Executive Summary
Final Report on Focused Audit of NUI Corporation and its Affiliates
Docket No. GA03030213

Presented to the:

Division of Audits
New Jersey Board of Public Utilities

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I. Introduction

The New Jersey Board of Public Utilities (BPU or NJBPU) selected The Liberty Consulting Group (Liberty) to conduct a Focused Audit of NUI Corporation (NUI) and its subsidiaries. The audit scope included the examination of:

- Internal financial controls, financial integrity, and corporate accountability
- Reasons for poor non-utility investment performance and effects on Elizabethtown Gas Company (ETG)
- Adequacy of adequate separation between utility and the holding company to assure that ETG customers have not been exposed to non-utility risks
- Potential commingling of funds and resources, utility support to the parent
- Effects of NUI diversification on ETG's financial integrity and capital costs.

The specific focus areas established for this audit included:

Corporate Governance	Financial Interaction	Accounting/Property Records
Strategic Planning	Affiliate Transactions	Executive Compensation

II. Planning and Resource Allocation

The BPU approved NUI Corporation's petition to form a holding company in an order dated February 20, 2001 (the Holding-Company Order). The utility-services entity came to be called NUI Utilities, Inc. (NUI Utilities). Separate business units conducted NUI's gas distribution utility operations. NUI sold its New York, Pennsylvania, and North Carolina gas utility operations in 2002. It now has ETG and City Gas of Florida (CGF), along with much smaller gas-distribution operations in Maryland and Virginia. ETG has two-thirds of NUI's gas distribution customers At least eight other NUI subsidiaries conducted a variety of non-utility activities. They formed a major focus of Liberty's audit work.

A. Non-Utility Growth Plans

NUI planned to grow by acquiring small gas utilities in multiple states, beginning with CGF in 1988. By 1992 NUI questioned the wisdom of continuing this strategy. It stopped buying new companies in 1994, and had sold a number of its acquisitions by 2002. NUI is continuing a major gas pipeline project in Florida. The first phase is in operation. The project has not been profitable to date, primarily because planned gas-fired electricity generation has been delayed.

NUI's 1995 strategic plans showed three aggressive goals: a 15 percent per year growth in earnings per share, a 15 percent return on equity, and revenues of $1 billion per year. NUI expected this growth to come from non-utility businesses considered to be related to its core strengths as a utility-service provider. Energy trading and telecommunications formed important parts of its growth strategy.

NUI was especially enthusiastic about TIC, largely a commission-based seller of telecommunications equipment and US Postal Service expedited delivery services. NUI also saw bright prospects for NUI Telecom, a telecommunications service reseller to end users. Neither company ended up producing profits for NUI. TIC in particular performed very poorly. NUI originally purchased 49 percent of TIC in 1997. It purchased the remainder in 2001, believing that control of TIC's operations would improve its results. Losses continued and NUI shut TIC down after failing to find a buyer for it. NUI has also since sold NUI Telecom at a substantial discount to its original purchase price.

NUI also fared poorly in its plans to expand into the retail energy market. The Company sold its unprofitable competitive retail energy supplier, NUI Energy, in early 2003, after generating operating losses of $3 million (after taxes) in the first half of fiscal 2003. Energy Solution's energy service and consulting business also generated losses.

NUI also pursued international and environmental ventures. Energy and telecommunications in Eastern Europe typified NUI's international activities. Harbor dredging comprised its environmental venture. The performance of NUI's international and environmental ventures was disappointing as well. Despite considerable expenditures, NUI produced almost no sales or revenues, found no partners, and eventually secured no buyers.

NUI's lofty goal by 2000 was to transform itself from a small distribution company into a diversified business with much increased operational breadth and financial size. NUI made a significant personnel investment. It brought in new executives, most of them now gone. It spent nine person-years of employee time to change its culture. Even its compensation program used diversified energy companies and larger companies as a comparison base.

In the spring of 2001, NUI continued to target very aggressive growth:

- Doubling NUI value in five years (a compound growth rate of 15 percent)
- Executing transactions producing a 20 percent annual effect on financial performance
- Providing stockholder returns exceeding the rate of return of the S&P 500 companies.

Liberty found the NUI's goals for new ventures excessively optimistic, and the specific targets for existing NUI businesses inconsistent with its history and capabilities. In 2001, a Company consultant cautioned NUI, reporting that few companies had, in actual experience, matched the kind of performance that NUI was targeting.

Liberty also found that NUI did not inform itself well about the telecommunications market that represented a major growth area. NUI justified investments with market summary and prospect information that was outdated and inconsistent with industry conditions and prospects. More experienced competitors were already disappearing or reducing operations.

B. Utility Budgets and Resource Availability

ETG's capital needs have generally run at about $28 million per year. In September 2002, facing dwindling liquidity and increasing pressure from the financial community, NUI cut $11 million from NUI Utilities' capital budget on a publicly-expressed basis. This action was not consistent with the capital budget that the ETG advisory board had just approved. No effort was made to seek their input on the "cut" or even to inform them that it had happened. It was understood through specific agreement between senior NUI and NUI Utilities executives that there would be no cuts at all. Utility capital spending at the time of budget approval was expected to (and did) continue at the rate proposed before the September cut. Despite continuing to spend at higher amounts, NUI reports to the financial community through the spring of 2003 continued to show capital budgets at the lower amount. The NUI board did not address until July 2003 the gap between approved and actual spending that had been taking place since the start of the fiscal year.

Another interesting example of internal versus external budget information arose in September 2003. NUI executives had commissioned in August a study of major cost reductions. The goal was to improve earnings to meet investment analyst targets for NUI income for the coming fiscal year. It would take $26 million in cost reductions to provide enough earnings per share to meet analyst targets. Such cost reductions were not realistic.

The Company then faced a very significant and potentially mortal liquidity crisis. NUI executive management should not have focused on meeting unrealistic earnings targets in the midst of that crisis. That questionable focus did not, however, constitute the most significant problem with the effort. The study identified the extreme cuts needed to support earnings per share targets. The study specified personnel cuts of between 22 and 59 percent, which would have produced operating expense cuts of $27.7 to $52.3 million.

Liberty posed many questions about the study. An executive sponsor at NUI described the listed staff reductions as only "hypothetical." That explanation was not credible. Statements in the study evidenced a clear plan to make or to at least announce the making of significant cuts in personnel. Moreover, another senior executive separately reported to Liberty a cost-reduction plan that relied upon savings from early-stage reductions identified in the study. His report to Liberty did not describe the effort as hypothetical.

There was substantial investor interest in NUI's expected earnings for 2004, and specifically what cost-control efforts NUI would take to attain them. NUI held an investor conference shortly after its CEO departed in late September 2003. Many conference questions focused on plans to control operating expenses. There was skepticism surrounding perceived management delays in addressing operating costs. Liberty could not determine whether NUI actually intended the drastic, hasty, and potentially crippling cuts. NUI might merely have anticipated creating investor expectations of strong measures to support earnings estimates. Whatever the real intent, Liberty considers neither the intent to make the cuts nor the desire to create the appearance that they would be made to be consistent with prudent management.

Eventually, there were delays in preparation and approval of ETG's capital and expense budgets for fiscal 2004. For the past two years, therefore, utility management has been forced to operate under capital budgeting and personnel sizing constraints that impose substantial uncertainty, cause anxiety, and unnecessarily complicate the process of planning and providing utility service. It is quite unusual and moreover imprudent to permit such turmoil to persist for so long in utility operations.

Liberty did not perform the detailed reviews necessary to determine the efficiency and effectiveness with which ETG has delivered service. However, a summary examination of key trends showed no reduction in ETG's baseline levels of service delivery cost or effectiveness as NUI's financial difficulties increased. Changes in key areas of expenditure at ETG over the past several years match experience at New Jersey's two other gas-only LDCs.

C. Summary of Planning and Resource Allocation Conclusions

1. NUI's strategic planning for non-utility growth became unreasonably aggressive in the late 1990s, by incorporating a goal of growing at a rate far faster than general industry growth and by failing to provide clear, concrete means for reaching that goal.

2. Planning for NUI's non-utility businesses was unrealistically optimistic, too aggressive and outsized, and too broad for a company of its size and capabilities.

3. NUI's extremely aggressive assumptions about its growth engines did not have analytical foundations, and, in at least one case, ran contradictory to advice from its own consultant.

4. NUI's growth depended greatly on telecommunications successes; however, by early 2002 Company assumptions about the telecommunications market, the stability of market-opening regulatory measures, the inferences to be drawn by the withdrawal of competitors from the marketplace, and the level of its opportunities were poorly informed, and contributed to substantial losses on investments in that sector.

5. NUI exercised insufficient control over capital budgeting and reporting for its non-utility investments, failing to apply structured project selection criteria or established hurdle rates, and experiencing some failures to secure director approval, missing and untimely cost information entry, and failure to reconcile budgeted and actual costs.

6. NUI announced or prepared to announce arbitrary, unsupported actions regarding ETG capital and operating expenses and personnel. Its investor-community driven approach to managing the corporation produced actions not based on the needs of ETG, caused inappropriate uncertainty and turmoil for ETG, and failed to comport with standards of prudent management or good utility practice.

7. NUI's management did not keep the directors sufficiently informed about financial problems as they were developing, until after disclosure of intercompany balances in 2003.

8. Despite major, continuing non-utility financial problems, NUI did not curtail utility spending or resources, and experienced no noticeable degradation in service quality.

III. General Affiliate Issues

A. The Three-Part Allocator

The parent provided corporate administrative functions such as accounting, human resources, legal, and information technology to subsidiaries. NUI uses a three-factor formula to assign most costs incurred to provide shared overhead and support services. This factor consists of the equally weighted average of relative subsidiary labor, plant, and customers.

Liberty found that NUI overused the general allocator. NUI was engaged in aggressive non-utility expansion efforts. The substantial growth in headquarters staff and costs did not materially improve utility operations, but overuse of the three-part allocator caused ETG to pay for the strong majority of added support costs. NUI should have charged significantly more to non-utility operations. Good utility practice favors more direct means of charging or allocating when use of a general allocator is not a sufficient indicator of cost causation.

B. Office Space

NUI allocated office-space costs to affiliates, including NUI Utilities, on the basis of space actually used. Third-party rentals reduced costs to be allocated. Unoccupied space, however, did not. Utility operations should not be a residual source of payment of space that became vacant for reasons not associated with utility activities. ETG has borne an annual amount, roughly estimated at $500,000, which should not be allocated to utility operations.

C. Summary of General Affiliate Conclusions

1. NUI failed to capture adequately and allocate fully the costs that its non-utility operations have imposed, which has resulted in the allocation of excess costs to ETG. NUI also paid insufficient attention to developing proper overhead rates for its charges among affiliates.

2. ETG has borne and will in the future bear even greater responsibility for substantial rental costs, as more space in Bedminster and Union is rendered excess by non-utility operations reductions, that should be allocated to non-utility operations.

IV. Non-Energy Affiliates

A. Utility Business Systems

Utility Business Services, Inc. (UBS) provides print and mail services (billing), payment processing, a customer information system (WINS CIS), and data services for water and waste water utilities. UBS did billing and payment processing for NUI Utilities. Operations Applications and Services (OAS), which had been part of UBS, performs geographical mapping and tracking of utility distribution property. NUI has sought to sell UBS since July 2003. OAS, whose personnel came from NUI Utilities, was to be returned there.

UBS tried beginning in 1998 to develop a customer-information system for gas distribution companies. ETG was intended to be the first user. Development efforts continued into 2001, but ultimately failed. While they were underway, NUI Utilities transferred billing activities and personnel to UBS. NUI Utilities paid substantial sums for the development work. There was no written contract between the utility and UBS for that work.

UBS used corporate IT equipment, even before 1998. UBS continued to use the equipment until retiring it in 2001. UBS stopped paying use fees in 1998. There was no record of any equipment asset transfer from NUI to UBS. NUI offered inconsistent explanations for the lack of a documented transfer. NUI made no calculation of market value of the equipment when transferred. The value was likely nominal, given age and obsolescence considerations.

