

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	No. 07-_____
Proposed General Increase	:	
In Rates For Gas Service	:	

Direct Testimony of
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(Registered in Illinois as a CPA)
Vice President
Financial and Accounting Services
Peoples Energy Corporation

On Behalf of
North Shore Gas Company

March 9, 2007

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1 **I. INTRODUCTION AND BACKGROUND**

2 **A. Identification of Witness**

3 Q. Please state your name and business address.

4 A. My name is Linda M. Kallas. My business address is 130 E. Randolph, Chicago, Illinois,
5 60601.

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

7 A. I am employed by Peoples Energy Corporation (“Peoples Energy”) as Vice President of
8 Financial and Accounting Services. The parent company of Peoples Energy is Integryx
9 Energy Group, Inc.

10 **B. Purposes of Testimony**

11 Q. On whose behalf are you submitting your direct testimony?

12 A. I am submitting my direct testimony on behalf of North Shore Gas Company (“North
13 Shore” or the “Company”), for which I provide services pursuant to an Intercompany
14 Services Agreement to which North Shore and its parent company Peoples Energy
15 Corporation (“Peoples Energy”), as well as The Peoples Gas Light Coke and Company
16 (“Peoples Gas”), another subsidiary of Peoples Energy, are parties, approved by the
17 Illinois Commerce Commission (the “Commission” or “ICC”).

18 Q. What are the purposes of your direct testimony?

19 A. North Shore is proposing the use of its fiscal year 2006 (October 1, 2005, through and
20 including September 30, 2006) as the test year in this proceeding. I will support the
21 prudence and the justness and reasonableness of the costs and expenses recorded on the
22 Company’s books and records during fiscal year 2006. I will discuss the preparation of

23 Schedules under Part 285 of the Commission's rules, 83 Illinois Administrative ("Ill.
24 Adm.") Code Part 285, based on those books and records. I will discuss operating
25 expense categories for which significant changes occurred in fiscal year 2006 over the
26 actual amounts incurred in fiscal year 2005. For North Shore, I define significant as a
27 change (either an increase or decrease) of 10%, but not less than \$100,000. In particular,
28 I will address the Company's expenses for uncollectible accounts, taxes other than
29 income taxes, and intercompany services.

30 I will also support the ratemaking adjustment proposed by North Shore witness
31 Mr. Fiorella (North Shore Exhibit ("Ex.") SF-1.0), related to the gas charge settlement in
32 ICC Docket Nos. 01-0706, 02-0726, 03-0704, and 04-0682.

33 **C. Summary of Conclusions**

34 Q. Please summarize the conclusions you make in your direct testimony.

35 A. In brief, the conclusions of my direct testimony are as follows. The Company's books
36 and records for the test year (fiscal year 2006) fairly state the results of operations of
37 North Shore and are appropriate as the primary basis for the determination of the
38 Company's just and reasonable revenue requirement in this proceeding. The ratemaking
39 adjustment referenced herein is appropriate and just and reasonable to properly and
40 correctly reflect the gas charge settlement in ICC Docket Nos. 01-0706, 02-0726,
41 03-0704, and 04-0682.

42 **D. Itemized Attachments to Direct Testimony**

43 Q. Are you sponsoring any attachments to your direct testimony?

44 A. Yes. I sponsor North Shore Ex. LK-1.1, which consists of the following Schedules from
45 83 Ill. Admin. Code Part 285: Schedule C-4 (Comparative Operating Income Statements

46 for Prior Years and the Test Year), Schedule C-16 (Uncollectible Expense, Page 1 of 4),
47 Schedule C-18 (Taxes Other Than Income Taxes, Page 4 of 4), and Schedule C-13
48 (Summary of Affiliated Interest Transactions, Page 1 of 2). In addition, I sponsor North
49 Shore Ex. LK-1.2, Uncollectible Expense. I will discuss these exhibits later in my
50 testimony.

51 Q. Were these exhibits prepared under your supervision and direction?

52 A. Yes.

53 **E. Background and Experience**

54 Q. What is your educational background?

55 A. I graduated from the University of Illinois at Chicago in 1981 and received a Bachelor of
56 Science degree in accounting. I also became a Certified Public Accountant registered in
57 Illinois in 1982. In 1988, I received a Masters of Business Administration degree from
58 DePaul University.

59 Q. Please describe your business experience.

60 A. My business experience with the Peoples Energy companies began in 1981. I was
61 directly employed by Peoples Gas from 1981 until 2002, at which time I became an
62 employee of Peoples Energy. My experience generally has involved duties and
63 supervisory positions relating to accounting and financial reporting. I assumed the
64 position of Vice President and Controller of Peoples Energy, Peoples Gas, and North
65 Shore in October 2002. I assumed my current position as Vice President of Financial and
66 Accounting Services as of February 21, 2007, the date of the transaction involving
67 Peoples Energy and WPS Resources Corporation that led to the latter's changing its name

68 to Integrys Energy Group, Inc., and becoming the parent company of Peoples Energy.
69 Pending the establishment of Integrys Business Support, LLC (“IBS”), I will remain
70 employed by Peoples Energy.

