Robert Fatzinger	SJG Senior Vice President, Customer & Distribution Operations	Distribution Construction, Safety Programs, Leak Repair
3/28/2013	Howard Lubow / Gregory Oetting / Ryan Pfaff	Jeff DuBois	SJG President	Utility Budgeting, Gas Operations, and Interaction with Board.
3/28/2013	Howard Lubow / Gregory Oetting /Chadwick Epps	Gina Merritt-Epps	General counsel and Corporate Secretary	Status of Legal Matters, Code of Ethics, and Administration of Legal Department
3/28/2013	Howard Lubow / Gregory Oetting / Ryan Pfaff	Jeff DuBois	SJG President	Utility Budgeting, Gas Operations, and Interaction with Board.

Note: All Interviewees' titles were as of the date of interview.

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2	Affiliate Relationships and Transactions/Affiliate Transfers	1	Various	Payments By SJG on Behalf of Affiliates – Apart from off-system sales of gas, most of the billings by SJG to affiliates during the audit period were to obtain reimbursement for payments SJG made to vendors on behalf of the affiliates. Overland understands there are efficiencies achieved by having a single affiliate pay for vendor services provided to multiple affiliates. However, the parent company, SJI, or the service company, SJIS, should fund these payments and seek reimbursement from subsidiaries, not the utility.
2	Affiliate Relationships and Transactions/SJESP	2	2-41	Appliance Services – SJESP - SJESP should add the disclaimers to the front page of its website in accordance with EDECA Standards Section 14:4-3.5(k).
2	Affiliate Relationships and Transactions/SJESP	3	2-25	Cross Subsidization – SJESP - SJG should charge SJESP for its use of company garages to maintain SJESP vehicles. SJESP should also be charged for its use of a storeroom in SJG’s materials and supplies storage facility.
2	Affiliate Relationships and Transactions/MAS	4	2-34	Cross Subsidization – MAS - Overland recommends modifying the Services Agreement between SJG and MAS to remove the requirement that SJG bear any risk relating to any liquidation of MAS. Specifically, the requirement that SJG pay “reasonable costs” in the event of a “termination for convenience” should be removed. If SJG successfully argues to the NJBPU that modifying the agreement is not possible, we recommend the NJBPU prevent such costs from being passed on to SJG’s ratepayers by prohibiting SJG from recording them, should they be incurred, in regulated, above-the-line accounts.

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2	Affiliate Relationships and Transactions/MAS	5	2-30 to 2-31	Competitive Bidding – MAS – Given the circumstances under which MAS obtained its most recent contract to provide meter reading to SJG and Atlantic City Electric (ACE), we recommend the BPU do the following: 1) Enforce the “re-bid” price of[Begin Confidential] [End Confidential]cents per read, which essentially represents MAS’s match of a lower initial bid by competitor Accu-Read, and ensure that it has not been adjusted to a higher price since the contract went into effect. 2) Prohibit MAS from “negotiating” with SJG to raise its price at the end of year three of the five year contract in order to recoup the revenue lost by having to resubmit its initial bid at a lower price. 3) Given the inherent conflict of interest between MAS and its utility customers created by common ownership, monitor all future MAS contract bid processes to ensure that they are competitive and impartial, or limit the amount of meter reading expense incurred from MAS that SJG records in above-the-line (regulated) accounts to either a) a price based on cost plus a regulated investment return or b) the inflation-adjusted amounts in the re-bid price-per-read submitted in the current contract.
2	Affiliate Relationships and Transactions/MAS	6	2-30 to 2-33	EDECA Compliance and Competitive Bidding – Millennium Account Services - Given that MAS’s owners have had complete control of MAS’s pricing and that the pricing has never complied with the traditional regulatory pricing standard for affiliate services (lower of cost or market), Overland recommends SJG document and demonstrate the benefits it currently receives from its relationship with MAS. Specifically, we recommend SJG file testimony and cost-benefit data in its next rate proceeding supporting the assertion that, under the pricing and terms of its current Services Agreement, SJG continues to benefit in the form of a net savings from paying MAS to read its meters.

