

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

THE PEOPLES GAS LIGHT	:	
AND COKE COMPANY	:	
	:	No. 07-_____
Proposed General Increase	:	
In Rates For Gas Service	:	

Direct Testimony of
LINDA M. KALLAS
(Registered in Illinois as a CPA)

Vice President
Financial and Accounting Services
Peoples Energy Corporation

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

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

19 A. Peoples Gas 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.

23 I will discuss the preparation of Schedules under Part 285 of the Commission's
24 rules, 83 Ill. Adm. Code Part 285, based on those books and records. I will discuss
25 operating expense categories for which significant changes occurred in fiscal year 2006
26 over the actual amounts incurred in fiscal year 2005. For Peoples Gas, I define
27 significant as a change (either an increase or decrease) of 10%, but not less than
28 \$500,000. In particular, I will address the Company's expenses for uncollectible
29 accounts, taxes other than income taxes, and intercompany services.

30 I will also support certain ratemaking adjustments proposed by Peoples Gas
31 witness Mr. Fiorella (Peoples Gas Exhibit ("Ex.") SF-1.0), including one related to the
32 gas charge settlement in ICC Docket Nos. 01-0707, 02-0727, 03-0705, and 04-0683.

33 **C. Summary of Conclusions**

34 Q. Please summarize the conclusions of 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 Peoples Gas 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 adjustments referenced herein are appropriate and just and reasonable, including properly
40 and correctly reflecting the gas charge settlement in ICC Docket Nos. 01-0707, 02-0727,
41 03-0705, and 04-0683.

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

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

44 A. Yes. I sponsor Peoples Gas 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, Pages 1 and 2 of 4). In addition, I sponsor
49 Peoples Gas 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 of 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. Peoples Gas 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 Peoples Gas Ex. LK-1.1 and for the other
89 Schedules attached to other Peoples Gas 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 accuracy
112 of the information. These reports were also compared to Peoples Gas' SEC financial

113 statements and any differences were reviewed for appropriateness. The Schedules were
114 prepared by staff personnel but in all cases a series of reviews took place. These reviews
115 included a check of the schedules by the appropriate Manager, a high level review by me,
116 and a final review by the Director of Decision Support who was functioning as the
117 project lead for the rate case preparation. In all cases, the Schedules were checked for
118 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 Peoples Gas'
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, Peoples Gas' financial statements are the subject of annual
132 independent audits. (The independent auditors audit the Peoples Energy consolidated
133 financial statements, which include Peoples Gas activity as well as the activity of Peoples
134 Energy's other subsidiaries, and also separately audit the financial statements of Peoples
135 Gas 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 Peoples Gas 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 auditor's review of the effectiveness of Peoples Energy's internal controls over financial
147 reporting.

148 On December 14, 2006, Peoples Gas 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 Peoples Gas and subsidiary companies at September 30, 2006 and 2005,
155 and the results of their operations and their cash flows for each of the three
156 years in the period ended September 30, 2006, in conformity with
157 accounting principles generally accepted in the United States of America.
158 Also, in our opinion, such financial statement schedules, when considered
159 in relation to the basic consolidated financial statements taken as a whole,
160 present fairly in all material respects the information set forth therein.

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

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

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

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

184 All of Peoples Energy's subsidiaries, including Peoples Gas, are subject to
185 oversight by senior management and the Peoples Energy's Board of Directors. On a
186 yearly basis, a budget is prepared and presented to both groups. Significant variances
187 from prior years must be supported. Although the Board of Directors officially approves
188 only the capital budget, the operating budget is presented. Comparisons of this budget to
189 actual results (with explanations of significant variances) also are presented at every
190 Board of Directors' meeting. Finally, on a monthly basis I preside over a more detailed

191 review of each segment's financial results, including Peoples Gas, which includes a
192 discussion of variances to the original budget.

193 Other witnesses testifying on behalf of Peoples Gas provide additional data and
194 other information that supports its proposed revenue requirement.

195 Q. Please describe Schedule C-4, page 1, which is part of Peoples Gas Ex. LK-1.1.

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

204 Test year Other Operation and Maintenance Expenses of \$384,738,000, shown on
205 page 1, column C, line 8, reflects all expenses recorded in Accounts 401 and 402 other
206 than the Cost of Gas, which is shown on page 1, column C, line 7. The test year amount
207 shown for Other Operation and Maintenance Expenses, \$384,738,000, is the same as that
208 shown on Peoples Gas Ex. SF-1.1 at Schedule C-1, page 1 of 1, line 14, column C,
209 sponsored by Company witness Mr. Fiorella.