If NUI succeeds in selling UBS, NUI Utilities will require an agreement with the new owner to provide service for a transition period. NUI drafted such an agreement, which Liberty reviewed. NUI made changes to address Liberty concerns about service standards and technical contract issues. The agreement also contains economic terms that Liberty found unreasonable. Examples included sharply increased fees, a long term, and a right to very substantial early-termination fees for the service provider. Those terms were intended to produce a higher UBS sale price. NUI is now for sale. It should be made clear that any eventual acquirer of NUI Utilities will not recover early termination fees or service fees above specified levels. ETG customers should not bear excessive costs designed to increase the UBS sale price.

The portion of the NUI Utilities engineering group responsible for geographic-information system activities transferred to UBS to form OAS in July 1998. This group continued to develop system capabilities begun as part of utility operations, and it began to sell those capabilities to third parties. The group also continued to perform work for NUI Utilities. It changed, however, from charging its actual costs to pricing work on the basis of estimated job costs that included a markup to allow OAS an opportunity for profit. Such pricing would not be considered appropriate for performance of an in-house utility operations function.

UBS and OAS have contributed a combined average of about $800,000 per year in pre-tax profits for the past five years. Since 1998, they have drawn substantial benefit from NUI's commingling of utility and non-utility financial resources. Their combined share of the intercompany payable balance has grown from $800,000 to $3.9 million.

B. Summary of Utility Business Systems Conclusions

1. UBS and OAS produced moderate operating profits; their operations were funded from commingled resources, and ultimately NUI Utilities, for a total of about $3.9 million.

2. UBS received from an affiliate the transfer of at least the beneficial use of equipment for which it had previously made annual payments, without documenting any formal asset transfer and without continuing to pay appropriate fees.

3. UBS provided services to NUI Utilities with no written agreement, making it impossible to establish responsibilities, pricing, duration, or other material terms and conditions.

4. UBS services for NUI Utilities came without any analysis of marketplace alternatives.

5. NUI's draft agreement under which a UBS purchaser would provide transitional services to ETG provided for excessive costs; measures need not be taken to amend the agreement, but should be taken to assure that ETG customers do not bear such costs.

6. NUI inappropriately permitted NUI Utilities to fund the development of a customer-information system intended for sale in the open market.

7. OAS was permitted to appropriate without compensation utility-created intellectual property that it used as a basis for services sold to third-parties.

8. NUI Utilities engineering-services resources performing an in-house utility function at cost were transferred to OAS non-utility operations, after which pricing inappropriately changed to cost plus a mark-up, in order to provide a profit margin for NUI's non-utility businesses.

C. NUI Environmental Group

NUI Capital (an NUI subsidiary) formed NUI Environmental Group, Inc. (NUI Environmental) in fiscal 1996 to develop a decontamination solution for sediment dredged from the NJ/NY harbor area. NUI Environmental completed in fiscal 2001 a $485,000 pilot study project. NUI began to seek a buyer for NUI Environmental in September 2002. None has been found and NUI halted the operations of this subsidiary as of June 30, 2003. NUI Environmental had negative annual net income (of about one $500,000 to $1.5 million) since 2000. NUI made substantial use of the common NUI cash pool. Its intercompany payables balance grew from zero in September 1997 to about $6.5 million at June 30, 2003.

D. Summary of NUI Environmental Conclusions

1. NUI Environmental has produced little income and steady losses since its creation. Its operations have benefited substantially from NUI's commingling of utility and non-utility financial resources, at a cumulative total of $6.5 million.

2. NUI Environmental had no material transactions with affiliates, other than by the general allocators used to account for support services from NUI.

E. TIC Enterprises

TIC Enterprises, LLC (TIC), an NUI Capital subsidiary, provided commissioned sales and marketing primarily of telecommunications equipment for various businesses. NUI purchased 49 percent of TIC in 1997. TIC sold equipment, local and long-distance service, cellular phone service, and network services in the telecommunications industry. TIC also provided an outsourced sales force for U.S. Postal Service expedited delivery services. TIC incurred substantial expenses to grow a sales force, but experienced significant reductions in its business.

NUI acquired the remainder of TIC in May 2001. NUI Capital believed that acquiring operating control of the business would allow it to reverse sizeable losses. During two full years of operation under NUI control, TIC lost $12 million (2001) and $31 million (2002). NUI shut down TIC operations (excepting limited business lines transferred to NUI Telecom) after failing to find a buyer, making all of its investment and the substantial operating losses unrecoverable.

TIC sold just over $1 million worth of telecommunications equipment and services to NUI, which used them to provide common services to affiliates, including ETG. NUI did not charge TIC for common overheads or services for 2001, and did not file with the BPU the equipment sale and service agreements.

A substantial portion of the funding to cover TIC investment and operating losses has come from NUI's common cash pooling arrangement. TIC's share of the intercompany balance peaked at $21.2 million at June 30, 2003.

F. Summary of TIC Conclusions

1. TIC has produced crippling operating and write-down losses since its creation.

2. TIC's operations received major support from NUI's commingling of utility and non-utility financial resources.

3. NUI failed to require TIC to operate its business with affiliates: (a) in compliance with the Holding-Company Order requirement for reporting administrative service agreements, and (b) in a manner permitting verification of the reasonableness of need and costs.

4. Failure to make proper allocations of corporate costs to TIC caused ETG's operating costs in the test year from the most recent base rate case to be excessive by an amount of $300,000.

G. NUI Ventures

NUI formed Ventures in 1996 as a unit of NUI, not as a separate subsidiary of NUI Capital, to centralize development of projects and new business opportunities, and take peripheral businesses out of NUI Utilities. NUI Capital organized NUI International, Inc. (International) to explore international business opportunities. NUI shut down International and Ventures in September 2003. Ventures held oversight responsibility for International and two NUI Capital subsidiaries (Environmental and UBS), and for a fuel-cell project.

NUI's interest in international opportunities began in 1998, and focused on Russia and several other Eastern European countries. The projects examined eventually included gas exports, a trans-Siberian fiber optic backbone, compressed natural gas as an automobile fuel, and gas trading. NUI did not seek to invest its own capital at material levels, but to parlay its experience and contacts into equity interests in ventures that would be funded by partners.

None of the NUI Ventures projects, including those of NUI International, produced revenues. NUI Ventures lost an average of somewhat more than $1 million per year across six years of operation. NUI Ventures also generated an $8.5 million intercompany payable.

H. Summary of NUI Ventures Conclusions

1. NUI Ventures and NUI International have produced steady losses since their creation. NUI Ventures' gained significant advantage from the commingling of NUI's utility and non-utility financial resources. It accumulated an intercompany payable of about $8.5 million.

2. NUI Environmental did not have material transactions with affiliates, other than those resulting from the use of the general allocator used to account for NUI support services.

I. NUI Telecom

NUI Capital acquired a company known as ITG in November, 1999. It later changed the name to NUI Telecom, Inc. (Telecom). This affiliate provided telecommunication services to small and medium-sized businesses, primarily as a reseller. The purchase price ended up totaling $4.8 million. Telecom also operated similar businesses acquired later:

- Norcom, Inc., a provider in the Northeast and Southeast, acquired for $4.2 million
- Telcorp, Ltd., a reseller of advanced services, acquired for $7.2 million.

NUI Telecom took over responsibility for supplying a number of NUI telecommunications services. NUI allowed NUI Telecom to determine what portions of Company business to take over from third parties, without analyzing whether NUI Telecom was the most effective alternative. NUI has never had a written agreement with NUI Telecom, which exposed NUI Utilities to risk as the Company completed negotiations to sell NUI Telecom.

NUI Telecom operated as a subsidiary of NUI Capital for most of fiscal 2000, but NUI did not begin to allocate overhead and support costs to it until fiscal 2001. NUI's policy was not to change a fiscal year's corporate allocations after initial establishment.

NUI Telecom increased its operating revenues from $5.2 million in 2000 to $35.6 million in 2003. Vast increases in operating expenses, however, caused NUI Telecom nevertheless to suffer losses in each of these years, averaging somewhat over $2 million. Like the other non-utility operations, it has drawn substantial benefit from NUI's commingling of utility and non-utility financial resources. Its intercompany payable balance grew from $2.8 million in its first year of NUI ownership to $22.1 million by June 30, 2003.

In June, 2003, NUI approved a plan to sell Telecom. NUI recorded a write-down of $16.2 million in goodwill and intangible assets. Former members of ITG management recently purchased NUI Telecom. NUI received only a fraction of what it paid for ITG and the other companies combined into NUI Telecom.

J. Summary of NUI Telecom Conclusions

1. NUI failed to require NUI Telecom to operate its business with affiliates: (a) in compliance with the Holding-Company Order requirement involving reporting of administrative service agreements, and (b) in a manner that permits verification of the reasonableness and prudence of the need for and costs of goods and services provided.

2. NUI Telecom has produced losses since its creation. Its operations have been partially funded by the corporate cash concentration account, and ultimately NUI Utilities, for a cumulative total of about $22.1 million at June 30, 2003.

3. NUI failed to make adequate allocations of corporate costs for NUI Telecom. That failure caused at least $30,000 in excess operating costs to ETG during the test year used in its last base rate filing.

V. Financial Results and Credit Ratings

A. Financial Results

ETG has provided the bulk NUI's net income and dividends. ETG's annual net income has ranged between $12.8 and $21.1 million between 1998 and 2003. Across this period, net contributions from the other NUI gas-distribution operations have not been substantial.

During this same period, NUI invested heavily in non-utility businesses. NUI met with poor results in its non-utility ventures. The following Table shows the net income results that NUI reported to Liberty, by non-utility venture.

NUI Non-Utility Income Summary ($000)

	1998	1999	2000	2001	2002	2003
NUI Energy	($1,524)	$853	($669)	$1,315	($1,551)	($9,824)
NUI Energy Brokers	($125)	$2,347	$4,419	$7,562	$6,864	$2,685
NUI Telecom	-	-	($574)	($936)	($2,218)	($26,082)
TIC	-	-	-	($5,425)	($31,281)	($3,997)
Energy Solutions	($60)	($51)	($237)	($24)	($63)	($31)
NUI Capital	$864	$902	$1,111	($5,188)	-	-
UBS	$554	$471	$587	$917	$191	$528
NUI Ventures	($238)	($720)	($1,303)	($1,210)	($2,506)	($1,209)
NUI Environmental	($92)	($163)	($1,677)	($797)	($1,275)	($1,352)
Virginia Gas	-	-	-	$108	($401)	($487)
Saltville Storage	-	-	-	-	-	$109
TOTAL	($621)	$3,639	$1,657	($3,678)	($32,240)	($39,660)

Amounts are in thousands; 2003 amounts are not audited.

NUI's net cumulative equity investment in non-utility businesses reached $165 million through June 30, 2003. It fell to $140 million at the end of fiscal 2003. In addition to $75.5 million in operating losses from 2001-2003, NUI has experienced net income losses of $23.3 million from accounting-related write-offs for non-utility operations. Total losses of $98.8 million over three years represented over one-third of the total equity capital of NUI.

B. Capital Structure

ETG's common equity as a percentage of permanent capital structure at fiscal-year end ranged from 43.3 to 47.0 percent for the years of 1998 through 2001. An NUI common-stock issuance netted $37.2 million in March 2002. NUI allocated 100 percent of the proceeds to ETG. None went to its non-utility businesses or other utilities. NUI soon thereafter filed an ETG rate case. The filing included 100 percent of the equity increase produced by the sale of parent stock to the public. This assignment of all of the equity increase to ETG produced for ETG an equity level of 52.5 percent of permanent capital.

NUI did not retain this increased equity in ETG on a long-term basis. NUI recorded a "special dividend" of $31.9 million to NUI in June 2003. The explanation of NUI management was that dividends "should have been paid" in higher levels from ETG to NUI from 1996 through 2002. NUI therefore contributed "book equity" to ETG, filed and settled a rate case on the higher resulting amount of equity, and then removed much of the increase in 2003.

ETG never had effective use of a significant portion of the equity capital included in its 2002 rating case filing. Since the March 2002 NUI equity issuance, the inter-company balance owed by NUI to NUI Utilities did not fall below $54.7 million. This sum is far more than the $37.2 million in proceeds from that stock issuance. For the first year in which new rates became effective in New Jersey, ETG's share of the average balance owed to NUI Utilities was actually far greater. It was about $87.4 million.