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2	Affiliate Relationships and Transactions/MAS	7	2-30 to 2-33	EDECA Compliance and Competitive Bidding – Millennium Account Services - EDECA Section 14:4-3.5(t)(6) requires that “transfers of services [to a utility] not produced, purchased or developed for sale on the open market” be priced at “the lower of fully allocated cost or fair market value.” Through ACE and SJG’s process of soliciting competitive bids in 2012, MAS adjusted the rates charged to the two utilities for meter reading services to reflect current fair market value. However, in order to fully comply with the EDECA regulation in this section, Overland recommends that MAS determine what its fully allocated cost would be to provide meter reading services to SJG and charge the utility the lower of fully allocated cost or fair market value, ensuring compliance with this EDECA standard. If MAS is unable to comply with the standard, Overland further recommends that the NJBPU prevent amounts charged to SJG that exceed the lower of fully allocated costs or fair market value from being passed on to SJG’s ratepayers by requiring SJG to record the excess charges below-the-line.
2	Affiliate Relationships and Transactions/Prior Audit Recommendations	8	2-40 to 2-43	Prior Audit Recommendations - SJG should encourage the BPU to rule on relevant, outstanding issues from the 2005 audit and any matters that are contested in the current audit. For any recommendations not implemented, the company should file a status report with the BPU every three months until a final decision is rendered.
2	Affiliate Relationships and Transactions/EDECA Standards	9	2-36	EDECA Standards - SJESP Plumbing Service - South Jersey Energy Service Plus Plumbing Service should be listed as an RCBS in the SJG Compliance Plan.
2	Affiliate Relationships and Transactions/EDECA Standards	10	2-36	EDECA Standards - Millennium Account Services - Overland recommends that SJG list Millennium Account Services as an RCBS in SJG’s Affiliate Standards Compliance Plan.
2	Affiliate Relationships and Transactions/EDECA Standards	11	2-34	EDECA Standards - Millennium Account Services - Overland recommends that SJG terminate any joint advertising and marketing agreements that it has with MAS (including utility advertising shown on the side of MAS vehicles) in order to be in compliance with EDECA Standard 14:4-3.5(o)(2).

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3	SJI Cost Distributions	1	Various	SJI should immediately develop the reporting capability to show how costs incurred in the parent organization are incurred, by function (department) and cost type, how functional costs are directly charged and to what subsidiaries, which of the functional costs are pooled for allocation and how allocable costs by function are distributed to each subsidiary. The current reporting process does not provide an audit trail from costs incurred by function to the ultimate affiliates to which such costs are directly charged or allocated. Parent company cost allocation reporting should permit the identification, for each SJI function and major cost type (e.g. loaded payroll, outside services, etc.), of the costs that are directly charged to each subsidiary, and the costs that are allocated to subsidiaries through the MSF allocator. The applicable MSF allocation percentages and amounts allocated to each subsidiary should also be identified.
3	SJI Cost Distributions	2	Various	SJI should update and improve its Cost Allocation Manual to provide a complete description of the various steps involved in calculating the three-factor formula which is used to distribute a majority of the costs it incurs. A majority of the costs SJI incurs within the parent organization are allocated to subsidiaries through the Management Service Fee (MSF) using the three-factor formula. During the years 2009 through 2011, the three factor allocator distributed an average of more than \$10 million annually, more than three-fourths of which was allocated to SJG. Calculating the individual components of the formula requires multiple steps and involves assumptions, none of which are explained or justified in the CAM. SJI's CAM should be enhanced to include a full description of the steps and assumptions used to calculate the three-factor formula, including the basis for changing the amounts for assets, revenues, cost of service or payroll data as found in consolidating financial data or the books of individual subsidiaries. Any changes in the calculation, such as the change that occurred between the 2009 and 2010 allocation years in the way SJRG's and SJE's revenues were treated (pre-tax vs. after tax), should be separately highlighted in a section entitled "changes in calculation methods or assumptions from the prior year."