210 Other than Depreciation Expense totaling \$48,664,000 (shown on Schedule C-4,
211 page 1, line 9, column C) and Amortization Expense totaling \$8,185,000 (shown on
212 Schedule C-4, page 1, line 10, column C), the remaining operating expenses (shown on
213 Schedule C-4, page 1, lines 11 through 15, column C) essentially represent taxes imposed

214 by federal, state, and local governments. The test year amounts shown for Depreciation
215 Expense, Amortization, and taxes are the same as those shown on Peoples Gas Ex. SF-1.1
216 at Schedule C-1, page 1 of 1, line 15, column C, line 16, column C, line 17, column C,
217 and lines 19 through 22, Column C, sponsored by Mr. Fiorella.

218 The test year amount shown for Operating Income, (\$10,412,000), on
219 Schedule C-4, page 1, line 17, column C, is the same as that shown on Peoples Gas
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, \$1,622,291,000, on Schedule C-4, page 1,
222 line 5, column C, is the same as that shown on Peoples Gas 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, \$1,052,333,000, on Schedule C-4, page 1, line 7, column
225 C, is the same as that shown on Peoples Gas Ex. SF-1.1 at Schedule C-1, page 1 of 1,
226 line 3, column C, sponsored by Mr. Fiorella

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

228 A. Pages 2 through 4 show in more detail Peoples Gas' Operation and Maintenance Expense
229 for the test year and the three preceding years by Account, including Cost of Gas. Total
230 Operation and Maintenance Expense for the test year, shown on page 4, column C,
231 line 39, is \$1,437,071,000. This amount is equal to the sum of the Cost of Gas on page 2,
232 column C, line 7, and Total Operation and Maintenance, Excluding Cost of Gas on
233 page 4, column C, line 38. Total Operation and Maintenance, Excluding Cost of Gas, for
234 the test year is \$384,738,000 as also noted previously.

235 Q. Is it your position that all of the expenses reflected on Schedule C-4 that are incorporated
236 in Peoples Gas' proposed revenue requirement were prudently incurred and reasonable in
237 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 ensure significant changes in costs
244 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 \$500,000 which I believe to be reasonable criteria. For example, the first grouping
251 of accounts on Schedule C-4 is labeled "Cost of Gas". The total for these accounts for
252 fiscal year 2005 was \$853,453,000, as shown on Schedule C-4, page 2, column D, line 7.
253 The total for these same accounts for fiscal year 2006 was \$1,052,333,000 (as shown on
254 Schedule C-4, page 2, column C, line 7), a difference of over 20% and almost
255 \$200 million. Therefore, I will present an explanation of the variance. However, the
256 next grouping of accounts on Schedule C-4 is labeled "Production-Operation". The total
257 for these accounts for fiscal year 2005 was \$697,000, as shown on Schedule C-4, page 2,

258 column D, line 11. The total for these same accounts for fiscal year 2006 was \$557,000
259 (Schedule C-4, page 2, column C, line 11), a decrease of \$140,000. Because the
260 difference was less than \$500,000, I am not offering an explanation of this variance in my
261 direct testimony.

262 Q. Please explain the main driver(s) causing the increase of \$198,880,000 in Cost of Gas
263 from fiscal year 2005 to the test year (as shown on Schedule C-4, page 2, columns D vs.
264 C, line 7).

265 A. Gas Costs increased mainly due to the increases in gas prices. The average cost of gas in
266 fiscal year 2005 was \$6.73 per dth, compared to \$8.75 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 Peoples Gas Rider 2.
270 Therefore, this increase has no effect on the portion of Peoples Gas 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 \$1,226,000 increase in expense from fiscal year 2005 to fiscal year
276 2006 for Underground Storage Expense-Operation shown on Schedule C-4, page 2,
277 columns C and D, line 22.

278 A. The primary reason for this increase is a \$1,587,000 increase in Compressor Station Fuel
279 and Power (Schedule C-4, page 2, columns D vs. C, line 17). Compressor fuel expense is

280 a function of the volumes used and the price of gas. This increase is mainly due to the
281 increase in gas costs described above.

