STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion	:	
-vs-	:	05-0748
North Shore Gas Company	:	
Reconciliation of revenues collected under gas adjustment charges with actual costs prudently incurred.	:	

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Initial Brief in this proceeding.

I. INTRODUCTION

On November 22, 2005, the Commission approved an Order commencing reconciliation proceedings in accordance with the requirements of Section 9-220 of the Illinois Public Utilities Act (the "Act"). 220 ILCS 5/9-220. The Commission's Order directed North Shore Gas Company ("North Shore", "Respondent" or the "Company") to present evidence reconciling revenue collected under the Company's purchased gas adjustment clause ("PGA") with the actual cost of natural gas supplies prudently purchased for the twelve-month period from October 1, 2004 through September 30, 2005. (Initiating Order, Docket No. 05-0748, p. 2.)

Pursuant to proper legal notice, a pre-hearing conference was held on April 26, 2006, before a duly authorized Administrative Law Judge of the Commission at its offices in Chicago, Illinois. Thereafter, an evidentiary hearing was held on May 30, 2007. Appearances were entered by counsel on behalf of the Company, the People of the State of Illinois, the Citizens Utility Board ("CUB"), and Staff. North Shore presented the testimony of James Orsi, Manager of Gas Accounting, Peoples Energy Corporation; Thomas E. Zack, Director of Gas Supply and Hub Services, The Peoples Gas Light and Coke Company; and Linda M. Kallas, Vice President and Controller, Peoples Energy Corporation. CUB presented the testimony of Jerome D. Mierzwa, Principal and Vice President of Exeter Associates, Inc. Staff presented the testimony of Dianna Hathhorn, Accountant, Accounting Department of the Financial Analysis Division; Dennis Anderson, Senior Energy Engineer in the Gas Section of the Engineering Department of the Energy Division; and David Rearden, Senior Economist, Policy Program of the Energy Division. At the conclusion of the hearing on May 30, 2007, the record was marked "Heard and Taken."

II. LEGAL STANDARDS

PGA reconciliation proceedings are governed by Section 9-220 of the Act, which provides, in part:

> Annually, the Commission shall initiate public hearings to determine whether the clauses reflect actual costs of fuel, gas, power, or coal transportation purchased to determine whether such purchases

> were prudent, and to reconcile any amounts collected with the actual costs of fuel, power, gas, or coal transportation prudently purchased. In each such proceeding, the burden of proof shall be upon the utility to establish the prudence of its cost of fuel, power, gas, or coal transportation purchases and costs.

220 ILCS 5/9-220.

The standard used by the Commission to assess the prudency of a utility's gas purchases under Section 9-220 of the Act is as follows:

> Prudence is that standard of care which a reasonable person would be expected to exercise under the same circumstances encountered by utility management at the time decisions had to be made.

Illinois Power Co. v. Illinois Commerce Commission, 245 Ill. App. 3d 367, 371 (3d Dist. 1993) (quoting the Commission); Docket No. 88-0142, p. 25 (Order entered February 5, 1992). Furthermore, "[i]n determining whether a judgment was prudently made, only those facts available at the time judgment was exercised can be considered. Hindsight review is impermissible."' (Id. at 371 (quoting the Commission); Docket No. 88-0142, p. 25-26.)

III. SUMMARY OF STAFF'S POSITION

In direct and rebuttal testimony, Staff recommended various adjustments to the Company's PGA reconciliation for the twelve-month period from October 1, 2004 through September 30, 2005. While the Company accepted certain of Staff's adjustments, it did not accept others. Staff's uncontested and contested recommendations are discussed herein. Staff recommends that the Commission adjust North Shore's 2005 PGA reconciliation by the amount of $1,004,785.40, via the Commodity Gas Charge (CGC) through an Ordered Reconciliation Factor (Factor O), as indicated on ICC Staff Exhibit 4.0, Schedule 4.1, to be reflected in the Company's first monthly PGA filing after entry of the Final Order in this proceeding.

IV. UNCONTESTED ISSUES

A. Lost Gas Revenue Policy and Adjustment

In direct testimony, Staff witness Hathhorn expressed concern regarding the Company's policy of not billing third parties for the cost of gas lost as a result of damage to gas lines by those third parties since ratepayers bear the burden of this gas cost through the PGA. Ms. Hathhorn recommended that the Company revise its process in order to consistently and routinely bill third parties for its estimated cost of gas lost as a result of damage to gas lines by third parties. She further recommended that any revenues recovered through these third party billings flow through the PGA. Finally, Ms. Hathhorn made an adjustment of $335.47 for revenues collected from third parties for the cost of gas lost as a result of damage to gas lines by third parties that was not flowed through the PGA in the reconciliation year. (ICC Staff Exhibit 1.0, pp. 13-14; ICC Staff Exhibit 4.0, p. 12.) In rebuttal testimony, North Shore's witness Zack stated the Company accepted Staff's recommendation, did not contest Staff's proposed disallowance, and agreed that amounts recovered from third parties for lost gas would be flowed through the PGA. (Respondent's Exhibit D, p. 4.)