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3	SJI Cost Distributions	3	3-24	SJI should correct the template used to calculate the payroll component of the three-factor formula to prevent assigning payroll from unregulated holding company South Jersey Energy Services to the payroll component factor used to distribute costs to SJG. As explained in findings above, in calculating the payroll component of the three-factor formula, the calculation works such that a majority of payroll percentage from SJES that remains unassigned after amounts are "allocated out" is added to SJG's share of the formula's payroll component factor. SJES' payroll is not attributable to SJG, and therefore should not serve to increase SJG's share of the three-factor allocator's payroll component. SJI should correct this error in its three-factor formula worksheet template.
4	SJIS Cost Distributions	1	4-17 to 4-19	Overland strongly recommends that SJIS develop (or be required to develop) reporting that shows the following on a monthly and an annual basis: 1) SJIS costs incurred by function and account, 2) how functional costs are classified for distribution by cost distribution method (i.e. the amounts, by function, directly charged or allocated using each allocation method), and 3) how these SJIS functional costs are distributed and billed to each affiliate (i.e., show the amounts for each method allocated to each affiliate). It should go without saying; however, it is important to emphasize that the totals for each function in items 1, 2 and 3 above should tie with one-another, both on a monthly as well as an annual basis. That means either SJIS will have to incorporate the full cost collection and distribution process into one system, or perform the monthly analysis necessary to identify functional amounts as incurred, as pooled for distribution by method, and as distributed to each affiliate, such that the total amounts reported for each SJIS function at each stage of the process equal one-another for a given timeframe.
4	SJIS Cost Distributions	2	4-23 to 4-25	SJIS should improve support for allocation factors to include 1) support for current year (as opposed to previous years') factors for all allocators and 2) the input data used to calculate each affiliates share of all allocators.

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4	SJIS Cost Distributions	3	4-23 to 4-25	<p>SJI should improve Cost Allocation Manual documentation of the SJIS allocation process. Specifically, documentation in the CAM should be expanded to include the following:</p> <ul style="list-style-type: none"> • A description of the functions performed by SJIS at least equivalent to the descriptions contained in this report. Currently, the descriptions of “Services Provided by SJI Services, LCC, to SJG,” spanning parts of pages 9 and 10 of the CAM dated at year-end 2011, consists of a very limited amount of information. The CAM should list, by function, the responsibilities of each function equivalent to those listed in this Chapter, to provide a reasonable understanding of what services are actually provided to affiliates. • An end-to-end description of the process by which SJIS incurs costs, identifies them for direct charging or pools them for distribution, and distributes and bills them to affiliates, including the basis for various allocators used to distribute “billable to multiple clients” costs. To the extent current procedures remain in place (notwithstanding other recommendations discussed above), the CAM should describe how timecard data is collected and input into the Lawson system, and the other recurring journal entries required to produce an SJIS affiliate billing, and the purpose of each. In the current CAM, descriptions of various SJIS processes and items are scattered throughout the CAM and various exhibits and attachments. This scattered approach inhibits an understanding of the process as a whole.
6	Exec Mgmt & Corp Gov	1	6-5 to 6-6	<p>We recommend the SJI board maintain an up-to-date, comprehensive catalog of each board member’s experience on all corporate boards, including, but not limited to, committee assignments, committee chair assignments, lead independent director assignments, etc. Time periods served in each capacity should be tracked. Not only is this information needed in assessing compliance with NYSE rules, but it also important in determining the skill set that each director brings to SJI.</p>
6	Exec Mgmt & Corp Gov	2	6-6 to 6-7	<p>In the spirit of full disclosure, the company should reveal in its proxy statement the outside relationships that Directors Campbell, Hartnett-Devlin, and Petrowski have. As the board becomes aware of new relationships that could (by a reasonable person) be viewed as a conflict of interest, such relationships should also be disclosed in the company’s proxy statement. If applicable, the board’s rationale for concluding that any reported relationship is not an actual conflict of interest should also be disclosed.</p>

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6	Exec Mgmt & Corp Gov	3	6-6 to 6-7	We recommend that Directors Campbell, Hartnett-Devlin, and Petrowski recuse themselves from any discussions or decisions that the SJI board or its subsidiary boards or executive committees make concerning any matters involving the markets in which they have a specific outside interest and/or relationship. The same would apply to any other director whose outside relationships are specifically disclosed by the company. By doing this, concerns that such directors might not act in the best interest of SJI and its subsidiaries or that such directors might give preferential treatment to the companies in which they have an outside interest or relationship will be alleviated.
6	Exec Mgmt & Corp Gov	4	6-7 to 6-9	We recommend that the SJI Governance Committee and the entire board consider candidates who possess accounting expertise, especially those with a CPA or with CFO experience, when next adding or replacing current members. Accounting is the one area, of all key areas of expertise that the Governance Committee identified as being needed, that is missing from the current SJI board.
6	Exec Mgmt & Corp Gov	5	6-15 to 6-16	At a minimum, every other year, each SJI director should attend one external continuing education seminar, class, and/or conference on the topic of corporate governance and/or the utility industry. No more than two members should be given credit for attending any particular continuing education offering so as to encourage as much diversity of training as possible. This continuing education requirement should be disclosed in the company's annual proxy statement, and any member who fails to meet the requirement should provide a written explanation for his/her nonperformance in the proxy statement.
6	Exec Mgmt & Corp Gov	6	6-23 to 6-24	We recommend the Audit Committee charter be amended to specifically state that the independent accountants report directly to the Audit Committee. This will eliminate any ambiguity surrounding the matter and more directly observe the requirements of the Sarbanes-Oxley Act.
6	Exec Mgmt & Corp Gov	7	6-24 to 6-26	Until it is demonstrated that the growth in and level of SJI audit fees are reasonable, we recommend the Audit Committee either put the SJI financial statement audit up for competitive bid in an environment in which all qualified firms have a reasonable expectation of being awarded the work or significantly curtail future increases in audit fees from the incumbent firm, Deloitte & Touche.