282 Q. Please explain the \$547,000 increase in expense from fiscal year 2005 to fiscal year 2006
283 for Underground Storage Expense-Maintenance shown on Schedule C-4, page 3,
284 columns D vs. C, line 10.

285 A. Almost the entire variance is reflected in the account for Maintenance of Compressor
286 Station Equipment (Schedule C-4, page 3, columns D vs. C, line 6). The failure of a
287 bearing in a large gas compressor damaged the crankshaft. The cost of repair was
288 approximately \$546,000.

289 Q. Please explain the \$607,000 increase in expense from fiscal year 2005 to fiscal year 2006
290 for Transmission Expenses-Operation shown on Schedule C-4, page 3, columns D vs. C,
291 line 26.

292 A. Almost the entire increase relates to the increase in Measuring and Regulating Station
293 Expenses, which increased by \$519,000 from fiscal year 2005 to fiscal year 2006
294 (Schedule C-4, page 3, columns D vs. C, line 23). Of this increase, approximately
295 \$411,000 is attributable to the increase in the cost of gas utilized at measuring and
296 regulating stations. I have previously addressed increased gas costs.

297 Q. Please explain the \$6,676,000 increase in expenses for the category Customer Accounts
298 Expenses-Operation shown on Schedule C-4, page 4, columns D vs. C, line 15.

299 A. The primary reason for this change was an increase in Uncollectible Accounts of
300 \$5,563,000 (Schedule C-4, page 4, columns D vs. C, line 13), which I will address later

301 in my direct testimony. There were numerous other factors, including offsets, that
302 resulted in the remaining net variance.

303 Q. Please explain the \$105,932,000 increase in the category Total Administrative and
304 General Expenses-Operation shown on Schedule C-4, page 4, columns D vs. C, line 34.

305 A. The major reason for this increase was the \$107,159,000 increase in Miscellaneous
306 General Expenses (Schedule C-4, page 4, Columns D vs. C, line 32). In turn, the largest
307 factor causing the increase in Miscellaneous General Expenses is a charge of
308 \$103,030,000 recorded in fiscal year 2006 for settlement of the Company's fiscal year
309 2001 through fiscal year 2004 gas charge proceedings. As also described more fully later
310 in my testimony, these costs have no effect on the cost of service or capital structure for
311 the test year in the calculation of the base rate revenue requirement in this proceeding.
312 Other changes in this account are associated with increases in environmental costs of
313 \$3,014,000. These costs are included in customers' bills under Respondent's Rider 11
314 with a corresponding amount included in expense. Therefore, this increase has no effect
315 on Peoples Gas' base rate revenue requirement. The costs incurred and charged to
316 customers under Rider 11 are reviewed annually by the Commission in a separate
317 reconciliation proceeding and are not to be set in this rate case.

318 The second factor affecting this category was an increase of \$9,221,000 from
319 fiscal year 2005 to fiscal year 2006 in Outside Services Employed (Schedule C-4, page 4,
320 columns D vs. C, line 26) mainly due to billings from Peoples Energy under the
321 Intercompany Services Agreement approved by the Commission. This increase was the
322 result of numerous items, the most significant individual items being increases in labor
323 and overhead costs due to salary and headcount increases, as well as increased legal,

324 pension, and group insurance costs. Due to the corporate reorganization that occurred
325 late in fiscal year 2004, Peoples Energy was not at full employee complement during
326 fiscal year 2005. Portions of the increase in legal fees that are considered nonrecurring
327 are reflected as ratemaking adjustments on Schedule C-2.9 (\$1,728,000) and
328 Schedule C-2.29 (\$867,000), part of Peoples Gas Ex. SF-1.1, sponsored by Company
329 witness Mr. Fiorella.

330 Also contributing to the increase in Total Administrative and General Expenses-
331 Operation is the recognition of \$1,346,000 of rate case costs that had been deferred in
332 2005 and earlier in 2006 in connection with preparation for a potential rate increase filing
333 that was never made. (These costs are reflected as a ratemaking adjustment on
334 Schedule C-2.16, part of Peoples Gas Ex. SF-1.1, sponsored by Company witness
335 Mr. Fiorella.)