71 Q. What were your responsibilities as Vice President and Controller of Peoples Energy,
72 Peoples Gas, and North Shore?

73 A. My responsibilities include oversight of all accounting activities of Peoples Energy and
74 all of its wholly owned subsidiaries. I am in charge of the recording of financial activity
75 and the related accounting records, accounting information systems and reports, and the
76 executive supervision of the system of internal accounting controls. I am also responsible
77 for ensuring compliance with tax regulations, Generally Accepted Accounting Principles,
78 Securities and Exchange Commission (“SEC”) reporting requirements, and other outside
79 reporting requirements including the ICC annual report. The departments directly under
80 my supervision are Financial Reporting and Compliance, General Accounting, Gas
81 Accounting, and Tax Administration. I have continued and will continue these
82 responsibilities during a transition period, pending the establishment of IBS.

83 **II. FINANCIAL STATEMENTS AND PART 285 SCHEDULES**

84 Q. North Shore Ex. LK-1.1 sets forth certain of the Schedules required to be filed pursuant
85 to 83 Ill. Admin. Code Part 285. Are those the only Part 285 Schedules prepared under
86 your supervision and direction?

87 A. No, I am responsible for a large number of the Part 285 Schedules. I am responsible for
88 the Schedules attached hereto as part of North Shore Ex. LK-1.1 and for the other
89 Schedules attached to other North Shore witnesses’ testimony or included in the Part 285

90 filing to the extent that those Schedules were derived from the Company's books and
91 records.

92 Q. Is the information contained in the Part 285 Schedules that is drawn from the Company's
93 books and records accurate and appropriate?

94 A. Yes. The Company's books and records for the test year, fiscal year 2006, were properly
95 prepared, and they correctly record its actual revenues, costs, and expenses incurred in
96 fiscal year 2006 in accordance with Generally Accepted Accounting Principles. The data
97 in the Part 285 Schedules is accurately drawn from the Company's books and records for
98 fiscal year 2006. The data in the Part 285 Schedules that is drawn from the Company's
99 books and records for prior periods also is correct and accurate.

100 Q. Please explain generally the preparation of the Company's Part 285 Schedules filed in
101 this proceeding.

102 A. The source data for the schedules is the SAP system used to record the financial results
103 for all of the Peoples Energy companies. The SAP system records financial results in
104 natural accounts representing the type of cost incurred (e.g. labor, outside services,
105 materials, etc.). Separately, within SAP, these accounts are mapped to the Uniform
106 System of Accounts ("USOA") based on the project or activity related to the cost (e.g.,
107 labor dollars related to repairing a main would be mapped to Account 887.00). Most
108 revenue and balance sheet accounts are directly mapped to the USOA. A reporting tool
109 was used to develop the Income Statement, Balance Sheet, and Statement of Cash Flows
110 for all of the periods required. These reports were reviewed by various people, including
111 myself, and any significant variances between years were analyzed to ensure the
112 accuracy of the information. These reports were also compared to North Shore's SEC

113 financial statements and any differences were reviewed for appropriateness. The
114 Schedules were prepared by staff personnel but in all cases a series of reviews took place.
115 These reviews included a check of the schedules by the appropriate Manager, a high level
116 review by me, and a final review by the Director of Decision Support who was
117 functioning as the project lead for the rate case preparation. In all cases, the Schedules
118 were checked for conformity with the underlying financial statements.

119 Q. Why are the Company's books and records for the test year (fiscal year 2006) appropriate
120 as the primary basis for the determination of the Company's just and reasonable revenue
121 requirement in this proceeding?

122 A. The Company's rate filing is based on an historical test year (its fiscal year 2006), with
123 appropriate adjustments. Thus, the primary basis for the determination of North Shore's
124 proposed revenue requirement is and should be its actual experience during fiscal year
125 2006.

126 As I stated above, the Company's books and records for fiscal year 2006 fairly
127 present its actual revenues, costs, and expenses incurred in fiscal year 2006 in accordance
128 with Generally Accepted Accounting Principles, and the data in the Part 285 Schedules
129 that is drawn from those books and records is accurate and correct. The revenue
130 requirement and how it was calculated are set forth in the Part 285 Schedules.