NUI financial management at the time classified NUI debt to NUI Utilities as NUI Utilities equity. This designation had no significant meaning for ratemaking purposes. This paper "asset" did not represent one that ETG had access to in any tangible way. ETG had only the "IOU" left after NUI took cash assets out of the common cash-concentration account for use by non-utility affiliates. NUI recorded a charge against the equity capital in the full amount of the receivable due from NUI ($61.4 million) at the 2002 fiscal-year end. Management was reacting to its outside auditor's finding that the plans and cash situation of NUI did not include or permit paying back the receivable. This finding confirms that NUI Utilities/ETG should not for ratemaking purposes be deemed to have had the use of the equity funds related to the inter-company balance. Moreover, the failure to disclose the circumstances surrounding the balance is not defensible.

C. Credit Ratings

The decline in NUI Utilities' credit rating since September 2002 arose directly from the financial difficulties and reduced credit rating at NUI. Moody's has decreased NUI Utilities' credit rating from the A3 level all the way to the Ba3 level, six total ratings notches, in five separate ratings downgrades from September 2002 to October 2003. Moody's has been clear that its rating actions involving NUI Utilities reflect the parent's non-utility business risks and losses and the common management of NUI Utilities' financials and treasury operations with those of NUI. Moody's has also several times cited the free flow of funds across business lines and the sharing of central services. Moody's also cited the large payable from NUI to NUI Utilities in its October 6, 2003 downgrade of NUI Utilities.

NUI Utilities' downgrades therefore very clearly resulted from poor financial performance by non-utility ventures, and the financing and support that accrued to them because of the structuring of NUI Utilities credit agreements and the free flow of funds among all NUI entities. The credit-rating agencies rely on four key credit rating ratios in evaluating the financial strength of entities that they rate:

- Total debt to total capital percentage
- Pre-tax interest coverage
- Funds from operations as a percentage of total debt
- Funds from operations interest coverage.

NUI Utilities' own financial results and credit ratings statistics in each of these four categories remained strong, and would have independently supported investment grade ratings throughout the parent's financial struggles due to non-utility performance.

D. Summary of Financial Results and Credit Ratings Conclusions

1. ETG has remained consistently and solidly profitable across at least the past six years, while NUI's non-utility businesses have recorded crippling financial losses, which began to become apparent starting in 2001 and escalated thereafter.

2. No aspect of NUI Utilities/ETG performance on stand-alone bases contributed to NUI's financial distress, nor is there reason to believe that utility operations would have had financial problems absent affiliation with poor performing non-utility businesses.

3. NUI Utilities' credit rating declines to below-investment-grade level were specifically due to financial problems at NUI's non-utility entities and NUI's financial management.

4. The capital structure presented by ETG in the 2002 rate case constituted an improper basis for establishing rates, and resulted from a confusing reporting structure and failure to disclose circumstances that were relevant to the BPU's consideration of the increase request.

5. ETG customers have paid between \$3.4 million and \$5.5 million more annually in rates since the effective date of ETG's last base rate case, in comparison with what would have been the most likely rate case results, had NUI candidly reported its actual equity circumstances at the time.

6. Following the \$61.4 million charge against NUI Utilities' equity following an outside audit, NUI Utilities/ETG's equity levels fell too low to conform to good utility practice; repayment of the intercompany balance after a November 2003 refinancing remedied this deficiency.

7. NUI Utilities would have maintained a strong, investment grade credit rating if it had been properly insulated from NUI.

E. Cash Pooling

Prior to August 2003, NUI operated a single corporate cash pool for the holding company and for all of its subsidiaries and business units, both utility and non-utility. ETG's revenue flowed into this single NUI cash pool, or bank concentration account, along with all other utility revenue and receipts. The receipts of all NUI entities also flowed into this same, single pool. Disbursements by all NUI companies also came from this single NUI pool. This situation allowed NUI's non-utility businesses to continually secure funding from the single corporate cash account, from which NUI paid invoices for all its entities.

NUI did not settle on a regular basis the inter-company balances that resulted from this common pooling arrangement. The balances accumulated to amounts that were immense for an enterprise of NUI's size. The inter-company payable from NUI to NUI Utilities grew to \$190 million by March 2003. The total equity capital of NUI Utilities was only about \$270 million at this time. Only in 2003 did NUI begin to recognize, document, and start to address the inter-company balance.

As NUI's financial condition deteriorated, outside lenders demanded protection of their loans. At the same time, NUI's failure to set up loan agreements among affiliates was depriving its "lending" affiliates, principally NUI Utilities, of even the simplest of loan protections.

F. Summary of Cash Pooling Conclusions

1. NUI inappropriately commingled the funds of NUI Utilities and its non-utility affiliates by using a single cash pool that operated without sufficient controls and required NUI Utilities to make loans to affiliates that were unreasonable.

2. BPU holding-company approval in 2001 should have led to prompt efforts to segregate cash management, restrict or prohibit inter-company transfers and loans, and set in place specific procedures and rules for settling inter-company balances; NUI failed to take the actions reasonably necessary to comply with the order.

3. Management's failure to adopt prudent practices and protections for credit agreements and receivables balances put NUI Utilities, as an NUI creditor, at considerable disadvantage when compared to NUI's outside creditors in recovering funds lent.

G. Deferred Payment Gas Supply Contracts and Settlements

By March 2001 NUI was already using all of its committed lines of credit and about 40 percent of the maximum amount available under its discretionary lines. NUI, already financially extended, faced the prospect of significant additional financing needs for:

- Filling ETG's gas storage from April to October
- The purchase of Virginia Gas
- The purchase of the remaining 51 percent of TIC.

NUI EB, the affiliate that provided a number of gas-portfolio services to ETG, determined that Enron, then NUI EB's largest trading counterparty, might be interested in a deferred payment arrangement for supplying storage gas. NUI Utilities entered agreements with Enron for gas purchases through October, with payments beginning in December, and a swap. The swap provided for NUI to exchange monthly agreement prices for published index prices. Therefore, if the fixed price in the agreement fell above the eventually reported index price, Enron would pay NUI the difference. If the index price proved to be the higher one, then NUI would pay Enron the difference. NUI had protection if the market would drop; Enron had it if the market would rise.

NUI's capability to finance all of its utility needs and non-utility investment plans would have been at substantial risk during the summer of 2001, if it had not been for the Enron transaction. Short-term debt would have reached $236 million in July 2001 under normal gas-payment arrangements. NUI would, at best, have exceeded its existing credit lines by about $3.5 million. As it was, NUI continued to experience credit capacity and liquidity problems in late 2001, even with the $49.8 million of temporary financing from Enron and the issuance of $60 million of Senior Notes by NUI in August 2001.

ETG also arranged for storage gas purchases with payment deferrals in 2002 and 2003, mainly through Occidental. ETG should not have included interest costs incurred for deferring Enron and Occidental payments for customer recovery through the BGSS mechanism. Liberty measured the interest that ETG paid in the Enron transaction at $2,254,704, by applying to the purchased volumes the difference between the fixed price of the swap agreement and the final fixed contract price for the gas purchase. Occidental 2002 and 2003 interest amounted to $416,427 (2002) and $486,202 (2003). The total amount to be charged to ETG customers for such interest-related costs therefore amounted to $3,157,333.

Enron told the NUI EB president in November 2001 that it needed advance payment on the amounts that ETG owed Enron in deferred payments. NUI EB eventually negotiated a settlement. The settlement agreement produced a strikingly inappropriate NUI transfer of value from ETG to a non-utility affiliate. Moreover, it came on the heels of a financing arrangement that provided temporary financing for NUI at significant additional expense to ETG customers.

In late November 2001, ETG owed Enron a net total of $49.3 million for the gas purchased on a deferred-payment basis. Payments were due from December 2001 through April 2002. Enron at the same time owed NUI EB and NUI Energy $4.8 million on separate agreements not involving ETG. Enron's mounting financial troubles caused it to lose its investment-grade credit ratings as of November 28, 2001. The downgrade produced collateral calls on many of its energy trades and hundreds of millions of dollars in debt defaults. Participants in energy markets knew that Enron's circumstances had become critical. Enron declared bankruptcy three days later.

ETG had title to and possession of the gas it purchased from Enron, which it held in storage by this time. ETG would certainly have to pay Enron for the gas, but it is not clear what theory would require even an advancement of the payments for which it had contracted in the ordinary course of business, and well prior to Enron's financial collapse.

ETG's ability to advance payments to a company desperately needing cash to meet collateral calls and other creditor claims offered significant value to Enron. NUI EB and NUI Energy, in contrast, found themselves facing only exposure (as unsecured creditors) from Enron's problems. They had nothing to offer Enron, which owed them $4.8 million. A very substantial portion of that amount, perhaps all of it, was highly likely to become uncollectible. The settlement NUI EB negotiated gave it and NUI Energy recovery of 100 percent of the $4.8 million. NUI EB also kept a net deal margin of $669,000. NUI did not share any portion of the $4.8 million or of the $669,000 with ETG.

NUI credited none of the reduction to ETG, despite the fact that the only thing of value that NUI collectively offered to Enron was ETG's obligation to make those payments. NUI EB and NUI Energy also received 100 percent of the $4.8 million Enron owed them. The most they were likely to receive absent a settlement was half the face amount. It would at the time have been reasonable to consider the substantial possibility they would receive close to nothing. Only the very large ETG net payable to Enron gave NUI leverage with Enron. NUI should therefore have credited at a minimum at least half of the face value of the $4.8 million to ETG and it should have credited all of the $669,000 to ETG.

ETG actually ended up incurring more than 100 percent of all the amounts it owed to Enron. It paid NUI EB (through interest charges on the inter-company balance) interest on a deferred payment plan that ETG never even got to fully use. NUI assigned ETG a payable obligation of the full amount of $49.3 million to NUI EB in December, 2001. Effectively, therefore, ETG did not get to make its payments from December 2001 through April 2002, but had to make them in a lump sum in December 2001. ETG therefore lost the time value of money for which it paid. What is particularly egregious is that ETG, after already being charged the full amount of the Enron contract, now also had to pay the intercompany interest rate on its payable to NUI EB. NUI financial management thus effectively required ETG to pay interest on money that it had borrowed in the first place. Part of the actual funding to pay Enron came from an NUI Utilities bank loan with First Union.

H. Summary of Conclusions about Deferred Payment Supply Contracts

1. ETG paid interest charges for deferring payments for storage gas; the interest costs, which were inappropriately included in the BGSS mechanism, were $2,254,704 for 2001, $416,427 for 2002, and $486,202 for 2003; ETG's future BGSS recovery should be reduced by $3,157,333.

2. ETG provided the leverage that produced the Enron settlement agreement in November 2001, but NUI inappropriately assigned the financial benefit of the settlement to NUI EB, and made other, inappropriate charges to ETG. Future ETG BGSS recovery should be reduced by at least $3,097,961 for Enron settlement benefits that NUI inappropriately assigned to non-utility affiliates.

I. Credit Facilities Usage

NUI secured working capital funding for utility use at the parent level through November 2001. In December 2001, NUI first established a separate, $145 million revolving line of credit for NUI Utilities with a group of banks. Concurrently, NUI replaced $232.5 of short-term parent borrowing with a much smaller, $80 million, revolving line of credit. The same group of banks provided the new NUI Utilities and NUI parent lines of credit.

NUI immediately drew down the entire $145 million of available NUI Utilities credit, and placed the funds in the single NUI cash pool. NUI then immediately used funds from the cash pool to pay down NUI short-term borrowings. The parent's short-term debt effectively was "reassigned" to NUI Utilities, but NUI Utilities did not receive the corresponding cash. NUI Utilities instead received an "IOU" in the form of an Inter-company receivable. The "reassignment" of $145 million in short-term debt to Utilities, turned what had been a $61.2 million payable from NUI Utilities to NUI into a receivable to NUI Utilities from NUI. The receivables balance for Utilities did not fall below $54.7 million from the end of 2001 until its repayment following a major, November 2003 refinancing. It reached a peak of $190.1 million at the end of February 2003.