336 Partially offsetting these increases was a reduction of \$10,224,000 in expenses for
337 Employee Pensions and Benefits (Schedule C-4, page 4, columns D vs. C, line 29).
338 Fiscal year 2005 includes \$10,400,000 in restructuring related charges and a \$2,100,000
339 charge for a change in accounting for pensions on executive deferred compensation.
340 Also causing the decrease in this account was the impact of the Medicare Part D, which
341 was included for a full year in fiscal year 2006 versus a partial year in fiscal year 2005.
342 Offsetting these increases are higher fiscal year 2006 costs that resulted from the changes
343 in the assumptions used by the Company's actuaries to calculate pension expense and
344 post-employment benefit expense. These costs are calculated each year by an
345 independent actuary and must be based on current and forecasted market conditions as of
346 the applicable measurement date. As such, these costs will vary as the underlying

347 assumptions change each year. For the test year, the discount rate used for the pension
348 and post-employment calculations decreased 89 basis points and 102 points, respectively.
349 Finally, also included in Employee Benefit costs for 2005 are a one-time vacation accrual
350 true-up of \$2,600,000 and a \$2,200,000 charge related to the fiscal year 2001 gas charge
351 filing for issues not contested by the Company. This charge should have been recorded
352 in Account 930.2, the misclassification was found after the fiscal year was closed, and
353 was corrected in fiscal year 2006.

354 **IV. UNCOLLECTIBLE EXPENSES**

355 Q. During your discussion of increases in expenses shown on Schedule C-4, you indicated
356 that there was an increase from fiscal year 2005 to fiscal year 2006 of \$5,563,000 for
357 Uncollectible Expense. What are the reasons for this increase?

358 A. The major reason is the increase in the cost of gas as I addressed previously in my direct
359 testimony. When one looks at uncollectible expenses as a percentage of applicable
360 revenues, uncollectible expense percentages were about the same in fiscal year 2006 and
361 fiscal year 2005 and actually coming down from previous levels.

362 Q. Please describe Schedule C-16 (page 1) of Peoples Gas Exhibit LK-1.1.

363 A. Schedule C-16 (page 1) shows uncollectible expense as a percentage of applicable
364 revenues for the test year and the three preceding fiscal years. The Schedule shows that
365 uncollectible expense as a percentage of applicable revenues has decreased over this time
366 period. For fiscal year 2003, this figure was 3.23%. This went down to 2.80% for fiscal
367 year 2004. The figure went down further, to 2.49%, in fiscal year 2005. Finally, there
368 was as slight increase, to 2.54%, in fiscal year 2006.

369 Q. Please describe Peoples Gas Exhibit LK-1.2.

370 A. Peoples Gas Ex. LK-1.2 provides a long-term history of uncollectible expense, net write-
371 offs, provision rates, and average gas charges for fiscal years 1997 through 2006. The
372 exhibit shows that on a dollar basis, there has been a large increase in uncollectible
373 expense due to increases in natural gas prices. Peoples Gas experienced an approximate
374 tripling of natural gas prices during this period, from approximately 30 cents per therm in
375 fiscal year 1997 to approximately 88 cents per therm in the test year. Rising gas prices
376 resulted in an overall increase in the amount of billings charged as write-offs, net of
377 collection recoveries. However, Peoples Gas has been able to control its uncollectible
378 expenses over this period of time. For example, the accrual rate for fiscal year 2006,
379 2.54%, is approximately the same as the accrual rate for fiscal year 1997, 2.50%. In fact,
380 when one looks at the effective write-off rate (a comparison of current year net write-offs
381 over prior year revenues), this amount actually decreased from 2.31% in fiscal year 1997
382 to 2.10% in fiscal year 2006. Note that within the ten-year time period shown on this
383 exhibit, there has been substantial fluctuation as Peoples Gas has adapted to control its
384 uncollectible expenses.

385 Q. What has Peoples Gas done to control its uncollectible expenses?

386 A. Peoples Gas has, over the time period covered by Peoples Gas Ex. LK-1.2, instituted a
387 number of enhanced credit and collection procedures. These include: requiring deposits
388 from high risk customers based on a behavioral scoring methodology when an account is
389 established; customer credit reporting; automated review for outstanding balances on
390 previous accounts for new applicants; automated outbound collection calls; and
391 disconnection prioritization based on a delinquent customer's behavioral score.

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

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

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

402 A. Yes, in fiscal year 2006, an adjustment to the reserve was made pursuant to the terms of a
403 settlement in past gas supply proceedings. The adjustment was charged to
404 Account 930.2, Miscellaneous General Expenses, and does not impact uncollectible
405 expense shown on Schedule C-16, which is included in Peoples Gas Ex. LK-1.1. As
406 described later in my testimony, this adjustment is part of a ratemaking adjustment
407 related to the gas charge settlement.