131 Moreover, North Shore's financial statements are the subject of annual
132 independent audits. (The independent auditors audit the Peoples Energy consolidated
133 financial statements, which include North Shore activity as well as the activity of Peoples
134 Energy's other subsidiaries, and also separately audit the financial statements of North
135 Shore on a stand-alone basis.) Such independent audits are conducted to determine

136 whether, in accordance with the applicable standards, the Company's financial statements
137 present fairly (in all material respects) its financial position at the applicable dates, and
138 the results of its operations and cash flows for the applicable periods, and in conformity
139 with Generally Accepted Accounting Principles. Moreover, since their adoption
140 following the enactment of the Sarbanes-Oxley Act, the independent auditors have
141 conducted the annual audits of the financial statements and of the effectiveness of
142 internal controls over financial reporting in accordance with the standards of the Public
143 Company Accounting Oversight Board. Although North Shore as a separate SEC
144 registrant is not yet subject to the internal control audit specified by Section 404 of
145 Sarbanes-Oxley, its internal controls, processes, and related documentation are part of the
146 auditors review of the effectiveness of Peoples Energy's internal controls over financial
147 reporting.

148 On December 14, 2006, North Shore filed its Form 10-K annual report for its
149 fiscal year 2006 with the SEC. (The report was filed as a combined report with Peoples
150 Energy.) The report of the independent auditors included in the Form 10-K for 2006
151 states in part:

152 In our opinion, the consolidated financial statements referred to
153 above present fairly, in all material respects, the financial position of
154 North Shore Gas and subsidiary companies at September 30, 2006 and
155 2005, and the results of their operations and their cash flows for each of
156 the three years in the period ended September 30, 2006, in conformity
157 with accounting principles generally accepted in the United States of
158 America. Also, in our opinion, such financial statement schedules, when
159 considered in relation to the basic consolidated financial statements taken
160 as a whole, present fairly in all material respects the information set forth
161 therein.

162 In addition, the report of the independent auditor included the following as it
163 relates to internal controls over financial reporting of Peoples Energy:

164 In our opinion, management's assessment that the Company
165 maintained effective internal control over financial reporting as of
166 September 30, 2006, is fairly stated, in all material respects, based on the
167 criteria established in *Internal Control - Integrated Framework* issued by
168 the Committee of Sponsoring Organizations of the Treadway
169 Commission. Also in our opinion, the Company maintained, in all
170 material respects, effective internal control over financial reporting as of
171 September 30, 2006, based on the criteria established in *Internal Control -*
172 *Integrated Framework* issued by the Committee of Sponsoring
173 Organizations of the Treadway Commission.

174 Thus, the Company's actual experience in the test year (fiscal year 2006) is
175 correctly and accurately reflected in its books and records. The governing standards and
176 accounting principles were properly applied by North Shore so as to prepare books and
177 records that are correct and accurate regarding the results of that actual experience.

178 The Company's books and records also reflect North Shore's underlying business
179 processes. The books and records reflect its internal controls, as indicated above. The
180 books and records also reflect the results of North Shore's underlying policies and
181 practices for the prudent, reasonable, and efficient conduct of its business operations,
182 including capital project activity, the operation and maintenance of its gas distribution
183 and information systems, and the other activities in which it engages in order to provide
184 safe, adequate, and reliable service to its customers.

185 All of Peoples Energy's subsidiaries, including North Shore Gas, are subject to
186 oversight by senior management and the Peoples Energy's Board of Directors. On a
187 yearly basis, a budget is prepared and presented to both groups. Significant variances
188 from prior years must be supported. Although the Board of Directors officially approves
189 only the capital budget, the operating budget is presented. Comparisons of this budget to

190 actual results (with explanations of significant variances) also are presented at every
191 Board of Directors' meeting. Finally, on a monthly basis I preside over a more detailed
192 review of each segment's financial results, including North Shore Gas, which includes a
193 discussion of variances to the original budget

194 Other witnesses testifying on behalf of North Shore provide additional data and
195 other information that supports its proposed revenue requirement.

196 Q. Please describe Schedule C-4, page 1, which is part of North Shore Ex. LK-1.1.

197 A. Schedule C-4 shows North Shore's Operating Income Statements for the fiscal 2006 test
198 year and the three preceding years by Federal Energy Regulatory Commission ("FERC")
199 Accounts (the Uniform System of Accounts). Page 1 provides aggregate figures for the
200 categories of items within Operating Revenues, Operating Expenses, and Operating
201 Income. Column A identifies Account numbers. Column B identifies Account names or
202 categories. Column C sets forth figures based on the Company's books and records for
203 fiscal year 2006. Columns D, E, and F set forth figures based on the Company's books
204 and records for fiscal years 2005, 2004, and 2003, respectively.

205 Test year Other Operation and Maintenance Expenses of \$43,640,000, shown on
206 page 1, column C, line 8, reflects all expenses recorded in Accounts 401 and 402 other
207 than the Cost of Gas, which is shown on page 1, column C, line 7. The test year amount
208 shown for Other Operation and Maintenance Expenses, \$43,640,000, is the same as that
209 shown on North Shore Ex. SF-1.1 at Schedule C-1, page 1 of 1, line 14, column C,
210 sponsored by Company witness Mr. Fiorella.