There has been little correlation between NUI Utilities' outstanding debt and utility cash needs since December 2001. Only consideration of non-utility funds use causes sources and uses of funds to match. The close correlation has been between the receivable due to NUI Utilities and the amount that NUI Utilities borrowed against its available credit. In other words, had there been no substantial inter-company receivables balance, NUI Utilities' working capital needs would have been significantly smaller.

J. Summary of Credit Facilities Usage Conclusions

1. NUI used NUI Utilities' credit capability and funds from its revolving line of credit and operating receipts to fund the holding companies' non-utility investments and operations.

K. Joint Credit Negotiations

Creation of the holding company and the separate NUI Utilities line of credit in 2001 gave NUI an opportunity to structure separate lines of credit, lenders, and cash management operations for utility operations and for its far riskier non-regulated operations. Instead, NUI tied NUI Utilities lines of credit to those of the parent and the non-utility businesses through joint negotiation of credit agreements with common lenders. The lenders to NUI and NUI Utilities under the December 2001 and February 2003 revolving credit agreements were the same, the dates are the same, the same persons signed them, and they were negotiated jointly. NUI made lending to the holding company and non-utility businesses a requirement for bank participation in NUI Utilities' revolving line of credit. Each of the four amendments to the NUI and NUI Utilities December 2001 credit agreements were also as of the same day.

When problems at non-utility entities and a re-audit of NUI financials in 2002 led to technical defaults on the NUI revolving credit agreement, both parent and utility credit agreements were simultaneously amended by NUI and lenders. These amendments made the Utilities' credit agreement measurably more expensive, even though the defaults were caused entirely by failures at NUI's non-utility businesses.

L. Summary of Joint Credit Negotiation Conclusions

1. NUI improperly made working capital access for NUI Utilities dependent upon the credit of NUI by jointly negotiating revolving lines of credit.

2. The actions that caused a failure of separation have done severe damage to the capital access of the utilities; NUI has seriously damaged NUI Utilities` access to working capital, and very substantially increased the cost of such capital by tying the sources and negotiations for regulated and non-regulated funding together.

3. Had NUI management and lenders not linked NUI Utilities and NUI finances, the poor performance of NUI's non-utility operations would have raised NUI financing costs substantially and NUI would earlier have lost the ability to continue funding non-utility investments and operating losses.

M. Cash Management Re-Engineering

A provision of the NUI Utilities' 2003 revolving line of credit agreement required that the cash management system for NUI Utilities be segregated from that of NUI by November 12, 2003. NUI began restructuring its cash management system in April 2003, in order to segregate the funds of NUI Utilities and NUI. The Company completed principal work on the segregation of cash management systems by October 2003. Liberty performed a review and analysis of the progress made by NUI, and tested the separation of the cash pools.

According to company senior management, NUI was not at the outset of Liberty's audit using nor had it been using a cash forecasting model. The absence of cash forecasts became increasingly problematic for NUI as the company neared its borrowing limits in the summer of 2003. The development of the cash forecasts eventually proved to be quite problematic, and outside consultants were brought in to take over the development of this critical tool.

With the assistance of the outside consultant, NUI did eventually establish and use cash flow models for both NUI Utilities and NUI by November 2003. The cash flow forecasting methods and models have been used by NUI effectively to forecast the cash flow and liquidity status of each NUI entity as the Company entered the 2003-2004 winter heating season.

N. Summary of Cash Management Re-Engineering Conclusions

1. NUI has adopted a new cash-management structure and process whose design provides appropriately for the separation of utility and non-utility cash.

2. NUI has begun to operate under the new segregated cash-management structure, but has not yet formally adopted its cash management agreement.

3. NUI management needs to complete its final review and approval of the cash management agreement, and to complete the development of a number of new bank-account controls.

4. NUI did not have the necessary cash forecasting models when it faced liquidity crises in 2002 and 2003. NUI eventually succeeded in establishing and using cash forecasting model that should effectively separate the cash and liquidity status of NUI Utilities from non-utility operations.

O. Long-Term Debt

Only NUI Utilities and NUI issue long-term debt financing. At June 30, 2003, NUI Utilities had $250 million of long-term debt outstanding. NUI issues long-term debt financing for the holding company and non-utility affiliates. NUI had $60 million of Senior Notes outstanding at June 30, 2003. NUI's senior note purchase agreement, dated August 20, 2001, restricted the financing activities of NUI Utilities significantly. Section 10.9 of this agreement established the ability of NUI creditors to inhibit the ability of NUI Utilities to grant security interests to creditors in connection with Utilities' financing. This provision effectively barred NUI Utilities from issuing secured indebtedness. This restriction harmed NUI Utilities and provided for an inappropriate cross-subsidization of NUI by NUI Utilities.

Other NUI senior-note covenants also restrict the activities of NUI Utilities. For instance, Section 10.6 prohibits any restricted subsidiary, including NUI Utilities, from providing any guaranty of any obligations. Section 10.7 of the agreement does not permit ETG or CGF to enter into any agreement that would restrict the ability of these companies to pay dividends to the parent. Section 10.8 of the agreement limits the sale of assets of restricted subsidiaries, including NUI Utilities, to 15 percent of NUI's consolidated total assets.

NUI proposed a comprehensive refinancing of both NUI Utilities and NUI to the NJBPU on August 20, 2003. The proposal as it related to NUI Utilities included the following components:

- Three-year maturity term loan secured by property, plant, and equipment to extend the maturity of existing debt and provide additional dollars for capital investment
- Restructuring of a portion of the $200 million gas revenue bonds to take advantage of current lower interest rates
- A secured revolving credit facility to support utility operating requirements, secured by NUI Utilities' property, plant and equipment
- Accounts receivable securitization at NUI Utilities for working capital
- Interim liquidity facility to satisfy peak utility gas-supply requirements.

Liberty raised a number of concerns about this refinancing plan. First, the proposed securitization of NUI Utilities' assets in order to acquire financing should not have been required. A stand-alone NUI Utilities would have been able to raise financing based on its own credit at a reasonable rate and without securitizing its assets to a group of NUI's existing creditors. NUI's refinancing plan also proposed that NUI's creditors receive a pledge of NUI Utilities' common stock as security for their loans. Such a pledge of NUI Utilities' common stock would allow NUI's creditors potentially to gain operating control of the utility. Providing access to an operating utility by an entity whose interests focus on debt repayment is clearly contrary to good utility practice and sound regulatory policy.

The financing proposal was also inappropriately sized as between NUI and NUI Utilities. The August proposal included $300 million of total financing for NUI Utilities, and only $105 million for NUI. The August proposal would not have provided sufficient funding for NUI to pay back the inter-company payable balance to Utilities, and would have raised excessive levels of funds with NUI Utilities as the obligor. By contrast, the eventual financing, completed in November 2003 included $255 million of financing for NUI and only $150 million for NUI Utilities.

P. Summary of Long-Term Debt Conclusions

1. NUI Utilities' financing has been substantially and inappropriately restricted by the covenants of the NUI senior notes.

2. A structural default on the NUI senior notes caused significant additional cost for NUI Utilities in the renegotiation of the revolving credit facility in early 2003. NUI was forced to enter negotiations with the senior note holders and the bank lenders to NUI and to NUI Utilities to resolve the senior notes default. These negotiations produced an increase in the interest rate on Corp.'s senior notes, additional security provisions for the senior note holders, and higher interest rates on both NUI and NUI Utilities revolving lines of credit.

3. The refinancing plan that NUI proposed in August 2003 was inappropriate, would have further used NUI Utilities credit and assets in support of NUI credit, and demonstrated the harm to NUI Utilities from inadequate separation of utility financing. The plan was proposed without pursuit of other options, it would have further tied NUI Utilities' financing to NUI, it would have pledged utility assets and common stock to NUI creditors, and was in gross funding disproportion between NUI and NUI Utilities.

Q. Asset Sales and Recognition of the Inter-company Balance

On July 16, 2003, an NUI management presentation to the NJBPU first recognized many of the financial and regulatory problems that faced the company. In its presentation, NUI recognized significant financial failings in its non-utility businesses, the negative impact of a PricewaterhouseCoopers three-year audit, and four (at that time) Moody's credit rating downgrades. NUI reported that the company was "reorganizing," and revising its strategic focus, with the following key initiatives:

- Implement new cash management and accounting controls
- Produce separate audited financials for NUI Utilities
- Strengthen internal controls

- Dispose of non-core businesses
- Restructure short and long-term financing
- Settle the inter-company balances
- Revise the corporate structure.

Key stakeholders forced most of the proposed NUI initiatives upon the company. The first two mentioned above were required by NUI's bank lending group. The next two were strongly suggested by public ratings actions by Moody's. Restructuring NUI financing would be required before the end of 2003 to avoid defaults on existing debt covenants. This presentation was the first to reveal the magnitude of the inter-company balance to the BPU.

NUI reported a total payables balance to NUI Utilities of approximately $112 million. Payables from non-utility business to NUI Utilities were $164.9 million. NUI disclosed later, on July 24, 2003, that the net balance would have been $144 million, but for a retroactive and non-cash dividend of $31.9 million just recorded from ETG. NUI also reported that the Company was exiting the NUI Energy and NUI Environmental businesses, and had hired an investment advisor to provide "strategic alternatives" for UBS and NUI Telecom.

In subsequent weeks, NUI management offered a plan to liquidate the payable to NUI Utilities by June 30, 2004. This plan would use the proceeds from the sale of non-utility businesses and residual assets to pay part of the inter-company balance, with the rest to be paid by June 30, 2004. NUI relied on this plan a number of times in interviews with Liberty.

After dropping this refinancing proposal, management made other proposals for securing the resources needed to satisfy the intercompany balance and restore financial stability. These plans focused upon the sale of limited NUI assets, some of them utility and some of them non-utility in nature. Liberty found these partial sales packages to be unrealistic in terms of the valuations being used and in terms of the execution risks that they presented. In the meantime, there remained a looming short-term liquidity crisis potential, along with a longer-term, similar potential, should NUI not be able to find a way to replace credit capacity prior to the expiration of the NUI and NUI Utilities revolving credit agreements in February 2004.

NUI management decided in mid-September 2003 that solving NUI's financial predicament and satisfying stakeholder needs required a sale of the entire corporation. Unlike those plans management had previously focused on, this option showed sufficient apparent executability and timeliness to monetize the value of sufficient assets to pay NUI creditors, deal with the revolving credit facilities, and pay to NUI Utilities the inter-company payable balance.

R. 2003 Liquidity Position

NUI senior executive management in July 2003 assured Liberty that existing lines of credit were adequate for the storage-filling season. NUI management also noted that an additional line of credit was being arranged to cover all winter season contingencies, including higher gas prices. NUI management also indicated that the new credit facility was to be in place in "one or two weeks" after that July 8 meeting. In August 2003, Liberty learned that NUI was near its borrowing limits in June and July. This situation caused immediate concern, because NUI Utilities' borrowing needs generally peak in the September through January period. NUI eventually proposed to manage around its September and October peak borrowing days by carefully scheduling receipts and disbursements on the monthly gas-settlement day, when borrowing is at peak levels. NUI Utilities finally closed on a $50 million liquidity line of credit with Drawbridge Special Opportunities Group in October 2003, for an approximate annual rate of 10 percent. This rate is exceedingly high for a utility.

NUI hired "corporate recovery" consultants in late September 2003. The consultants developed new liquidity forecasts following NUI's apparently failed internal efforts. The consultant's new liquidity forecasts were shared with Liberty in late October 2003. The new forecasts indicated that NUI Utilities would have ample credit availability during the 2003/04 winter with the new $50 million Drawbridge facility. The Drawbridge liquidity facility was terminated and replaced by Utilities' portions of the financing in November 2003.

This Credit Suisse First Boston (CSFB) credit agreement includes a $50 million unsecured term loan and a $50 million revolving line of credit, each of which has an initial term of 364 days. The costs of borrowing on the NUI Utilities financings initially exceed 10 percent annually. By comparison, an investment-grade utility would have been able to borrow working capital funds for about 2 percent as of the November 24, 2003 closing date.