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7	Strategic Planning	1	7-5	Overland recommends that SJI track its progress toward its goals in becoming an industry leader in the areas mentioned in its vision and mission statement by making more extensive use of benchmarking studies as a basis to more effectively demonstrate its progress.
7	Strategic Planning	2	7-6	Overland recommends that SJI document and retain balanced scorecard information for all of its employees, complete with the results of how the employee achieved the balanced scorecard objectives and the quantitative assessment of the employee’s level of achievement. This information should be retained for all years that are subject to SJI’s document retention policies and guidelines.
7	Strategic Planning	3	7-8 to 7-9	The SJI five-year strategic plan should include more of a forward looking view of how the utility will operate for the five years covered by the 2011 – 2015 Strategic Plan. Included in this view should be a more detailed assessment of any anticipated regulatory filings (e.g. rate case filings) and financial metrics as they relate to credit ratings (see Chapter 9 – Finance, Risk Management and Cash Management).
8	External Relations	1	8-5 to 8-6	SJG should record its share of corporate donations in below-the-line account 426.1, Donations Expense, instead of account 923, Outside Services Expense.
8	External Relations	2	8-2 to 8-3	The “government” component of GRA, handled primarily by the General Manager, Government and Community Relations, is a corporate function performed on behalf of SJI and all of its subsidiaries. SJI should consider incorporating this function in its parent organization or in SJI Services, instead of in SJG.
8	External Relations	3	8-4 to 8-5	The BPU should determine whether the costs incurred by employees in conducting legislative analysis, advocacy and “social investment” activities should be funded by ratepayers or by shareholders. To the extent the BPU determines that any of these activities should be funded by shareholders, SJG should record its share of the activities “below-the-line,” in FERC account 426.4 – Expenditures for Certain Civic, Political and Related Activities.
9	Finance, Risk Management and Cash Management/Finance	1	9-21 to 9-22	The balanced scorecard for the person responsible for the Finance Department should have specific objectives that cover all components within the Finance Department, specific and detailed metrics to describe the expectation of how the objective is to be achieved, and documentation of the actual result and a comparison to the expectation, which will determine the rating for that particular objective.

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9	Finance, Risk Management and Cash Management/Finance	2	9-8	The Company currently does not consider forecasted estimates of credit metrics in its decision-making process. The Company should develop these estimates based on internal financial forecasts and use these metrics to help guide its strategic planning decisions. This analysis should be reviewed by both senior management and the Board of Directors.
9	Finance, Risk Management and Cash Management/Finance	3	9-11 to 9-13	Representatives of SJI and SJG should conduct meetings with the rating agencies and BPU Staff to develop a plan to enhance current ring-fencing provisions to a level sufficient to ensure that SJG's credit ratings are more reflective of SJG as a standalone company and negative influences from the activities of SJG's affiliates are minimized.
9	Finance, Risk Management and Cash Management/Finance	4	9-17 to 9-18	The dividend policy for SJG should be revised such that SJG's dividends are not linked, directly or indirectly, to the financial performance of the unregulated affiliates.
9	Finance, Risk Management and Cash Management/Risk Management	1	9-32	It appears that SJI is in the process of implementing the use of the quantitative metric, Value at Risk (VaR), to measure trading risks. Since VaR is a widely used metric in the utility industry to measure company risk, SJI should strive to obtain the information necessary to measure its VaR so that it can monitor the company's risk over time and also benchmark it against other similar utility holding companies.
9	Finance, Risk Management and Cash Management/Risk Management	2	9-30 to 9-32	Mr. Lynch's balanced scorecard should contain more performance objectives that are considered stretch objectives. These objectives encourage the Risk Management function to reach higher standards of risk management relative to industry peers. Mr. Lynch's balanced scorecard should contain a description of how he performed against the objectives that were set for him at the beginning of each year.
9	Finance, Risk Management and Cash Management/Risk Management	3	9-29	SJI should more extensively use benchmarking data to compare its risk management function metrics to those of its peers.
10	Accounting and Property Records	1	10-4 to 10-5	Internal Audit should perform a focused review of the SJG Property, Plant and Equipment internal control procedures, particularly in regards to the retirement of SJG assets, to ensure that these controls are effectively designed and are being adequately followed.
10	Accounting and Property Records	2	10-12 to 10-13	The SJI Internal Audit department should make a concerted effort to develop more accurate budgets and it should regularly report the budget-to-actual variance of its audits to members of management.