211 Other than Depreciation Expense totaling \$5,724,000 (shown on Schedule C-4,
212 page 1, line 9, column C), the remaining operating expenses (shown on Schedule C-4,

213 page 1, lines 10 through 15, column C) essentially represent taxes imposed by federal,
214 state, and local governments. The test year amounts shown for Depreciation Expense and
215 taxes are the same as those shown on North Shore Ex. SF-1.1 at Schedule C-1, page 1 of
216 1, line 15, column C, line 17, column C, and lines 19 through 22, Column C, sponsored
217 by Mr. Fiorella.

218 The test year amount shown for Operating Income, \$10,093,000, on
219 Schedule C-4, page 1, line 17, column C, is the same as that shown on North Shore
220 Ex. SF-1.1 at Schedule C-1, page 1 of 1, line 24, column C, sponsored by Mr. Fiorella.

221 The total operating revenues figure, \$299,589,000, on Schedule C-4, page 1,
222 line 5, column C, is the same as that shown on North Shore Ex. SF-1.1 at Schedule C-1,
223 page 1 of 1, line 1, column C, sponsored by Mr. Fiorella.

224 The Cost of Gas figure, \$220,300,000, on Schedule C-4, page 1, line 7, column C,
225 is the same as that shown on North Shore Ex. SF-1.1 at Schedule C-1, page 1 of 1, line 3,
226 column C, sponsored by Mr. Fiorella

227 Q. Please describe pages 2 through 3 of Schedule C-4.

228 A. Pages 2 through 3 show in more detail North Shore's Operation and Maintenance
229 Expense for the test year and the three preceding years by Account, including Cost of
230 Gas. Total Operation and Maintenance Expense for the test year, shown on page 3,
231 column C, line 38, is \$263,940,000. This amount is equal to the sum of the Cost of Gas
232 on page 2, column C, line 8, and Total Operation and Maintenance, Excluding Cost of
233 Gas on page 3, column C, line 37. Total Operation and Maintenance, Excluding Cost of
234 Gas, for the test year is \$43,640,000, as also noted above.

235 Q. Is it your position that all of the expenses reflected on Schedule C-4 that are incorporated
236 in North Shore's proposed revenue requirement were prudently incurred and reasonable
237 in amount?

238 A. Yes, based on the information in my testimony and its attachments and that provided by
239 the Company's other witnesses.

240 Q. What controls does the Company have in place to make sure that the expenses reflected
241 on Schedule C-4 were prudently incurred and just and reasonable?

242 A. As noted earlier, the company has process and procedures that ensure proper recording of
243 activity. It also employs various review processes that ensures significant changes in
244 costs are appropriate

245 **III. ACCOUNT VARIANCES**

246 Q. Have you undertaken an analysis to determine if there were significant variances in the
247 operating expense Accounts from fiscal year 2005 to the test year, fiscal year 2006?

248 A. Yes. For purposes of this analysis, I looked at major groupings of Accounts and I defined
249 "significant" to be a change, whether an increase or decrease, of at least 10% but not less
250 than \$100,000, which I believe to be reasonable criteria for North Shore. For example,
251 the first grouping of Accounts on Schedule C-4 is labeled "Cost of Gas". The total for
252 these accounts for fiscal year 2005 was \$180,922,000 as shown on Schedule C-4, page 2,
253 column D, line 8. The total for these same accounts for fiscal year 2006 was
254 \$220,300,000 (as shown on Schedule C-4, page 2, column C, line 8), a difference of over
255 20% and almost \$40 million. Therefore, I will present an explanation of the variance.
256 However, the next grouping of Accounts on Schedule C-4 is labeled "Production-
257 Operation". The total for these accounts for fiscal year 2005 was \$42,000, as shown on

258 Schedule C-4, page 2, column D, line 15. The total for these same accounts for fiscal
259 year 2006 was \$68,000 (Schedule C-4, page 2, column C, line 15). Because the
260 difference was only \$26,000, much less than \$100,000, I am not offering an explanation
261 of this variance.

262 Q. Please explain the main driver(s) causing the increase of \$39,378,000 in Cost of Gas from
263 fiscal year 2005 to the test year as shown on Schedule C-4, page 2, columns D vs. C,
264 line 8.

265 A. Gas Costs increased mainly due to the increases in gas prices. The average cost of gas in
266 fiscal year 2005 was \$6.85 per dth, compared to \$8.56 per dth during the test year. These
267 prices primarily reflect the commodity costs, hedge settlements, and non-commodity
268 costs, primarily pipeline transportation and storage demand charges.