B. Gas Purchase and Agency Agreement

Staff witness Anderson explained that in Docket No. 01-0706, North Shore's 2001 – 2004 PGA reconciliation proceedings, the Commission found the Company's Gas Purchase and Agency Agreement ("GPAA") to be imprudent.

(Docket No. 01-0706, Order, dated March 28, 2006, Finding (5), adopting the Settlement Agreement.) The same GPAA was also in effect for the month of October of the reconciliation period that is the subject of the instant proceeding. Accordingly, Staff determined that the GPAA is also imprudent in the instant proceeding. (ICC Staff Exhibit 2.0, p. 3.) Staff witness Rearden recommended that the Commission disallow $337,269, based on North Shore having the GPAA in effect for the month of October 2004. (ICC Staff Exhibit 3.0, pp. 4-5; Attachment 3.1) The Company determined that it would not contest the recommended disallowance of $337,269. (Respondent's Exhibit F, pp. 1-2.)

V. CONTESTED ISSUES

A. Banked Gas Reconciliation Adjustment

Staff witness Hathhorn proposed to disallow $388,126.48 for a reconciling adjustment to the liability for the redelivery of gas to transportation customers' gas bank accounts (i.e., banked gas) entered on the Company's books in May 2005.[1] Staff maintains the disallowance is necessary because of uncertainty concerning the accuracy of the Company's proposed adjustment.[2] It is uncontested that the Company's proposed adjustment for banked gas inappropriately includes amounts for periods prior to the reconciliation year. (ICC Staff Exhibit 1.0, pp. 8-9.) It is also uncontested that the Company's proposed adjustment relies on its questionable internal controls for banked gas that were in

[1] The Company's adjustment is described in Respondent's Exhibit C, Supplemental Testimony of Linda M. Kallas.

[2] ICC Staff Exhibit 4.0, p. 5, beginning at line 96, and Attachment A thereto, provides a detailed example of the deficiency of the Company's reconciliation process, contributing to Staff's opinion regarding its accuracy.

place during the reconciliation period. (Id., pp. 9-10.)

Banked gas refers to the Company's recognition of a liability for the redelivery of gas to transportation customers' gas bank accounts. The monthly change in the liability is recorded at the current last-in-first-out price, and may be either an increase or a decrease to PGA gas costs, depending upon consumption. For the year ended September 30, 2005, this liability increased PGA costs by $1,213,963.03. (Id., pp. 6-7.)

Staff objects only to the May 2005 adjustment to banked gas, which accounts for 32% of banked gas PGA costs for the reconciliation year ($388,126.48/$1,213,963.03). (*See* ICC Staff Exhibit 4.0, p. 3 and Respondent's Exhibit A, Exhibit 1, p. 3 of 9, line 1.b.) The adjustment was recorded when the Company discovered a difference in the volumes attributed to banked gas in its general ledger system versus the volumes attributed to banked gas in its customer billing systems. (ICC Staff Exhibit 1.0, p. 7.) The difference was discovered during the implementation of Sarbanes-Oxley. Sarbanes-Oxley refers to the Sarbanes-Oxley Act of 2002, which requires the evaluation of the effectiveness of an organization's internal controls over its financial reporting. It is undisputed that the banked gas reconciliation process was considered a significant deficiency for Sarbanes-Oxley purposes in FY 2005. (Id., p. 8.) This review found that the monthly reconciliation of the gas bank account balances between the general ledger and subsidiary customer ledgers was not being performed in fiscal 2005. The Company confessed that "[t]he way in which large volume transportation customers are billed results in a timing difference that needed to be, **but was not being**, reconciled." (Respondent's Exhibit C, p. 9, emphasis added.) Ironically, while the Company admitted that its adjustment is the result of its lack of internal controls (Respondent's Exhibit E, p. 8), it still expects full compensation from the ratepayers.

Additionally, the Company acknowledges that it is not possible to identify how much of the volume difference occurred during FY 2005 or prior periods. (Respondent's Exhibit C, p. 14.) The Company compares these prior year costs (of unknown amount) to pipeline refunds. (Id., pp. 8-9.) The comparison is deliberately deceptive. The pipeline refunds to which the Company refers are flowed back in fiscal years subsequent to the year in which the activity occurred because there is no way for the Company to know the amount of refund at the time of occurrence.[3] This is absolutely not the case for the banked gas adjustment. The only reason the Company did not make its adjustment in the proper time period is because it was not performing the necessary reconciliations to record the adjustment in the proper time period. These two scenarios are not comparable and the Company's arguments as such are disingenuous. (ICC Staff Exhibit 1.0, pp. 8-9.)