S. NUI Sale Announcement

The NUI CFO noted on September 10, 2003 that NUI was working with an investment banking advisor in analyzing the potential sale of parts or all of NUI. On September 25, 2003, NUI announced that the entire NUI would be offered for sale. One of the firms seeking to become the sale advisor was CSFB. This firm presented an offer to provide interim financing for the entire company in a manner that would meet all funding needs until the closing of the sale. The closing of the NUI sale, allowing for the sales process and all required regulatory approvals, is expected to take about another year.

NUI entertained proposals from several investment banking firms interested in running the sales process. NUI also discussed with these firms and other funding sources potential interim financing until closing of the sale. NUI selected Credit Suisse First Boston to co-manage the sale of NUI, along with Berenson, NUI's existing financial advisor. Credit Suisse First Boston also proposed a major refinancing through a syndication of lenders. On November 24, 2003, NUI and NUI Utilities closed on a $405 million package of credit facilities with CSFB. The credit facilities provide maximum financing levels of $255 million to NUI and $150 million to NUI Utilities for 364 days, extendable for two 180-day periods.

The anticipated monetization of the equity value of NUI through the sale of the company provides CSFB's expected future and final source of repayment for the NUI debt. The following paragraphs summarize the components of this refinancing.

NUI – $255 million Term Loan: NUI entered unsecured term loan for $255 million with an initial term of 364 days. NUI can extend it for two 180-day periods for a 50 basis point fee for each extension. NUI paid a 3 percent fee at closing. The interest rate on the term loan is the Euro-Rate with a 2 percent floor plus 6 percent (or an alternate base rate plus 5 percent). The initial interest rate is 8 percent, which produces an initial total cost of financing of over 11 percent.

NUI Utilities - $150 million: NUI Utilities entered into a three-part credit agreement or a total of $150 million. The agreement includes a $50 million unsecured term loan and a $50 million revolving line of credit. Each has an initial term of 364 days. NUI Utilities also has options to extend these two facilities for two 180-day periods, with a 50-basis-point fee for each extension. The proceeds of the term loan and an $85 million inter-company receivable payment from NUI allowed payoff and termination of the existing NUI Utilities line of credit with Fleet Bank. The new revolving credit facility replaced the Drawbridge $50 million liquidity line of credit. Moody's has issued a rating of Ba3 on these financings, which reflects the total of six ratings levels lost in five separate ratings actions since September 2002.

A third $50 million financing facility is called the delayed draw term loan. This term loan may be drawn before November 22, 2003, and is solely for the purpose of paying the maturity of NUI Utilities' $50 million of Medium Term Notes on February 1, 2005. A 50 basis point fee would be paid to exercise this option.

NUI Utilities paid CSFB a fee of 3 percent at closing. A commitment fee of 0.625 percent on the unused portion of all three of the financing pieces also will apply. Interest rates on the Utilities financings are either the Euro-Rate with a 2 percent floor plus 5 percent or an alternate base rate plus 4 percent. Either alternative would result in an initial 7 percent interest rate, which produced an initial total cost of borrowing of over 10 percent annually. By comparison, an investment-grade utility should be able to borrow working capital funds for about 2.0 percent as of November 24, 2003.

T. Summary of Conclusions- Restructurings, Liquidity, Refinancing, and NUI Sale

1. The sale of NUI's non-regulated businesses, as originally proposed by NUI, was not feasible and would not have provided sufficient funds to pay both NUI creditors and the intercompany balance to Utilities.

2. A potential liquidity crisis for NUI Utilities in the winter of 2003-2004 was avoided only with extremely high-cost credit facilities.

3. The only feasible solution for resolving the inter-company balance and revolving credit renewal issues was to monetize the value of the whole company through the sale of NUI.

4. The CSFB interim financing package for NUI provided the best available financing bridge to the sale of the company, but came at costs much higher than NUI Utilities' own financial characteristics would have warranted.

VI. Accounting and Controls

A. Account Structure and Systems

The NUI accounting system operates on the basis of collecting accounting information from the NUI business units through various feeder groups. NUI enters information into a financial system provided by "PeopleSoft." This system serves as the primary central collection process. NUI uses it to develop routine financial statements, to support special data or analysis queries, and to generate routine and special reports. NUI has adopted a chart of accounts based upon the FERC USofA. Earlier NUI business ventures primarily included businesses under state utility regulatory jurisdiction, which made this system sound as an accounting framework. This chart of accounts, with minor additions, proved adaptable to the new businesses.

Prior to January 2003 the controllers in each business unit reported to the head of that unit. NUI has corrected this weakness in the organizational accounting structure; as of January 2003 the business unit controllers began to report directly to the NUI Corporate Controller.

Liberty's analysis of the chart of accounts, the general ledger, and sub ledgers demonstrated that separate accounts are adequately maintained for each business unit. Additionally, each unit maintains sufficient general ledger intercompany balances of payables/receivables between each respective business unit. NUI, however, did not limit intercompany balance recording to what would traditionally be considered to be goods and services.

B. Policies and Procedures

NUI Corporation has acted as agent for the business units, including ETG, and has coordinated daily cash receipt and disbursement since 1990. It had no written policy to guide these cash pooling actions. Liberty would have expected to see a formal cash-management agreement clearly setting forth the terms and conditions under which services would be provided. These weaknesses contributed to the financial problems addressed above.

Internal controls within the NUI and UBS accounting functions provide critical links in assuring sound performance. Liberty found formal policies and procedures to have been largely non-existent until 2003, when NUI corrected many deficiencies. Bank reconciliations are now routinely being performed monthly. NUI's single cash pool is being divided into two cash pools that segregate utility resources. Liberty has tested changes to the cash separation process and the bank reconciliation process, and reviewed the two cash pools, in order to verify separation. Liberty's testing found them to be generally sufficient. Formal policies and procedures, however, required completion and formal documentation in a number of cases.

C. Intercompany Balances

NUI performs external financial reporting on a consolidated basis, which means that the Company excludes intercompany accounts payable and receivable balances from such reports. However, NUI Utilities operates ETG as a regulated utility under the jurisdiction of the BPU, which requires use of the FERC Uniform System of Accounts prescribed for Natural Gas Companies subject to the provisions of the Natural Gas Act. ETG must file with the BPU an annual report similar to FERC Form 2.

A number of non-utility affiliates did little if any direct business with NUI Utilities, but came to owe NUI Utilities a total of over $157.9 million as of August 30, 2003. The funds provided by NUI Utilities to these entities have provided them ongoing access to capital, much as banks would. ETG/NUI Utilities funds were advanced to fund non-utility investments and cover non-utility losses. However, no detailed tracking of funds flow was possible at that time. There occurred a substantial reduction in the balance due NUI Utilities as 2003 progressed. It fell from $190 million at February 2003 to about $85 million by the time that NUI paid it off from the proceeds of the recent CSFB refinancing in November.

NUI did not account for much of the NUI Utilities receivable at the utility-division (*e.g.*, ETG) level. The failure to "push down" ETG's share of the receivables balance impeded the ability to examine ETG's condition on a stand-alone basis, which is the basis that the holding company order requires. Moreover, the Form 2 reports that ETG has filed with the BPU classified the receivables balances assigned to it as temporary cash investments, which they were not, instead of receivables, which they were.

NUI also failed to provide for the regular settlement of these balances. In Liberty's experience, monthly settlement is appropriate. The failure to settle the balances, assuming that there were the financial resources to do so, of course, is the primary reason why NUI found itself with insufficient financial strength to provide for ETG's liquidity needs in a predictable, secure, and economical manner.

NUI's intercompany accounts were also routinely out of balance. NUI did not report or perform routine reconciliation on a monthly or on any other regular basis. The sum total of all intercompany balances when aggregated should cancel each other completely. Liberty found monthly accounts routinely out of balance. The variances in some months approached $4 million dollars. NUI has been reconciling intercompany balances monthly since June 2003, after which there have not been significant imbalances.

PricewaterhouseCoopers prepared a certified audit report for NUI Utilities on a standalone basis for the fiscal years ended September 30, 2001 and 2002. NUI's auditors raised concerns about reflecting the $61.4 million of intercompany or associated accounts receivable due from NUI as an asset. Management responded by reflecting it as a charge that reduced equity. The restatement of the receivable due from NUI after the PricewaterhouseCoopers audit had a significant impact on the debt-to-equity ratio values of NUI Utilities, Inc. The total debt ratio increased from 54 to 60 percent due to this restatement of the $61.4 million as of September 30, 2002.

D. Accounts Payable and Receivable

NUI internal audits have since at least 1999 been finding control weakness and failures to apply adequate polices and procedures to purchasing and accounts payable, to receipts, and to accounts receivable. Arthur Andersen, NUI's contracted internal and external auditor until June 2002, deemed a sizeable number of these earlier internal audit findings not to be material. NUI's current outside auditors attached more significance to the negative findings about accounts payable and receivable. In particular, these new auditors found that many of the same weaknesses continued to exist in September of 2002. They determined that their findings of controls weaknesses, which included a number of accounts payable and receivable ones, were material.

Liberty's audit work has confirmed that NUI has taken programmatic steps to strengthen its internal controls for accounts payable and receivables. Draft updates to policies and procedures have been developed, but have not yet been finalized and approved.

E. Compensation and Benefits

NUI adequately collected and reflected payroll costs on the books of its business units. NUI has a reasonable basis for extracting costs by business-unit functions, including costs that NUI allocates. NUI used an adequate accounting process for recording and collecting payroll data. There have been control weaknesses, but NUI has been addressing them. NUI has been updating payroll internal controls to address the issues identified. Liberty's examination of draft policies and procedures related to payroll showed them sufficient to address identified problems. The procedures need finalization and approval by management.

F. Work Order Procedures & Continuing Property Records

NUI has adequate procedures to capitalize assets and determine accounting lives. They comport with good-utility practice. There has been no examination of fixed-asset or continuing-property-records functions since at least 1998. NUI should conduct an audit now.

Liberty found work order procedures adequate to support budgeting and tracking of costs. NUI has applied them in a manner that provides for adequate definition of project costs at an appropriate level of detail. NUI also uses appropriate procedures for tracking construction work in progress (CWIP) costs, but did not implement them system-wide until May 2003.

Liberty also found that NUI does not properly assign A&G overhead cost to the cost of construction. NUI's failure to do so has the effect of overstating A&G operating expenses, while understating plant asset values, accumulated reserves for depreciation, and annual depreciation expenses.

G. Joint Property

Liberty found only limited use of joint property among affiliates. One case, UBS use of billing equipment retired by 2000, was addressed above. In another case, Liberty found that ETG for ratemaking purposes has placed into its rate base a share of the costs for shared customer service system assets that are on the books of the Florida utility operations (CGF) of NUI Utilities. Liberty discovered no reason to question the accounting for those assets.

The principal instance of common asset use has been in the case of NUI shared overheads and support. NUI allocates the capital costs it incurs to provide those services as it does the people and other costs; *i.e.*, by applying the three-factor formula.

H. Summary of Accounting and Controls Conclusions

1. NUI has adopted an accounting structure and an accounting separation that is generally appropriate; however, its treatment of intercompany accounts in regulatory financial statements was not appropriate.

2. NUI's auditors' findings of duplicative accounts indicate a need for more rigor in assuring that account definitions and uses are sufficient to track costs with sufficient detail.

3. NUI business unit controllers reported to their business unit head; this approach represented a structural weakness prior to its correction in 2003.

4. NUI failed to adopt sound financial accounting policies and procedures in a number of areas; NUI has addressed controls issues programmatically, but needs to complete work on establishing a comprehensive and well-structured set of written policies and procedures.

5. ETG has not complied with the USofA reporting requirements in its classification and reporting of intercompany accounts payable/receivable transactions with associated or affiliated companies and has not accurately reported such activity on its FERC Form 2 annual reports.

6. NUI failed to regularly settle intercompany balances until recently, violating good practice.

7. The failure to push down a proportionate share of the NUI Utilities receivable balance substantially hindered examination of ETG's financial condition on a stand-alone basis.

8. NUI's management of accounts payable and receivable affecting ETG have suffered from a persistent lack of controls, which NUI has been correcting through systematic actions.