269 Note that gas costs are recovered in customers' bills under North Shore's Rider 2.
270 Therefore this increase has no effect on the portion of North Shore's revenue requirement
271 to be recovered through the base rates to be established in this case. (There is an indirect
272 impact on uncollectible expense, as I will describe later in my testimony.) The costs
273 incurred and charged to customers under Rider 2 are reviewed annually by the
274 Commission in a separate reconciliation proceeding and are not to be set in this rate case.

275 Q. Please explain the \$156,000 decrease in expense for Total Production-Maintenance
276 shown on Schedule C-4, page 2, columns D vs. C, line 20.

277 A. Almost the entire decrease, \$154,000, is due to the painting of liquid propane tanks which
278 occurred in fiscal year 2005, but not in fiscal year 2006.

279 Q. Please explain the \$280,000 increase in expenses for the category Total Distribution
280 Expenses-Maintenance shown on Schedule C-4, page 3, columns D vs. C, line 11.

281 A. The primary reasons were as follows. First, there was \$114,000 increase in Maintenance
282 Supervision and Engineering (Schedule C-4, page 3, columns D vs. C, line 2) as the
283 result of the transfer of the dispatcher position at North Shore from a union position to a
284 management position. This change was negotiated with the union. Second, there was a
285 \$70,000 increase in expense for Maintenance of Services (Schedule C-4, page 3,
286 columns D vs. C, line 8), which resulted from increased work on Buffalo boxes (the shut
287 off valve located on service pipes) due to increased collection activity at North Shore Gas
288 during fiscal year 2006. Third, there was a \$70,000 increase in expense for Maintenance
289 of Meters and House Regulators (Schedule C-4, page 3, columns D vs. C, line 9), which
290 was due to the fact that during fiscal year 2006, North Shore Gas conducted an exposed
291 pipe survey. As a result of the survey, there was a large expense for painting meters.

292 Q. Please explain the \$7,463,000 increase in the category Total Administrative and General
293 Expenses-Operation shown on Schedule C-4, page 3, columns D vs. C, line 33.

294 A. There were several major reasons for this increase. First and foremost, there was a
295 \$5,011,000 increase in Miscellaneous General Expenses (Schedule C-4, page 3,
296 columns D vs. C, line 32). In turn, the largest factor causing the increase in
297 Miscellaneous General Expenses is a charge of \$4,300,000 recorded in fiscal year 2006
298 for settlement of North Shore's fiscal year 2001 through fiscal year 2004 gas charge
299 proceedings. As also described more fully later in my testimony, these costs have no
300 effect on the cost of service or capital structure for the test year in the calculation of the
301 base rate revenue requirement in this proceeding. Other changes in this Account are

302 associated with increases in environmental costs of \$202,000. These costs are included
303 in customers' bills under Respondent's Rider 11 with a corresponding amount included in
304 expense. Therefore, this increase has no effect on North Shore's base rate revenue
305 requirement. The costs incurred and charged to customers under Rider 11 are reviewed
306 annually by the Commission in a separate reconciliation proceeding and are not to be set
307 in this rate case.

308 Second, during fiscal year 2006, North Shore expensed \$941,000 of rate case
309 costs that had been deferred in 2005 and earlier in 2006 in connection with preparation
310 for a potential rate increase filing that was never made. (These costs are reflected as a
311 ratemaking adjustment on Schedule C-2.16, part of North Shore Ex. SF-1.1, sponsored by
312 Company witness Mr. Fiorella.)

313 Third, there was an increase of \$1,279,000 in billings from Peoples Energy and
314 Peoples Gas under the Intercompany Services Agreement approved by the Commission.
315 This increase was the results of numerous items, the most significant individual items
316 being increases in labor and overhead costs of \$765,000 and legal costs of \$200,000
317 Labor and overhead costs increased mainly due to salary and headcount increases, as well
318 as increased pension and group insurance costs. Due to the corporate reorganization that
319 occurred late in fiscal year 2004, Peoples Energy was not at full employee complement
320 during fiscal year 2005.

321 Fourth, there was a \$107,000 increase in expenses for Injuries and Damages
322 (Schedule C-4, page 3, columns D vs. C, line 28), 65% of which was caused by an
323 increase in Excess Liability Insurance premiums and the purchase of additional Director
324 and Officer Liability coverage. Excess Liability Insurance premiums increased due to

325 hard market conditions that occurred subsequent to Hurricane Katrina and due to the
326 Company's past claim history. Director and Officer Liability insurance premiums
327 increased due to the purchase of an additional \$25 million of coverage. The remaining
328 35% increase in expenses was due to higher workers compensation claim experience that
329 related to a few severe injuries.