The Company attempts to shift the focus of the issue to the process it used post-FY2005 to correct its controls of the banked gas accounts. (Respondent's Exhibit C, pp. 9-10; Respondent's Exhibit G.) These

[3] 83 Ill. Adm. Code 525 ("Part 525") provides for customers to either be charged or refunded amounts for time periods when they were not customers. Factor O is distributed to current customers, without regard to when the customers entered or exited the system. The same can be said for the unamortized balance. The unamortized balance may be amortized through Factor A for up to twelve months. The possibility always exists that current customers were not on the system when the unamortized balance was generated. (ICC Staff Exhibit 4.0, pp. 6-7.)

improvements, though, do nothing—and can do nothing—to address how the Company's FY 2005 adjustment originated or why it is flawed. (ICC Staff Exhibit 1.0, pp. 11-12.)

The Company further attempts to cloud the record by stating that the basis for Staff's opinion that customers were harmed by the adjustment is that the customers in 2005 whose gas costs were affected by the adjustment were not necessarily the same customers who were on the system when the underbilling occurred. (Respondent's Exhibit E, p. 7.) However, as the discussion regarding Part 525 in footnote 3 above explains, the possibility always exists that current customers were not on the system when the unamortized balance was generated. Staff's concern is that gas costs for all PGA customers were increased during the 2005 reconciliation year for the Company's adjustment, yet the adjustment cannot be verified and relates to multiple past time periods. The Company's argument concerning how long its customers remain on its system[4] completely misses the point.

In conclusion, Staff recommends the Commission approve Staff's recommended disallowance of $388,126.48 for the liability for banked gas because: (1) it was caused by a lack of internal controls by the Company; (2) it is unverifiable; and (3) an unknown, unquantifiable amount of it relates to time periods prior to FY 2005.

[4] Respondent's Exhibit E, pp. 7-8.

B. Prior Period Adjustment

Staff witness Hathhorn proposed to disallow of $279,054.45 in costs related to FY 2004, which is a closed reconciliation year, as ordered in Docket No. 04-0682. (ICC Staff Exhibit 1.0, p. 12.) In order to adjust the FY 2004 reconciliation, the docket would need to be reopened. The Company compares the correction to the routine true-up of gas costs and revenues which result through Factor A. (Respondent's Exhibit E, p. 12.)

However, Factor A is an on-going automatic adjustment that flows the under/over recovery of actual gas costs and revenues from the second prior month into the calculation of the rate to charge customers. (ICC Staff Exhibit 4.0, p. 10.) Staff's adjustment does not relate to the routine true-up of gas costs to suppliers or revenues affected by usage. Rather, it is the result of a one-time error during the time period that was the subject of a global settlement. The Company advocated, and the Commission accepted, a settlement which rendered any analysis of Respondent's gas costs and revenues of these prior periods moot. By correcting this error within FY 2005, the Company is attempting to better its deal from that provided in the settlement of the prior years' reconciliations. (Id., p. 9.)

Since Staff did not review the Company's FY 2004 reconciliation activity due to the settlement in Docket No. 04-0682, there is no evidentiary record to review for possible errors in the FY 2004 reconciliation. As such, it is inappropriate now to allow increases to gas costs for FY 2004 because the issue, by default, was handled in the settlement. If the Company believes the costs in

ICC Staff Exhibit 4.0, Schedule 4.6 are material, Staff suggests the Company petition the Commission to re-open Docket No. 04-0682. (ICC Staff Exhibit 4.0, pp. 10-11.)

VI. MANAGEMENT AUDIT

In the Commission's Final Order in Docket No. 01-0706, North Shore's 2001 - 2004 PGA proceedings, the Company was ordered to engage outside consultants to perform a management audit of its gas purchasing practices, gas storage operations, and storage activities. (Docket No. 01-0706, Order, dated March 28, 2006, Finding (5), adopting the Settlement Agreement.) (*See* ICC Staff Exhibit 2.0, pp. 3-5.) Staff recommends that the Commission's Final Order in the instant proceeding contain corresponding Finding and Ordering Paragraphs, which provide that the instant proceeding is subject to reopening pending the outcome of the Company's management audit in Docket No. 06-0556. (ICC Staff Exhibit 1.0, pp. 14-16; ICC Staff Exhibit 4.0, p. 12.)

VII. CONCLUSION

For the foregoing reasons, the Staff of the Illinois Commerce Commission respectfully requests that the Commission adopt Staff's recommendation to adjust North Shore's 2005 PGA reconciliation by the amount of $1,004,785.40, via the Commodity Gas Charge (CGC) through an Ordered Reconciliation Factor (Factor O), as indicated on ICC Staff Exhibit 4.0, Schedule 4.1, to be reflected in the Company's first monthly PGA filing after entry of the Final Order in this proceeding.

Respectfully submitted,

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