9. The accounting process for recording and collecting payroll data are reasonable and adequate; NUI has been addressing long-standing controls weaknesses.

10. ETG overstates operating expenses by failing to assign A&G loaders to construction costs.

11. NUI Utilities needs to conduct an audit of its fixed-asset and continuing-property-records systems, because such an examination has not been conducted for an extended period of time.

VII. Energy Affiliates

A. Summary of Energy Affiliate Operations

NUI Energy operated as a retail energy marketing company in six states, mainly in New Jersey and Florida. NUI Energy offered commodity pricing options not available to customers from their local gas distribution companies. NUI Energy's annual sales had reached 24 to 25 Bcf/year when NUI sold the business effective July 1, 2003. NUI EB acquired all of the gas that NUI Energy needed, and resold it to NUI Energy. Sales to NUI Energy represented about 25 percent of NUI EB's total gas sales. NUI Energy operated at roughly a break-even rate from fiscal 2000 through 2002. It experienced a nearly $10 million loss in 2003.

NUI Energy Solutions acted as an energy management consulting company. NUI Energy employees actually provided its services to customers. NUI now classifies it as an inactive business unit. It has no employees and no corporate services are charged to it. NUI has no plans to add new business to it. NUI Energy Solutions suffered losses for each of the years 2000 through 2003, averaging less than $100,000 per year.

NUI Energy Brokers (NUI EB) has provided wholesale trading, brokering and risk-management services for NUI companies and for its own account. NUI EB has traded physical natural gas in the Northeast (primarily south and west of the Greater New York City area), the Southeast, and the Gulf Coast producing region. NUI EB has also traded natural gas futures, options and swaps on the New York Mercantile Exchange and in over-the-counter markets. NUI EB's total gas sales in fiscal 2002 were about 104 Bcf. NUI EB has reported profitability averaging over $5 million per year since 2000. Its profitability cannot be examined separately from that of NUI Energy, for whom NUI EB made gas purchases.

Virginia Gas Company is a natural gas storage, pipeline, and distribution company with principal operations in southwestern Virginia. Virginia Gas's storage capacity in its two facilities amounts to approximately 3 Bcf. Virginia Gas also owns and operates a 72-mile intrastate pipeline, and serves approximately 300 customers as an LDC. NUI also operates a joint venture, Saltville Gas Storage Company, LLC, with Duke Energy Corporation to develop additional high-deliverability storage facilities at the same location. The Saltville Gas Storage Company facility currently has about 1 Bcf of capacity. The joint venture plans to increase it to 6.1 Bcf by fiscal 2008, and perhaps ultimately to 12 Bcf. NUI formed NUI Storage, Inc. to develop other gas storage facilities. NUI Storage acquired options on land and mineral rights involving property located in Perry County, Mississippi. Its goal was to develop a gas storage facility with a working-gas capacity of about 7.8 Bcf. NUI Richton Storage, Inc., a subsidiary of NUI Storage, holds these options. Virginia Gas has had operating losses averaging about $400,000 for the past three years. Saltville had about $100,000 in net operating income for 2003, its first year of operation.

NUI Utilities' CGF division has been constructing a transmission pipeline across Florida, in conjunction with expanding its service territory westward. Phase I of the Florida East-West Pipeline project extends from West Palm Beach to South Bay.

B. Summary of Energy Affiliates Financial Results Conclusions

1. NUI's energy affiliates, except NUI EB, have not been profitable; their operations have been substantially funded by the common corporate concentration account, and ultimately NUI Utilities.

2. NUI's energy affiliates have had very sizeable balances payable to NUI Utilities. NUI Energy's balance peaked at about $23 million in 2002, and fell to $13.8 million in 2003, before NUI liquidated it. Energy Solutions payable balance was about $1 million from 2000 through liquidation in 2003. Virginia Gas has had extraordinarily large inter-company payable balances. Its 2001 balance of $37 million grew to $62 million in 2002. The 2003 balance before liquidation was $49 million. Saltville also had a significant payable balance of $20 million before liquidation in 2003. NUI EB has had a small inter-company payable in most years since 2000.

3. NUI failed to make adequate allocations of corporate costs for Virginia Gas in 2001. NUI made no allocations to Virginia Gas during fiscal 2001, even though NUI owned the company for a number of months in that year. This failure caused other NUI operations, including ETG, to absorb significant extra costs. ETG's allocation in the test year used for its last base rate filing were $287,292 higher due to the failure to make allocations to Virginia Gas.

C. Utility Gas Purchases and Sales

ETG has one remaining long-term gas-purchase contract with a third-party supplier. This remaining contract provides for 10,000 Dth/day, or 3.65 million Dth/year. NUI joined seven other Mid-Atlantic natural gas companies to form the East Coast Natural Gas Cooperative in 1995. NUI has sought to fill its seasonal and monthly gas-supply requirements through auctions conducted by this co-op. Generally, the long-term contract and co-op purchases secure base-load gas. NUI Utilities then must address the inevitable and daily variances that all LDCs experience. NUI Utilities meets these daily swings through withdrawals from storage, "pipeline shorts and longs," and purchase and sales transactions in the daily spot market. ETG also engages in the industry-typical practice of buying gas to support off-system sales that it makes to recoup a portion of its pipeline and storage capacity costs. Gas supply for ETG's off-system sales comes first from supplies that are committed to ETG's system, but prove to be excess to on-system customers' needs.

NUI EB conducted the gas-supply operations of all of the NUI Utilities' LDCs. Acting as each LDC's agent, NUI EB bought all LDC requirements for daily spot-market gas supplies and some of the monthly supplies. NUI EB also managed LDC gas-transmission and storage-capacity assets. NUI EB also conducted the utilities' individual secondary-market programs. These programs consisted of off-system sales and capacity-release activities.

NUI Utilities canceled its agency agreement for gas supply functions with NUI EB about two months before this report. NUI Utilities transferred functions formerly performed by NUI EB to a third party. The NUI Utilities personnel needed to support supply operations now work directly under the management of NUI Utilities personnel.

D. Controls on NUI EB Performance

NUI EB has also bought and sold gas routinely and continuously for its own customers and own account. It has done so at the same time as it bought and sold for NUI Utilities. NUI EB used the same resources, systems, and processes to serve its own needs and the daily LDC needs. The nature of NUI EB's business activities and those of NUI Utilities mean that the use of NUI EB to conduct ETG's gas-supply activities exposed NUI EB and its personnel to significant conflicts of interest.

When NUI EB made a sale for its own account, 100 percent of the resulting margins went to the account of shareowners. NUI EB also conducted NUI Utilities' secondary-market programs until the recent transfer of this function to a third party. In doing so, NUI EB sold ETG's gas in the same markets and to the same customers. The benefits to shareowners differed significantly, however. When NUI EB made an off-system sale for ETG, BPU rules required that 85 percent of the resulting margin be retained for ETG customers. The BPU allowed the remaining 15 percent to be treated as below-the line; *i.e.*, for the benefit of shareowners.

NUI EB conducted ETG's gas-supply activities pursuant to an agency agreement. EB's responsibilities under this agreement included: (a) acting as the utility's agent to acquire gas for delivery to the utility, and (b) performing all nominating, scheduling and any other activities necessary to accomplish delivery of the Utility's gas to its city gates. Beyond the utility's authority to suspend or terminate, the agreement imposed no limits or performance standards on NUI EB. There existed no formal policies and procedures for NUI EB's conduct of LDC gas-supply activities.

Liberty's audit work found no significant controls to address this conflict in NUI EB's roles for itself and for ETG. NUI EB told Liberty that it saw no competition between NUI EB's execution of off-system sales for the LDCs and sales for its own account because the transaction points for both types of sales are sufficiently liquid that execution of multiple sales is not a problem. NUI EB therefore appears not to have considered it necessary to adopt controls to address what Liberty saw as a conflict of interest.

Liberty found that NUI structured its affiliate relationships not to optimize utility needs, but to create opportunities for NUI EB and shareowners. Accommodations came at the expense of ETG customers, given the lack of adequate controls over the relationship. Examples include:

- The agreement under which NUI EB managed ETG's gas-supply assets gives NUI EB broad control over the use of utility assets, but imposes no effective limits or performance standards
- NUI EB conducted ETG's secondary-market activities; therefore NUI EB had access to essentially all of ETG's gas-supply resources to assure that NUI EB's customers' needs were met
- ETG allowed NUI EB to shift its requirements among ETG's city-gate delivery points, without cost or obligation, presumably to accommodate NUI EB's trading activities
- Only within the last year have energy-trading counter-parties been able to distinguish between NUI EB and NUI Utilities, which gave NUI EB an effective opportunity to trade on benefits of association with utility operations
- NUI EB used a number of ETG's people in the performance of functions common to NUI EB, ETG, NUI Energy and other unaffiliated asset-management clients
- NUI EB used one of NUI Utilities' storage contracts.

NUI Utilities focused on comparisons with other New Jersey LDC BGSS filings and comparisons of prices to indexes to evaluate NUI EB performance. NUI Utilities did not examine specifically how or even whether NUI EB assured that it did not sacrifice utility interests when it faced daily opportunities to transfer benefits away from utility operations. One of the most critical elements in serving gas LDC customers lies in assuring unbiased, professional, and attentive procurement and the offsetting of fixed or sunk supply, storage, and transportation costs.

E. NUI EB's Co-op Role

NUI EB's agency agreement with ETG did not provide NUI EB with separate compensation for helping to procure utility gas. That was one reason why NUI EB sought and ultimately obtained qualified-supplier status for Co-op auction participation. Participation in the auction process gave NUI EB a margin opportunity that would cover costs for purchasing services it provided to NUI Utilities. NUI EB began to win a number of auctions for sale to NUI EB after NUI EB personnel took a more central role in operation of the Co-op. NUI EB did not, however, sell much gas to the other co-op utility members.

NUI EB's increasing role as a provider of supply to NUI Utilities through the Co-op also caused ETG to bear additional costs. NUI EB's emergence as an NUI Utilities supplier came only after NUI EB took an increased role on the Co-op's buying committee. The number of bidders in Co-op auctions clearly fell thereafter. Liberty believes that NUI EB's participation as a bidder had the clear tendency to reduce the number of bids received, and to diminish the competitiveness of the prices in the bids. NUI EB held onto an ineffective bidding process despite clear indications of problems with it.

Liberty believes that NUI EB's duty to ETG included an obligation to obtain the best price available in the market when buying gas. NUI EB supposedly operated under the rule that it could not sell gas directly to ETG. A clear value in such a rule is to prevent NUI EB from buying from ETG under circumstances where NUI EB knew it could resell the same gas for more to a third party. Clearly, if NUI EB knew of a third party willing to pay a given price, it could just as well arrange for ETG to sell the gas directly to that party. In that event, ETG would receive the third party's higher price, not the lower price NUI EB was willing to pay. Introducing such a shell transaction did little more than provide NUI EB with a margin when it bought low from ETG and sold high to the third party. The entire margin that it took for itself came at direct and equal loss to ETG.

F. Gas Transaction Controls Conclusions

1. The relationship between NUI Utilities and NUI EB was not at arm's length; NUI EB received accommodations that were not consistent with good-utility practice and that would not have been provided to a non-affiliate performing similar functions.

2. Securing a third-party provider of service to ETG was an appropriate response to the NUI EB performance issues disclosed as a result of Liberty's audit. A fair competition among third-party asset managers will allow full value of ETG's supply, storage, and transportation assets to accrue to NUI Utilities' system-supply customers, who bear the costs of the assets. NUI Utilities is now evaluating a number of bids received from third parties for the management of various gas-supply management activities for the 12-month period that will begin with the April 2004 start of the storage injection season. NUI Utilities has so far conducted an open and competitive process.

3. NUI, NUI Utilities, and NUI EB failed to adopt controls sufficient to address trader incentives to designate NUI EB, rather than ETG, as the party-in-interest to economically more favorable transactions. NUI EB traders and NUI EB had a financial incentive to work in ways contrary to the interest of ETG. NUI, NUI Utilities, and NUI EB failed to institute and apply adequate controls on trader performance with respect to these incentives. NUI EB acted against the interest of ETG in ways that do not comport with good-utility practice or prudence. ETG and its customers suffered significant cost penalties as a result.