330 Fifth, there was a \$609,000 increase in expenses for Franchise Requirements
331 (Schedule C-4, page 3, columns D vs. C, line 30), the Account where the total value of
332 franchise gas provided to municipalities under franchise agreements is recorded. The
333 increase was caused by higher average gas charge rates in 2006 versus 2005, which I
334 discussed previously in my testimony, and higher usage by the municipalities receiving
335 franchise gas from North Shore Gas. Specifically, there was an increase of 20,451 Dth
336 from fiscal year 2005 to the test year. Note, however, that offsetting this item is the
337 \$167,000 increase in Duplicate Charges - Credit (Schedule C-4, page 3, columns D vs. C,
338 line 31). As prescribed by the Uniform System of Accounts, Duplicate Charges – Credit
339 represents non cash costs included in the Franchise Requirements account. That is, the
340 account for Franchise Requirements contains the value of gas charges, distribution
341 charges, and taxes that would have been billed to municipalities had they not been a party
342 to the franchise agreements. This account eliminates distribution charges and taxes as
343 such costs were not incurred by the Company.

344 **IV. UNCOLLECTIBLE EXPENSES**

- 345 Q. Are there any other Accounts that you would like to address in your direct testimony?
- 346 A. Yes, although the Total Customer Accounts Expense-Operations category, that includes
347 Account 904-Uncollectible Accounts, did not meet my criteria for addressing variances in

348 direct testimony, there was an increase that I would like to address, in part because of the
349 information required to be provided on this subject by the Commission's rules.

350 My starting point is the analysis required by the Commission's Part 285.
351 Schedule C-16, page 1, which is part of North Shore Ex. LK-1.1, shows uncollectible
352 expense as a percentage of applicable revenues for the test year and the three preceding
353 fiscal years. The schedule shows that, although there have been some fluctuations,
354 uncollectible expense as a percentage of applicable revenues has been fairly constant over
355 that time period. The amount was 0.72% in fiscal year 2003 compared to 0.70% in fiscal
356 year 2006.

357 Schedule C-16, page 1, also shows that uncollectible expense as a percentage of
358 applicable revenues, after going down from the fiscal year 2003 level, rose from 0.53% in
359 fiscal year 2004 to 0.60% in fiscal 2005, and then again up to 0.70% in fiscal year 2006.

360 Q. Is that an upward trend that you expect to continue?

361 A. No, not at this time. To determine if there is a trend, one should look at uncollectible
362 expense over a longer period of time. North Shore Ex. LK-1.2 provides a long-term
363 history of uncollectible expense, net write-offs, provision rates, and average gas charges
364 for fiscal years 1997 through 2006. The exhibit shows that, on a dollar basis, there has
365 been a large increase in uncollectible expense due to increases in natural gas prices.
366 North Shore experienced an approximate tripling of natural gas prices during this period,
367 from 31 cents per therm in fiscal year 1997 to 87 cents per therm in the test year. Rising
368 gas prices resulted in an overall increase in the amount of billings charged as write-offs,
369 net of collection recoveries. For example, in fiscal year 1997, net write-offs were
370 \$873,000 versus net write-offs of \$1,506,000, in the test year. However, the uncollectible

371 provision rate (expressed both as the accrual rate as well as the effective rate (after
372 adjustment)) has operated within a fairly tight range, as one would expect due to the
373 relationship between uncollectible expenses and gas costs.

374 Q. What has North Shore Gas done to control its uncollectible expenses?

375 A. North Shore has, over the time period covered by North Shore Ex. LK-1.2, instituted a
376 number of enhanced credit and collection procedures. These include: requiring deposits
377 from high risk customers based on a behavioral scoring methodology when an account is
378 established; customer credit reporting; automated review for outstanding balances on
379 previous accounts for new applicants; automated outbound collection calls; and
380 disconnection prioritization based on a delinquent customer's behavioral score.

381 Q. Schedule C-16 indicates an adjustment to the reserve for uncollectible accounts was
382 recorded in fiscal year 2005. Why was the adjustment recorded?

383 A. On a quarterly basis, if warranted, the Company performs a review of the adequacy of the
384 reserve for bad debt and adjusts based on aging factors and collection experience.
385 Adjustments to the reserve generally increase or decrease uncollectible expense that
386 results from applying a forecasted percentage of write-offs to revenue. The forecasted
387 percentage is established at the beginning of the year and applied consistently throughout
388 the year to current year revenue. Quarterly adjustments usually relate to pending write-
389 offs for prior period sales.

390 Q. Were any adjustments made to the reserve for bad debt during the test year?

391 A. Yes, in fiscal year 2006, an adjustment to the reserve was made pursuant to the terms of a
392 settlement in past gas supply proceedings. This adjustments was charged to

393 Account 930.2, Miscellaneous General Expenses, and do not impact uncollectible
394 expense shown on Schedule C-16, which is included in North Shore Ex. LK-1.1. As
395 described later in my testimony, this adjustment is part of a ratemaking adjustment
396 related to the gas charge settlement.