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10	Accounting and Property Records	3	10-15	Given the increasing complexity of SJI's operations, as well as the increasing number of control deficiencies identified by SJI's external auditors, the Company should engage a third party to conduct an external quality review of the SJI Internal Audit Department.
10	Accounting and Property Records	4	10-16	The Company should develop a comprehensive capitalization policy that could be referenced by Company employees when making complex decisions about whether to record an expenditure as an asset or as an expense.
11	Gas Procurement and Supply/Gas Supply	1	11-16	SJG should develop, and make available on its website, a comprehensive manual that could be downloaded by third party marketers interested in providing service to customers in SJG's service territory.
11	Gas Procurement and Supply/Gas Supply	2	11-16 to 11-17	SJG should enhance the information available to customers on its website regarding third-party supplier options. This would include consumer protection information as well as specific guidance on how a customer could switch suppliers.
11	Gas Procurement and Supply/Gas Supply	3	11-19 to 11-21	When conducting online auctions to enter into wholesale natural gas contracts, SJG should require a minimum of two bidders before awarding the contract to an affiliate.
11	Gas Procurement and Supply/Gas Supply	4	11-27 to 11-30	Regarding the additional controls implemented by the Company in response to the 2010 FERC investigation, SJI Internal Audit should perform a comprehensive review of these additional compliance measures implemented by the Company, and it should regularly test compliance with these controls every three years or more frequently if significant changes are implemented.
11	Gas Procurement and Supply/Gas Supply	5	11-27 to 11-30	The Company should annually file its FERC Compliance Manual with the NJ BPU, illustrating any changes from the previous compliance manual.
11	Gas Procurement and Supply/Gas Hedging	1	11-33 to 11-34	SJG should adhere to the established protocol of its non-discretionary hedging strategy. Specifically, SJG should remove the discretionary element of this program and it should increase the amount of supply that it hedges using this strategy so that it can hedge an amount closer to its stated goal of 20% of its supply requirements.
11	Gas Procurement and Supply/Gas Hedging	2	11-30 to 11-31	SJG should establish written performance expectations for its hedging program. These performance expectations should be compared to actual results to evaluate how well SJG's hedging strategies have performed, and they should be reviewed by SJG's Risk Management Committee on an annual basis.
11	Gas Procurement and Supply/Gas Hedging	3	11-36 to 11-37	SJG should establish documentation requirements for its discretionary hedging program. At a minimum, these documentation requirements should fully explain the Company's basis for entering into the hedge.

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11	Gas Procurement and Supply/Gas Hedging	4	11-36 to 11-37	SJG should consider significantly scaling down, or potentially even de-activating, its discretionary hedging program and utilizing alternative hedging strategies to achieve an adequate level of hedged gas supply.
11	Gas Procurement and Supply/Gas Hedging	5	11-37 to 11-38	SJG management should regularly consider the criteria for secondary transactions. This consideration should be formally documented and reviewed regularly by SJG’s Risk Management Committee at its quarterly meetings.
11	Gas Procurement and Supply/Gas Hedging	6	11-38	SJG’s Risk Management Committee should perform sensitivity and benchmarking analyses to test the effectiveness of its hedging program. These analyses should determine both how well SJG’s hedging program has been executed, as well as how well it has been designed.
12	Gas Delivery and Ops Mgmt.	1	12-14	The head of SJG’s Customer Distribution and Operations Department is the primary SJG officer in charge with maintaining a safe and reliable distribution pipeline system. We recommend that safety-related goals represent a minimum of 20% of this individual’s balanced scorecard.
12	Gas Delivery and Ops Mgmt.	2	12-15 to 12-18	SJG should institute a policy to repair Grade B Leaks within twelve months of discovery. This recommendation was originally made in SJG’s previous management audit, but it was not implemented.
12	Gas Delivery and Ops Mgmt.	3	12-19 to 12-20	SJG should integrate industry benchmark statistics into their performance targeting and should set performance targets at a “stretch” (aspirational) levels.
13	Contractor Performance	1	13-10 to 13-12	SJG’s key damage prevention metric is damages per 1,000 markout requests. We recommend that a goal to improve this statistic to “best in class” levels be reflected in the performance evaluations for employees directly responsible for damage prevention, including the Director of Work and Process Management and the Markout Coordinator.