408 **V. TAXES**

409 Q. Please describe Schedule C-18, included as part of Peoples Gas Ex. LK-1.1.

410 A. Schedule C-18, page 4 of 4, details Peoples Gas' Taxes Other Than Income Taxes
411 (federal, state, and local) for the test year. The total of these taxes for the test year,
412 shown on line 21, column F is \$168,747,000. The amount charged to expense as
413 reflected in line 21, column B, \$166,821,000, ties to Schedule C-4, page 1, line 11,
414 column C. Taxes that are based on the Company's revenue, i.e., Illinois Public Utility

415 (Schedule C-18, page 4, line 6), Annual Gross Revenue (line 7), and Municipal Public
416 Utility (line 16), in aggregate are \$141,290,000, or approximately 85% of total Taxes
417 Other Than Income Taxes for the test year. These taxes are a function of billed gas costs,
418 i.e. as billed costs rise, so do the billed taxes. These taxes are legal obligations and thus
419 are necessary expenses of the Company.

420 **VI. INTERCOMPANY SERVICES**

421 Q. Please describe Schedule C-13, included as part of Peoples Gas Ex. LK-1.1.

422 A. Schedule C-13, pages 1 and 2 summarize Peoples Gas' transactions with affiliated
423 interests for fiscal years 2006 and 2005. The exhibit shows amounts billed to Peoples
424 Gas by Peoples Energy and North Shore pursuant to the Intercompany Services
425 Agreement approved by the Commission in ICC Docket No. 55071; the amounts billed to
426 Peoples Gas by Peoples Energy and North Shore pursuant to the Intercompany Loan
427 Arrangement approved by the Commission in ICC Docket Nos. 04-0602 and 04-0603,
428 and the amounts billed to Peoples Gas by Peoples NGL for peaking services, pursuant to
429 an agreement approved by the Commission in ICC Docket No. 96-0452. The total
430 amounts billed to Peoples Gas for the test year were \$66,656,000. The exhibit also shows
431 the amounts billed by Peoples Gas to Peoples Energy, North Shore, Peoples Energy
432 Services, Peoples Energy Resources, Peoples Energy Production, and Peoples Energy
433 Home Services pursuant to the Intercompany Services Agreement. The exhibit also
434 shows the amount billed by Peoples Gas to North Shore under the Intercompany Loan
435 Agreement and the Underground Gas Storage Services Agreement approved by the
436 Commission in ICC Docket No. 57988. Finally, it shows amounts billed by Peoples Gas
437 to Peoples Energy Wholesale Marketing and Peoples NGL for hub services.

438 Q. Please describe the nature of these services provided to Peoples Gas by Peoples Energy.

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

447 Q. Please describe how these costs are allocated to Peoples Energy's subsidiaries, including
448 Peoples Gas.

449 A. Costs are generally allocated in one of three ways to the participating company, as most
450 appropriate: specific operational allocators, specific allocation of resources within a
451 department, or an allocator based on labor and assets of each company receiving the
452 service. For example, the cost of procurement services is allocated based on the number
453 of purchase orders processed for each company in the prior year. Cost centers that can
454 identify the number of employees that provide services for each company, or can
455 accurately track the employee time devoted to a particular company, allocate their costs
456 based on that information. For all other cost centers, costs are allocated based on the
457 relative weighting of labor and capital assets at each company receiving the service.

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

459 A. Certain common activities are required for any company regardless of its core business.
460 In many cases, when a service needed by several affiliated companies can be

461 consolidated, the overall cost to perform the service for all the companies is less than if
462 the activity were conducted separately by each company. Because Peoples Energy had
463 five significant subsidiaries at the time of the business services reorganization, it was able
464 to effectively use this model.

465 Q. Have you made a comparison of the costs charged to Peoples Gas by Peoples Energy for
466 services during fiscal year 2006 and the costs Peoples Gas incurred during fiscal year
467 1996 when it was performing most of such services for itself?

468 A. Yes. During fiscal year 2006, net billings from Peoples Energy to Peoples Gas for
469 Operating and Maintenance activity was a total of \$58,420,000. During fiscal year 1996,
470 Peoples Gas incurred costs of \$58,741,000 performing such services for itself and paying
471 Peoples Energy for more limited services. Fiscal year 1996 was chosen for comparison
472 with fiscal year 2006 because fiscal year 1996 was the test year for the Company's last
473 approved rate increase.