4. NUI EB's participation in Co-op auctions for NUI Utilities' gas was not consistent with its duties to ETG. NUI EB should not have sold gas to ETG as a Co-op bidder. The appropriate remedy for NUI EB's breach is for it to return to each utility whatever margins it made on the sale of gas to that utility. NUI EB's average margin on the volumes of gas that it sold in

2002 was 18.7 cents per Dth. Multiplying that margin by the 6.2 million Dth that NUI EB sold to ETG through the Co-op yields a total margin of $1,159,000.

G. Measuring Customer Harm

Liberty tested actual NUI EB purchase and sale transactions to examine the issue of structural conflicts that arise from NUI EB's buying and selling of gas for its own account at the same time that it does so for ETG. Liberty used gas sales transaction data from NUI EB to perform an initial examination of the distribution of ETG and NUI EB sales prices in comparison to each other. Liberty compared the prices that NUI EB produced for ETG sales and that NUI EB produced for sales for its own account. Liberty found that, for sales made at the same time, for the same delivery periods, and at the same delivery points, NUI EB received greater value from the marketplace for its own gas sales than it received for sales of gas for ETG's account.

Liberty discussed the pattern in the gas sales data with NUI Utilities' director of energy planning and with NUI EB's director of energy trading, in order to determine if any systemic reasons should produce the pattern that Liberty's preliminary analysis identified. NUI Utilities' representative was unaware that the pattern existed. Liberty found NUI EB's explanations to be unpersuasive.

Liberty had intended to continue its interviews and investigation, but became concerned about document integrity on the basis of statements made by an interviewee. Liberty therefore approached the NUI Controller to seek assistance in securing the underlying documents for later, more detailed review. The Controller contacted PricewaterhouseCoopers in order to determine what Company actions might prove appropriate to the circumstances. Almost immediately, PricewaterhouseCoopers extended its audit procedures in this area. Liberty agreed to defer its field work, provided that it was satisfied with the scope of the PricewaterhouseCoopers work, and provided that Liberty would have access to the results of that work.

PricewaterhouseCoopers' preliminary work also indicated the existence of the overall pattern that Liberty had observed in common sales transactions. Moreover, PricewaterhouseCoopers also heard trader statements in interviews and in audio taped phone conversations that Liberty found to raise questions of potentially severe impropriety. By this time, Liberty concluded that there was sufficient evidence to merit detailed examination of the following types of attitudes or conduct that could be adversely affecting costs that ETG recovered from customers:

- A significantly greater focus by NUI EB traders on NUI EB sales than on ETG sales, because of the recognition that NUI would keep the full 100 percent of margin that sales for NUI EB's account would produce, as compared with the 15 percent left for NUI after customers received the 85 percent required by the BPU on sales for ETG's account.
- A significantly lower hurdle rate for ETG sales than for NUI EB sales, in the sense that a trader would try to maximize NUI EB margins, while focusing in the case of ETG merely on assuring that any positive margin was obtained.

- The belief that getting ETG the best price in the market was not the performance standard, but that it was only necessary to avoid causing ETG a net loss in a transaction when made contemporaneously or in a redesignation of transaction parties after the fact.
- The creation of an expectation among at least some counter-parties that NUI EB would be prepared to sell them ETG gas for less than NUI EB gas.
- Potentially extensive use of "sleeving," which consisted, for example, of the practice by which NUI EB arranged to sell utility gas to a counter-party, and then buy it back essentially immediately at a very small mark-up from that same party in NUI EB's own name, and then sell the gas to a third party at significantly higher prices.
- Encouragement of reluctant counter-parties to sleeve by noting that it could not be found out by an examination of NUI EB's EMS records.
- Changing deal tickets after the close of the trading day, but before the deal tickets were entered into the NUI EB information system (EMS), when NUI EB had an unfavorable day overall, in order to shift profits from ETG to NUI EB to mitigate NUI EB losses.

It was not long into the PricewaterhouseCoopers examination when the Audit Committee of the Company's Board of Directors ordered a further investigation of NUI EB's operations and business practices by the law firm of Stier Anderson, LLC.

Liberty's transaction analysis and the preliminary results of the PricewaterhouseCoopers and Stier Anderson fieldwork to which Liberty had access show a pattern of activity that caused ETG to lose significant economic benefit.

Liberty's overarching conclusion with respect to NUI EB's performance for ETG is that it pervasively failed to meet its duty to get ETG the best prices available in the market. A measure of harm that Liberty identified springs from acceptance of the way that NUI EB actually ran its and ETG's business. That is, NUI EB treated its own and ETG's resources as common, operating them on an "all-for-one" basis. By simply requiring a corresponding "one for all" sharing of the benefits, Liberty calculated estimates of the value that had been inappropriately transferred from ETG to NUI EB.

Liberty calculated the weighted-average prices for ETG sales and purchases. Then Liberty calculated the weighted-average price for all NUI EB sales and purchases, including those for ETG. Then Liberty multiplied the difference in the weighted-average prices by the ETG sales and purchase volumes. Liberty believes that this approach provides an appropriate baseline for determining what should be NUI's obligation to make ETG customers whole.

This approach accomplished the result of giving ETG the same purchase and sale prices that NUI EB experienced overall. In other words, it gave ETG and NUI EB the benefits and burdens of each other's transactions proportionately. The Liberty's analysis produced a total for the 1999-2003 fiscal years of $10.7 million in imputed additional margins for ETG sales, net of the 15 percent sharing. It also shows an additional total of $3.9 million in imputed reductions in the cost of ETG purchases. The purchase analysis conducted by Liberty included only short-term purchases. Liberty assigned no value to differences in purchases of a longer-term nature, primarily because of the complexity of assessing the offsetting effects of the hedges that often accompany longer transactions.

Liberty also had access to two alternate methods for determining the amount that could be returned to ETG customers. The first was an analysis performed by NUI personnel. NUI's analysis, when adjusted to make it comparable with the Liberty analysis, resulted in damages for sales and purchases combined of about $6.7 million, before the application of the 15 percent margin sharing provision. A separate analysis prepared by Stier Anderson confirmed the pattern of pricing discrimination observed by Liberty. It found that ETG failed to get either the best or the average price of the day more than three-quarters of the time. Stier Anderson used EMS data to determine "monetary damage" that resulted from conduct by NUI EB to shift net revenue from ETG to NUI EB by giving more favorable pricing to the NUI EB transactions. The two Stier-Anderson calculations that Liberty found most useful measured harm to ETG at $5.6 to $6.2 million. Liberty believes that the NUI and the Stier Anderson work suggest that the low end of the range of potential harm to ETG customers is about $6 million. Liberty's $14.6 million calculation, on the other hand, produces an expression of the higher end of the range.

H. Counter-party Credit

The downgrades in NUI Utilities' credit rating that occurred as a consequence of failures in non-regulated businesses prompted its suppliers to begin demanding payment in advance for gas supplies. Additional, similar demands continued through the rest of calendar 2003. They also began to include pipeline companies demanding pre-payment of fixed charges.

NUI EB was a significant consumer of credit. Operating like a mutual-fund manager, NUI EB owned a portfolio, the value of which it sought to enhance through trading. If it could use borrowed money to supplement equity money, the portfolio could become bigger. A larger portfolio would offer more opportunities to trade. NUI's financial problems caused a drastic curtailment in the amount of cash and credit capacity it could let NUI EB use to trade. NUI EB reduced the margin collateral that it had on deposit with counter-parties during 2002 from $34.4 million to $5.0 million. Significant reductions in NUI EB trading volumes occurred through 2003.

As NUI worked to disentangle NUI Utilities finances from those of the parent, NUI EB began to distinguish itself from the utilities in its invoices and statements. This separation had become visible to third parties in the first half of 2003. NUI EB's counter-parties made a response, in terms of significant increases in collateral calls for NUI EB.

I. Audit Cooperation on NUI EB Issues

On many occasions involving NUI EB, NUI failed to conduct itself in compliance with the third Holding-Company Order condition by failing to provide timely and complete information necessary to meet the scope of the audit. Good-utility practice required more responsiveness than NUI offered.

VIII. Corporate Governance

A. Board of Directors

The NUI corporate board ("the board") has consisted of seven directors, including two inside directors, the Chairman of the board and the CEO, and five outside directors. NUI Corporation has a number of subsidiary corporations and second-tier subsidiary corporations, almost all of which have their own boards of directors that consist of NUI management employees:

- NUI Capital Corporation, with subsidiary corporations NUI Energy Inc., NUI Energy Brokers, Inc., NUI Energy Solutions, Inc., NUI Environmental Group, Inc., NUI International, Inc. (under which are NUI/Caritrade, Inc. and NUI Hungary, Inc.), NUI Sales Management, Inc. (under which is T.I.C. Enterprises, LLC), NUI Service, Inc., NUI Telecom, Inc., and Utility Business Services, Inc.
- NUI Saltville Storage, Inc., under which is Saltville Gas Storage Co LLC and of which the company is a 50 percent owner
- NUI Storage, Inc., under which is NUI Richton Storage, Inc.
- NUI Utilities, Inc. (under which ETG, CGF, and Elkton operate as divisions, but not separate corporate entities)
- Virginia Gas Company, under which is Virginia Gas Distribution Company, Virginia Gas Pipeline Company, and Virginia Gas Storage Company.

B. Board and Committee Size, Structure and Composition

Liberty found that the NUI board was small given the size of the work load, the scope of company business operations, the number of committees, and the frequency of meetings. Board members make a fairly substantial time commitment to NUI matters. In addition to board membership, directors are typically members of three and even four committees, and four of the five outside directors chair a committee. The board typically meets six times per year and committees typically meet two to three times per year. Board members estimated meeting length to be three to four hours on average and three to four hours of typical preparation time for each meeting.

The committee structure reflects a reasonable division of authority and responsibility for the various board functions. Committees include Audit, Compensation, Executive, Investment, and Nominating and Governance, which present a fairly typical structure. Because of the small size of the board, the Executive Committee, which includes all but one director, exists on paper but rarely, if ever, meets. A review of the committee activities indicates that there has been a focus on relevant matters.

The NUI board has been characterized by very low turnover for many years. From 1998 to the present, two long time directors left the board. One reached mandatory retirement age (72), and retired from the board in January 1999. The second resigned from the board voluntarily in January 2002. In 1998, one director was added, which means there has been a net reduction of one person to an already small board. Moreover, the added person was the only candidate considered for the position. Historically, the company has handled succession planning for the board and company executives on an ad hoc basis, without a formal succession plan or process.

The recently established Nominating and Governance Committee has had a heavy start-up workload, which was expected to continue for the next 12 to 24 months. The committee has instituted a self-assessment process for the board and the committees, a director succession planning process, and a board member education and training requirement.

C. Board and Committee Processes and Procedures

Identification of director candidates and the review process has been informal and undocumented. NUI has recently adopted formal, written guidelines and requirements for board member selection. NUI has not had specific requirements or guidelines for specific or general training or education needs, and has not offered such training. The company has recently developed draft guidelines for continuing education of directors.

Director attendance at board and committee meetings has generally been good. To the extent that members occasionally cannot attend in person, they generally attend by telephone. Board and committee members generally receive information packets from the general counsel to prepare for meetings with sufficient time to allow adequate review of those materials. Advance time varies from several days to several weeks.

The retention of board records has been deficient. There is no written policy on record retention. NUI does not routinely retain in an organized fashion those documents handed out at board meetings. In addition, the company was unable to produce with the minutes certain reports and presentations that directors specifically requested be filed with the minutes.

The board began a self-assessment process during 2003. Part of the process involves a survey of the directors, which provides valuable insights into what the board thinks about itself, but no outside perspectives. The first survey has been administered and compiled, but has not yet been reviewed by the board. The intention was to survey the board annually and to extend the surveys to the committees next year.

The Audit Committee's practices and procedures were generally in keeping with the requirements or proposed requirements of Sarbanes-Oxley and the securities exchanges. The recently approved charter of the Audit Committee implements or formalizes many of those requirements. The recently created Nominating and Governance Committee implements another of the requirements of Sarbanes-Oxley. The Company's corporate governance guidelines have been developed.