397 **V. TAXES**

398 Q. Please describe Schedule C-18, included as part of North Shore Ex. LK-1.1.

399 A. Schedule C-18, page 4 of 4, details North Shore's Taxes Other Than Income Taxes
400 (federal, state, and local) for the test year. The total of these taxes for the test year,
401 shown on line 19, column F is \$16,729,000. The amount charged to expense as reflected
402 in line 19, column B, \$16,508,000, ties to Schedule C-4, page 1, line 11, column C.
403 Taxes that are based on the Company's revenue, i.e., Illinois Public Utility
404 (Schedule C-18, page 4, line 6), Annual Gross Revenue (line 7), and Municipal Public
405 Utility (line 16), in aggregate are estimated at \$13,021,000, or nearly 79% of total Taxes
406 Other Than Income Taxes for the test year. These taxes are a function of billed gas costs,
407 i.e. as billed costs rise, so do the billed taxes. These taxes are legal obligations and thus
408 are necessary expenses of the Company.

409 **VI. INTERCOMPANY SERVICES**

410 Q. Please describe Schedule C-13, included as part of North Shore Ex. LK-1.1.

411 A. Schedule C-13, page 1 summarizes North Shore's transactions with affiliated interests for
412 fiscal years 2006 and 2005. The exhibit shows amounts billed to North Shore Gas by
413 Peoples Energy pursuant to the Intercompany Services Agreement approved by the
414 Commission in ICC Docket No. 55071 and the amounts billed to Respondent by Peoples
415 Gas pursuant to the same Intercompany Services Agreement, the Underground Gas

416 Storage Services Agreement approved by the Commission in ICC Docket No. 57988, and
417 the Intercompany Loan Arrangement approved by the Commission in ICC Docket
418 No. 04-0602. The total amounts billed to North Shore for the test year were \$17,234,000.
419 The exhibit also shows the amounts billed by North Shore to Peoples Gas pursuant to the
420 Intercompany Services Agreement and the Intercompany Loan Agreement, totaling
421 \$245,000 for the test year.

422 Q. Please describe the nature of these services provided to North Shore by Peoples Energy.

423 A. During fiscal year 2003, Peoples Energy and its subsidiaries adopted a business services
424 model for administrative support services that are common among all business units.
425 These activities are provided by Peoples Energy and include accounting, tax compliance,
426 auditing, finance, information technology, human resources, facilities management,
427 procurement, secretary services, treasury functions, risk management and legal services.
428 These services reflect general business activities that are required to operate any business
429 but are more efficiently performed by one work group under a single set of processes and
430 controls.

431 Q. Please describe how these costs are allocated to Peoples Energy's subsidiaries, including
432 North Shore.

433 A. Costs are generally allocated in one of three ways to the participating company, as most
434 appropriate: specific operational allocators, specific allocation of resources within a
435 department, or an allocator based on labor and assets of each company receiving the
436 service. For example, the cost of procurement services is allocated based on the number
437 of purchase orders processed for each company in the prior year. Cost centers that can
438 identify the number of employees that provide services for each company, or can

439 accurately track the employee time devoted to a particular company, allocate their costs
440 based on that information. For all other cost centers, costs are allocated based on the
441 relative weighting of labor and capital assets at each company receiving the service.

442 Q. What is the benefit of using a business services organization?

443 A. Certain common activities are required for any company regardless of its core business.
444 In many cases, when a service needed by several affiliated companies can be
445 consolidated, the overall cost to perform the service for all the companies is less than if
446 the activity were conducted separately by each company. Because Peoples Energy had
447 five significant subsidiaries at the time of the business services reorganization, it was able
448 to effectively use this model.

449 Q. What is the nature of the services provided by Peoples Gas to North Shore?

450 A. Peoples Gas provides a number of core functions to North Shore, including engineering
451 work, gas supply, customer support, regulatory compliance, and senior management
452 support. Similar services were provided by Peoples Gas to North Shore during the test
453 year used in the previous North Shore rate case. These services are normal activities
454 required by any utility but are more efficiently performed by one work group under a
455 single set of processes and controls

456 Q. Have you made a comparison of the costs charged to North Shore Gas by Peoples Energy
457 for services during fiscal year 2006 and the costs North Shore Gas incurred during fiscal
458 year 1996 when such services were being performed by Peoples Gas and Peoples
459 Energy?

460 A. Yes. During fiscal year 2006, North Shore was billed a total of \$10,113,000 by Peoples
461 Energy for administrative and general activity. During fiscal year 1996, North Shore was
462 billed \$5,292,000 by Peoples Energy for similar services. Fiscal year 1996 was chosen
463 for comparison with fiscal year 2006 because fiscal year 1996 was the test year for the
464 Company's last approved rate increase.