474 Q. Does this decrease in billings from Peoples Energy reflect a similar decrease in the costs
475 of the underlying services provided?

476 A. No. A better comparison of the change in the total cost of these services, would be a
477 combined review of Peoples Gas and North Shore activity. A similar analysis of these
478 costs for North Shore indicates a total of \$5,292,000 for fiscal year 1996 and \$10,113,000
479 for fiscal year 2006. Thus, the combined total for Peoples Gas and North Shore is
480 \$64,033,000 and \$68,533,000 for fiscal years 1996 and 2006, respectively. Inflating the
481 1996 amount based on the Consumer Price Index for each year would result in an
482 equivalent amount of \$82,353,000 for fiscal year 2006. This would equate to a savings of
483 almost \$13.8 million on an adjusted basis.

484 Q. What do you conclude from this comparison?

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

488 Q. Given the very insignificant increase in these costs for Peoples Gas, why is there a more
489 significant increase in the North Shore Gas intercompany billing amount.

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

499 **VII. SUPPORT FOR RATEMAKING ADJUSTMENTS**

500 Q. Did you provide support for any of the ratemaking adjustments sponsored by Peoples Gas
501 witness Mr. Fiorella?

502 A. Yes, I provided support for the adjustment shown on Schedule C-2.11 (part of Peoples
503 Gas Ex. SF-1.1), which eliminates the effects of the gas charge settlement in ICC Docket
504 Nos. 01-0707, 02-0727, 03-0705, and 04-0683 from test year net operating income. I
505 explain this adjustment in the next section of my direct testimony.

506 **VIII. GAS CHARGE SETTLEMENT**

507 Q. Please describe the effects of the gas charge settlement on the financial statements
508 included in this filing.

509 A. As discussed earlier in my testimony, applicable charges for fiscal year 2006 are included
510 in Account 930.2. The effects of this charge on the Income Statement (expense and
511 related taxes) and Balance Sheet (short-term liability, deferred taxes, cash, retained
512 earnings) have been reflected in the Income Statements, Balance Sheets, Statement of
513 Cash Flows, and Statements of Retained Earnings, as appropriate under Generally
514 Accepted Accounting Principles. As described in the testimony of Peoples Gas witness
515 Bradley Johnson, subsequent to the settlement agreement, Peoples Gas omitted dividend
516 payments to Peoples Energy for the third and fourth quarters of fiscal year 2006 to help
517 restore the Company's balance sheet equity. In addition, Peoples Gas issued common
518 stock to Peoples Energy, its parent company, over the May-September 2006 timeframe in
519 an aggregate dollar amount that, when combined with retained earnings during the last
520 two quarters of fiscal year 2006, restored the common equity balance at fiscal year-end to
521 approximately what it would have been absent the settlement charges.

522 The following schedule details the calculation of the charges recorded in fiscal
523 year 2006:

(Dollars in Thousands)

Refund	\$ 96,000
Payment to Illinois Attorney General and City of Chicago for Conservation Program	4,800
Hub fiscal revenues	10,662
Bad debt expense	4,900
Amounts recognized prior to fiscal 2006	<u>(13,332)</u>
Gas charge settlement per consolidated statements of operations for fiscal 2006	\$ 103,030

524
525 As noted previously, the net settlement amount recognized in fiscal year 2006
526 operating expense, \$103,030,000 is reflected as a ratemaking adjustment on
527 Schedule C-2.11, part of Peoples Gas Ex. SF-1.1, sponsored by Company witness
528 Mr. Fiorella.

529 Q. As part of the settlement, did the Company agree to forgive \$200 million of uncollectible
530 accounts that were previously written off to bad debt?

531 A. Yes.

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

534 A. The forgiveness of the debt does not directly affect expense, as the amounts would have
535 been recorded as bad debt expense in previous periods. However, the Company does
536 continue to pursue collection of amounts written off to bad debt and is successful in

537 recovering some dollars from these customers. This has the effect of ultimately lowering
538 bad debt expense. Because the company agreed to forgive these debts, the Company will
539 have higher bad debt expense than if it was able to pursue collection on these accounts.
540 An estimate of that impact was calculated and recorded as additional bad debt expense as
541 noted in the above table.

542 Q. Does this conclude your direct testimony?

543 A. Yes.