D. Board and Executive Knowledge about and Focus on ETG

The board has not focused sufficient attention on fulfilling its role with respect to the utility business or ETG in particular. NUI has not used the ETG Advisory Board effectively in this regard. The problems are exacerbated by the lack of utility operating and regulatory experience among the board's independent directors. Two independent directors have general industry experience. They were long-standing acquaintances of the NUI chairman through the American Gas Association; however, their experience was not related to gas utility operations or gas portfolio management. A telling example of this weakness is the lack of awareness of significant requirements of the BPU Holding-Company Order.

Liberty did not find among the independent directors a strong understanding of key indicators and events in the natural gas industry and the utility business. NUI senior executives exhibited the same lack of knowledge.

The packages and handouts provided to the board and the committees are limited, and do not present sufficient information and context for an in-depth understanding of the ETG business. The information provided about ETG in advance of the board meetings could be described as too generic and brief. The oral reports and information provided at board and committee meetings, as indicated in the meeting minutes, display the same lack of depth and scope. Furthermore, discussions as reflected in minutes and presentations, as well as interviews, do not appear to reflect an understanding of the relative importance of the various corporate entities.

E. Board Review of NUI Ventures

The board has not applied an effective mechanism for dealing with new ventures. The Chairman (and the other directors as well) did not appear to challenge management on the feasibility of new ventures, and did not institute a structured framework for evaluating, monitoring, and potentially terminating those ventures, despite the existence of broad expansion plans, aggressive actions to execute those plans, and significant failings of those actions to produce expected results. Moreover, the board has not established firm go/no go decision points, and has not set milestones or exit strategies for new ventures being pursued.

F. Internal/External Auditor

The Company used the same firm as both internal and external auditor prior to the emergence of outside concerns about controls. For many years, Arthur Andersen performed both functions. It was only as public awareness of auditor issues and conflicts came to the fore and as the exchanges raised the issue that the Company began to question the practice. When NUI replaced Andersen, it hired separate firms for the two roles.

Liberty would not conclude as a general rule that it was necessarily improper to use the same contracted firm for internal and external auditing at the time that NUI did so. However, one must consider the special circumstances at play here. There was a lack of internal resources at NUI to dedicate to oversight of auditing and controls issues. There was not strong senior management attention to controls issues. Non-utility operations spanned a wide range of business types and operating and financial risks, some of them potentially very large.

The introduction of the Holding-Company Order in early 2001 should have been viewed as a milestone event in the establishment of sound controls and financial separation. These factors taken together lead Liberty to conclude that NUI should have earlier adopted a more conservative approach by retaining separate firms to perform internal and external auditing.

G. Compliance with the BPU Holding-Company Order

On January 31, 2000, the Company filed a request with the BPU for permission to form a holding company to own all the outstanding stock of NUI. By order dated February 14, 2001, the BPU approved the petition subject to a number of conditions, including:

> *The assets of Elizabethtown Gas Company shall not be pledged to support any financing related to NUI Utilities' other divisions or its subsidiaries unless approved by the Board pursuant to N.J.S.A. 48:3-7.* [Order at 5, item 16]
>
> *There shall be no commingling of cash between NUI Utilities and NUI Capital. If NUI Capital shall fund operations, capital additions or investments by external borrowing, any such borrowing or commitments by NUI Capital or its subsidiaries must be non-recourse to NUI Utilities and may not provide for cross-default to, or for credit support from NUI Utilities, unless prior approval is granted by the Board.* [Ibid. at 6, item 24]

In interviews with Liberty, four of the five outside directors did not recall any briefing to the board on the subject or conditions of the order, other than being notified that NUI had received holding company approval. The fifth director remembered some type of discussion about the order but no specifics. All five stated that they learned of the specific requirements about commingling of cash and the intercompany balances from the PricewaterhouseCoopers audit. They stated their reactions to learning they were out of compliance with the Order. The comments show lack of common understanding about knowledge of the existence of the intercompany balances before the PricewaterhouseCoopers audit, disagreement about its significance in the context of holding company order compliance, and even different recollections about whether management had ever even informed directors of the order's requirements as they affected NUI's overall structure and operations.

NUI's official position is that it has been in full compliance with the Holding-Company Order at all times since its issuance. Its general counsel filed in April 2003 a letter so stating. Liberty concluded that there were several high level corporate failures with respect to compliance with the Order:

- Management clearly ignored key terms of the Order. It is difficult to comprehend how anyone could read its provisions and not come away with a clear understanding of several prohibited activities.
- The NUI board operated without a sound understanding of the Order and without requiring a structured process for overseeing compliance efforts
- The board failed to require management to adequately explain the Order's requirements or to institute reasonable measures for assuring continuing compliance with the Order.
- To the extent that the board may have been briefed on the Order, it appears that the conditions above were never mentioned. Liberty notes that no briefing documents have been produced by the company, there is no record of discussion of the order or its terms, and only one outside director believed that there had been a review of the order by management. Moreover, the statements of the directors indicate clearly that they

did not have even a basic knowledge or understanding of the requirements of the order.

H. Summary of Corporate Governance Conclusions

1. The NUI board was too small given the size of the work load, the number of committees, and the infrequency of meetings.

2. The committee structure provided a reasonable division of authority and responsibility for the various board functions.

3. NUI did not bring sufficient structure or order to its large number of subsidiary boards.

4. The NUI board has been characterized by low turnover; the process for identifying director candidates has not been sufficiently structured.

5. The NUI parent board demonstrated a lack of utility operating and regulatory experience; NUI had no specific guidelines for either industry or general training until recently.

6. NUI senior executive management and the NUI board did not focus sufficiently on fulfilling its role with respect to the utility business or ETG in particular.

7. Board members have made a reasonably substantial time commitment to NUI matters; director attendance at board and committee meetings has been good.

8. Directors received information to prepare for meetings with sufficient time, but the information contained insufficient details about ETG's business; oral reports and documents provided at board and committee meetings and the minutes displayed a lack of detail about ETG operations.

9. The board has not applied an effective mechanism for dealing with new ventures.

10. The division of responsibilities between the Chairman and CEO was reasonably understood and implemented; NUI has handled succession on an ad hoc basis, without a formal succession plan or process; beginning in 2003 the board began a self-assessment process.

11. NUI has not kept full records of board operations.

12. The Company's use of the same firm as both internal and external auditor was not sound.

13. The Audit Committee's practices and procedures were generally in the spirit of the new requirements; the recently approved charters of the Audit Committee and of the Nominating and Governance Committee implement or formalize many of the requirements of Sarbanes-Oxley and the exchanges; NUI has developed corporate-governance guidelines.

14. NUI experienced a number of high-level corporate failures with respect to compliance with the Holding-Company Order.

IX. Compensation of Executives and Directors

A. Establishment of Compensation

The Compensation Committee of the board of directors sets NUI policies for executive and director compensation. As currently constituted by charter created in November 2002, the committee consists of three or more independent directors selected annually by the board. NUI's consultant on executive and director compensation reported to this committee.

The committee has been meeting a minimum of three times per year in recent years:

- September, when it establishes an executive compensation plan and levels for the coming calendar year
- May, when it considers mid-year compensation revisions
- November, when it examines executive incentives which may have been earned the preceding year.

NUI uses a three-factor formula to allocate the costs of compensation for executives who serve multiple business units. They include the CEO, the COO/CFO, the general counsel/CAO, and the treasurer. ETG has borne between half and two-thirds of the costs that NUI allocates by using this formula.

Executive compensation at NUI includes the following elements:

- Base salary
- An annual cash incentive award, payable for and varying with performance during a given fiscal year
- Grants of restricted stock, which may be converted contingent upon the Company meeting certain performance goals
- Long-term incentive awards consisting of two parts: a cash award that pays out if the Company performs in an exceptional manner, and stock options which vest after 2004 if the executive stays on as an NUI employee.

Liberty concluded that the structure and administration of executive compensation have been reasonable. The overall structure (separate from the size of the components) of the compensation packages is reasonably comparable to those of similar utility companies.

B. Compensation Levels

NUI has used an inappropriate market for benchmarking its executive compensation. The result has been unjustifiably large increases in base salary. NUI's consultant recommended and NUI agreed that a proper NUI peer group included diversified energy companies, rather than gas distribution utilities. In effect, NUI used companies like it was seeking to become, not like those it represented then or now. NUI raised executive compensation substantially in 2002 on the basis of this faulty comparison base. Compensation prior to those raises was at a reasonable level; it compared favorably with the levels of two other New Jersey LDCs, South Jersey Industries (SJI) and New Jersey Resources Corporation (NJR). In 2002, however, total reported NUI CEO compensation was at $1.07 million, which far exceeded the $684,000 and $662,000 at SJI and NJR, respectively. These totals include SEC-reported values of restricted stock grants, which may differ from what eventually became vested.

C. Incentive Compensation

NUI did not hold to established incentives when it failed in some years to meet financial goals. The Company has not made long-term incentive program payments recently, because its financial performance did not warrant it. This portion of its incentive compensation plan has operated as designed and communicated. In 2001, however, when the CEO did not qualify to have restricted shares of stock vest, the board awarded him an additional cash bonus. In 2002, the board overrode the program again when it attributed ineligibility for payouts to warmer than normal weather. Yet again, in 2003 the Company made two special grants of restricted stock, even as the Company's financial condition continued to deteriorate.

The measures used to determine payouts to executives under the incentive compensation program have little to do with ETG or utility group performance, even though ETG represents much of the size and nearly all the value of NUI. Unlike the non-utility subsidiaries, ETG operates under the special restrictions and the high public expectations reserved for utility service providers. With one minor exception, NUI's incentives all related to corporate or subsidiary financial performance.

D. Director Compensation

Director compensation has been higher than it should be. NUI's directors are paid at the top of the relevant comparable market. In particular, the directors' packages exceed those of SJI and NJR. The compensation package for the ETG advisory board is too low to compensate them for the time it should reasonably take to fulfill its responsibilities, assuming that it is vested with more substantial authority than it has had to date. The consulting agreement with the Chairman of the board has become unsupportable. There may have been merit to some type of arrangement when he first retired. The agreement has, however, remained in place for too long. The initial contract was for three years. It has been renewed twice for a total of nine years; it currently costs more than $300,000 per year.

E. Corporate Compensation Policies

NUI allocates executive-compensation costs under the three-part allocator. This approach unduly burdens ETG. ETG has also borne an unfair portion of the cost of director compensation and a disproportionate share of the costs of the compensation consultants for the same reason. This approach is not reflective of the amount of time the executives and directors spend on ETG.

Paying directors in stock instead of cash is well-intentioned, but could cause problems in attracting new candidates. It aligns director interests directly with shareholder interests. However, it may discourage new board candidates by deferring much of the compensation until they retire or resign from the board. NUI's policy of requiring directors and executives to own a specified minimum amount of Company common stock is desirable, because it helps to align the interests of the directors and executives with those of the stockholders.

NUI's change-in-control agreements are a standard feature of the relationships between corporations and their officers. Such agreements seek to motivate the officers to work in the best interests of the shareholders in the event of a prospective takeover or merger.

F. Summary of Executive and Director Compensation Conclusions

1. The structure and administration of executive compensation have been reasonable; the change-in-control agreements are representative.

2. NUI has used an inappropriate market against which to compare executive and director compensation, resulting in raises in base salary that were too large.

3. The consulting agreement with the chairman of the board has become unreasonable, and should end.

4. The compensation of the members of ETG's advisory board is too low. Their appointment to the NUI Utilities board increases the significance of this weakness.

5. Requiring directors and executives to own a minimum amount of the common stock of the Company is a desirable policy because it helps assure that the interests of executives is in line with those of stockholders; the policy of paying directors in stock instead of cash may be well-intentioned, but could cause problems in attracting new directors.

6. NUI paid executive incentives even when financial performance did not meet goals; the measures that NUI uses in determining whether executives should be awarded payouts under the Company's incentive compensation program have little to do with utility performance.

7. ETG bears too much of the costs of executives and executive compensation consultants.