465 Q. Does this increase in billings from Peoples Energy reflect a similar increase in the cost of
466 the underlying services provided?

467 A. No. A better comparison of the change in the total cost of these services would be a
468 combined review of Peoples Gas and North Shore Gas activity. A similar analysis of
469 these costs for Peoples Gas indicates a total of \$58,741,000 for fiscal year 1996 and
470 \$58,420,000 for fiscal year 2006. Thus, the combined total for Peoples Gas and North
471 Shore is \$64,033,000 and \$68,533,000 for fiscal years 1996 and 2006, respectively.
472 Inflating the 1996 amount based on the Consumer Price Index for each year, would result
473 in an equivalent amount of \$82,353,000 for fiscal year 2006. This would equate to a
474 savings of almost \$13.8 million on an adjusted basis.

475 Q. What do you conclude from this comparison?

476 A. This indicates that overall, the service company model, including the sharing of costs by
477 other Peoples Energy entities, and other cost control measures have resulted in more
478 efficient processes and less overall costs for this activity.

479 Q. Given the very insignificant increase in these costs, why is there a more significant
480 increase in the North Shore intercompany billing amount?

481 A. Prior to the establishment of business services model, most of this activity was embedded
482 in Peoples Gas. A significant portion of the intercompany billing was based on the use of
483 time sheets by employees performing a particular activity. In cases where the activity
484 clearly benefited North Shore and not Peoples Gas, the time spent would get captured and
485 billed to North Shore Gas (e.g., recording North Shore journal entries). However, if the
486 activity was less specific to a company, it was more likely that Peoples Gas would get the
487 full cost of this activity (e.g. the work required to plan and control the month-end close
488 process). By moving to a business service model, Peoples Energy is better able to
489 allocate work and costs to all companies benefiting from the activity.

490 **VII. SUPPORT FOR RATEMAKING ADJUSTMENTS**

491 Q. Did you provide support for any of the ratemaking adjustments sponsored by North Shore
492 witness Mr. Fiorella?

493 A. Yes, I provided support for the adjustment shown on Schedule C-2.11 (part of North
494 Shore Ex. SF-1.1), which eliminates the effects of the gas charge settlement in ICC
495 Docket Nos. 01-0706, 02-0726, 03-0704, and 04-0682 from test year net operating
496 income. I explain this adjustment in the next section of my direct testimony.

497 **VIII. GAS CHARGE SETTLEMENT**

498 Q. What are the effects, if any, of the gas charge settlement on the financial statements
499 included in this filing?

500 A. As discussed earlier in my testimony, applicable charges for fiscal year 2006 are included
501 in Account 930.2. The effects of this charge on the Income Statement (expense and
502 related taxes) and Balance Sheet (short-term liability, deferred taxes, cash, retained
503 earnings) have been reflected in the Income Statements, Balance Sheets, Statement of

504 Cash Flows, and Statements of Retained Earnings, as appropriate under Generally
505 Accepted Accounting Principles. Subsequent to the settlement agreement, North Shore
506 suspended dividends to its parent company, Peoples Energy, for the remainder of fiscal
507 year 2006 resulting in a rebalance of its capital structure, as described in the testimony of
508 North Shore witness Bradley Johnson. Therefore, the settlement charge had no material
509 impact on North Shore's capital structure at September 30, 2006.

510 The following schedule details the calculation of the charges recorded in fiscal
511 year 2006:

<i>(Dollars in Thousands)</i>	
Refund	\$ 4,000
Payment to Illinois Attorney General and City of Chicago for Conservation Program	200
Bad debt expense	<u>100</u>
Gas charge settlement per consolidated statements of operations for fiscal 2006	\$ 4,300

512
513 As noted previously, the net settlement amount recognized in fiscal year 2006
514 operating expense, \$4,300,000 is reflected as a ratemaking adjustment on Schedule C-2,
515 part of North Shore Ex. SF-1.1, sponsored by Company witness Mr. Fiorella.

516 Q. As part of the settlement, did the Company agree to forgive \$7 million of uncollectible
517 accounts that were previously written off to bad debt?

518 A. Yes.

519 Q. How is that portion of the agreement reflected in the charges recorded per the above
520 schedule?

521 A. The forgiveness of the debt does not directly affect expense, as the amounts would have
522 been recorded as bad debt expense in previous periods. However, the Company does
523 continue to pursue collection of amounts written off to bad debt and is successful in
524 recovering some dollars from these customers. This has the affect of ultimately lowering
525 bad debt expense. Because the company agreed to forgive these debts, the Company will
526 have higher bad debt expense than if it was able to pursue collection on these accounts.
527 An estimate of that impact was calculated and recorded as additional bad debt expense as
528 noted in the above table.

529 Q. Does this conclude your direct testimony?

530 A. Yes.