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13	Contractor Performance	2	13-4 to 13-5	The division of gas system construction and maintenance functions between employees and contractors has remained constant for at least the last 12 years. Employees perform most routine maintenance while contractors perform essentially all construction. SJG has not conducted any studies of the costs and benefits of using employees vs. contractors since at least 2009. At least for the excavation location (markout) function, which is and has been handled by a contractor, the use of employees can be considered to be a best practice because it tends to provide better control over the process. Although it may be that the status quo continues to represent SJG's least-cost alternative, we recommend that SJG perform a high-level computation of the costs and benefits of each construction and maintenance function at least once every five years.
13	Contractor Performance	3	13-13 to 13-14	Objectives to achieve damage performance metrics; most importantly, damages per 1,000 locates, should be included in the Balanced Scorecards of all employees with responsibility for contractor safety procedures, especially employees with direct responsibility for overseeing the leak survey and damage prevention processes, including the Director, Work and Process Management (Anthony Pezzulo at the time of our audit) and the Markout Coordinator (William Tappin at the time of our audit).
14	Customer Service and Meter Reading	1	14-6 to 14-7	SJG should consider adding automated dialing and collection capability to its new phone and CIS system to enable it to initiate active collection efforts on past due amounts at an earlier stage in the account aging process. Currently available technology is capable of identifying past due accounts, dialing the associated customers automatically with payment messages, and facilitating the collection of payments from such customers over the phone, in many cases without the intervention of a live agent. This permits additional focus and effort to be applied to overdue accounts earlier in the aging process at a minimal incremental cost per collection attempt. Given that SJG is currently in the process of implementing a new CIS, we believe it is timely to consider implementing automated dialing and collection technology. Alternatively, SJG should at least ensure that its new CIS is designed with the capability of handling automated collection in the future.

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14	Customer Service and Meter Reading	2	14-13 to 14-15	Overland recommends that SJG establish performance targets for the following credit and collection statistics and add them to the balanced scorecard for the Manager, Customer Accounting and Billing: 1) arrearages over 60 and 90 days; 2) bad debts as a percentage of revenue; and 3) percentage of revenue recovered for accounts turned over to outside collection agencies. To the extent statistics are available from AGA surveys of arrearages and collection activities, the AGA statistics for peer companies should be used to establish benchmarks.
14	Customer Service and Meter Reading	3	14-7 to 14-11 and 14-13	Balanced scorecards for managers in the Customer Service function do not currently include performance targets for important department metrics. Assuming it is the responsibility of Customer Service managers to meet these targets, we recommend including them in the balanced scorecards for the Managers, Customer Service and Dispatch and Customer Accounting and Billing. Specifically, call answering, gas leak response, first call resolution, service appointments met and service representative courteousness and knowledgeable targets should be included in the balanced scorecard for the Manager, Customer Service and Dispatch. Targets for bad debts as a percentage of revenue, 60 and 90 day arrearage as a percentage of total outstanding accounts receivable, field collector productivity and percentage of revenues recovered by collection agencies should be added to the balanced scorecard for the Manager, Customer Accounting and Billing.
14	Customer Service and Meter Reading	4	14-13 to 14-15	As noted above in the Summary of Findings, SJG's disconnection rate is between one-third and one-half of its AGA Mid-Atlantic region peers. SJG should investigate the reasons that its disconnection rates are lower than its peers during a time when its bad debts as a percentage of revenue have been increasing. Based on this, SJG should determine whether its procedures for identifying and disconnecting non-pay accounts are appropriately aggressive. To the extent SJG's reliance on credit scoring may be causing it to leave non-pay accounts connected beyond the age that such accounts are disconnected by peer companies, SJG should adjust its procedures and perhaps increase the aggressiveness of its shut-off activities.

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14	Customer Service and Meter Reading	5	14-13 to 14-15	SJG should develop a written procedure describing the activities needed to systematically ensure that, to the extent possible, all customers eligible for energy assistance programs have appropriately identified and encouraged to apply for assistance. Further, the procedure should outline the processes and employee responsibilities required to ensure that all monthly billing credits due from the State of New Jersey under the State’s Lifeline program are appropriately processed and collected. SJG should ensure that to the extent permitted by law, its new CIS tracks energy assistance eligibility and participation.
15	Human Resources/Organization and Staffing	1	15-10	When Overland requested benchmarking data from SJI in the area of Human Resources recruiting, SJI’s response contained two benchmarking reports that were from October 2003 and April 2006. Assuming that the reports provided by SJI are used as benchmarks for Human Resources, then these reports should be updated on a yearly basis.
15	Human Resources/Workforce Management	1	15-11	SJI should ensure that each position in the company from the CEO to full-time entry level employees has an up-to-date job description documented and retained by Human Resources.
15	Human Resources/Compensation	1	15-15 to 15-17	SJI executives should incorporate more challenging base and stretch goals into their balanced scorecards in the future. This recommendation is based on the fact that SJI named executives in the 2012 Proxy achieved 95% of their performance targets.
15	Human Resources/Compensation	2	15-18 to 15-20	SJI should review the executive compensation peer group and choose companies that are relatively closer to SJI in size as well as other factors such as: utility vs. non-utility business, location, etc.
15	Human Resources/Training and Development	1	15-28 to 15-30	Overland found that some balanced scorecards from 2009 – 2011 were not filled out completely and the results of the scorecards were discussed informally between the employee and the supervisor. We recommend that all exempt employees have balanced scorecards filled out in their entirety and retained electronically in the employee’s file for future reference.
15	Human Resources/Training and Development	2	15-28 to 15-30	Overland recommends that mid-year reviews of employee performance be completed in their entirety, and formally documented, and retained electronically.
15	Human Resources/Benchmarking	1	various	In general, SJI Human Resources should obtain, and more extensively utilize, benchmarking data in order to improve the effectiveness and efficiency of the HR function.

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15	Human Resources/Labor Relations	1	15-39	SJI should strive to improve its relationship with the Local 76. Improving the relationship with the Local 76 might be achieved through consistent monthly meetings with the union as well as soliciting the help of outside facilitators to conduct relationship building workshops with the Company and the union.
16	Remediation Costs	1	16-5 to 16-6	The SJI Audit Committee should continue to perform annual reviews of the MGP Site remediation budget until all sites have been sufficiently repaired.
17	Support Services/Materials Procurement and Management	1	17-6	In response to discovery request OC-506, the Company indicated that it was “unable to quantify the dollar value of goods and services [other than gas materials] procured for SJG.” It stated that “payables information is not classified by goods or services, so there is not a way to pull this information directly.” The employees in charge of procurement activities should be able to quantify the purchases they make for an entity by type and by vendor. We recommend SJI and SJG take whatever steps are necessary to develop the capability to quantify the scope and dollar value of all managed procurement.
17	Support Services/Materials Procurement and Management	2	17-13	Most utilities gauge the performance and efficiency of their supply chain processes by benchmarking themselves against other utilities. Typical metrics include supply chain expense as a percentage of procurement spending, and various cost reduction and cost avoidance statistics. Survey-based benchmarking data covering supply chain activities is readily available. After it develops the capability to fully quantify the goods and services it purchases (as recommended above), we recommend SJG benchmark its supply chain costs and activities against peer utilities.
17	Support Services/Materials Procurement and Management	3	17-13	SJI indicated that it has not attempted to survey or implement any industry best practices in the supply chain area. We recommend SJG become familiar with, and to the extent feasible, implement, industry best practices for the sourcing of gas materials and other goods and services as well as inventory management.

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17	Support Services/Materials Procurement and Management	4	17-9 to 17-11	The McJunkin contract has not been rebid and its pricing has not been compared with other vendors since it was initiated in 2006. We recommend SJG benchmark the prices of outsourced gas materials procurement and storeroom management performed by McJunkin against other vendors. If benchmarking the price of equivalent services from other vendors is not possible, or if it shows that McJunkin is or may be a higher cost provider than other vendors, SJG should put the contract out for re-bid or at least use the benchmark results as a basis for negotiating cost reductions in the following year's Supply Agreement with McJunkin.
17	Support Services/Materials Procurement and Management	5	17-11 to 17-12	We recommend SJI and McJunkin adhere to all of the requirements of their Supply Agreement in the area of Key Performance Indicators (KPIs). Specifically, we recommend: A) McJunkin maintain and provide to SJG, in advance of discussions of annual performance, the "service-level KPI matrix" required in the Supply Agreement; B) McJunkin quantify cost savings at least annually, clearly show what the savings involve and how they were calculated, and show savings performance against the [Begin Confidential] [End Confidential] cost reduction baseline provided in the Supply Agreement; and C) SJG and McJunkin jointly review and reset KPI targets annually, as required in the Supply Agreement, and annually document the process of doing so. Our requests for the information covered in this recommendation resulted in no evidence that any of these requirements of the Supply Agreement were performed.
17	Support Services/Fleet Management	1	17-23	As is currently done by most utilities, we recommend the following: 1) SJI and SJG should track fleet costs and performance metrics at the per-vehicle and total function level, and 2) SJI and SJG should benchmark fleet operations and costs against peer utilities using a recognized benchmarking company such as Utilimarc and establish "best in class" performance targets using the benchmark statistics.
17	Support Services/Fleet Management	2	17-22 to 17-23	We recommend SJG begin to track the actual costs (ownership and operations) of its CNG fleet, and compare CNG ownership and operating costs with those of equivalent gasoline-powered vehicles.
17	Support Services/Facilities Management	1	17-25 to 17-27	We recommend SJG prepare lease agreements for SJI, SJIS and other affiliates that utilize SJG-owned facilities such as Folsom. We also recommend that SJG invoice its affiliates monthly for rent and other facilities costs owed.
17	Support Services/Facilities Management	2	17-25 to 17-29	We recommend SJG track facilities costs at the facility level, particularly for the Folsom headquarters building, which is operated by SJG and at least two affiliates.

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17	Support Services/Facilities Management	3	17-25 to 17-29	With regard to the pricing of space at the Folsom building, we recommend SJG: A) Annually obtain and review support for its market-based pricing; B) Annually compare this with the fully distributed regulated cost of the Folsom facility, which should include the return on investment and related income tax associated with the rate-based value of the building; and C) Annually charge affiliates using any SJG facilities the higher of market or fully distributed regulated cost.
17	Support Services/Facilities Management	4	17-29	SJI and SJG should participate in the International Facilities Management Association’s (IFMA’s) facilities benchmarking program. SJI and SJG should benchmark facilities-based costs (prepared in accordance with the recommendation above) and facility operating characteristics with IFMA benchmark statistics and identify opportunities for improvements and reductions in cost.
17	Support Services/Legal	1	17-30 to 17-34	The Legal Affairs function should have its own cost center where it can track all SJI internal and external legal costs, as well as analyze budget and actual expenditures.
17	Support Services/Legal	2	17-34 to 17-35	The Legal Affairs function (or the leader of the function) should have a BSC that contains well-documented, unambiguous, and/or quantitative metrics upon which to base the achievement of stated objectives.
17	Support Services/Legal	3	17-34 to 17-35	The Legal Affairs function (or the leader of the function) should have a BSC that is updated and completed on a yearly basis.
17	Support Services/Legal	4	17-35	The Legal Affairs group should obtain benchmark studies to compare its operations to other companies to find where it can make its operations more efficient.
17	Support Services/Legal	5	17-36 to 17-37	The Legal Affairs group should employ a competitive bidding process when selecting the law firms it will use to provide SJI with outside legal counsel.
17	Support Services/Insurance/Claims	1	17-42 to 17-45	SJI should ensure that the data provided to the benchmarking surveys are consistent and accurate according to its Insurance Schedule, where SJI’s insurance policies are tracked.
18	Information Technology	1	18-9 to 18-10	Overland recommends that the IT department obtain benchmarking data to determine how the help desk function at SJI performs against SJI’s peers in the utility industry.
18	Information Technology	2	18-8	The IT Director’s Balanced Scorecard should contain more performance objectives that are considered stretch objectives. These objectives will encourage the IT function to reach higher standards relative to industry peers.

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