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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Columbia Gas of Ohio, Inc. for Approval of a General Exemption of Certain Natural Gas Commodity Sales Services or Ancillary Services from Chapters 4905, 4909, and 4935 except Sections 4905.10, 4035.01 and 4935.03, and from specified sections of Chapter 4933 of the Revised Code.	)	Case No. 08-1344-GA-EXM

DIRECT PREPARED TESTIMONY OF RICHARD C. CAHAAN

July 8, 2011

Q1. Please state your full name and address.

A1. My name is Richard C. Cahaan. I am an independent consultant dealing with economics and regulatory policy. My address is 60 W. Dominion Blvd., Columbus, OH 43214.

Q2. Please provide your background and qualifications.

A2. From 1983 to 2009 I was employed by the Public Utilities Commission of Ohio. For more than two decades I served as the Chief Economist in the Capital Recovery and Financial Analysis Division of the Utilities Department. During my 28 years of public service I have testified in numerous rate cases and other proceedings before this Commission. A large part of my testimony before the Commission regarded the cost of capital and rate of return to be granted to regulated utilities. However, I have also presented economic analysis regarding many other issues, such as the rate stabilization plans of the Ohio electric utilities and policies regarding Construction Work in Progress . In 2010 after retiring from the State of Ohio, I became a consultant. Recently, I was retained as a consultant by the Commission to analyze and prepare testimony involving the first case concerning the Significantly Excessive Earnings Test established by the General Assembly in Senate Bill 221 (see In Re Columbus Southern Power Case No. 10-1261-EL-UNC).

I received a B.A. degree from Hamilton College and an M.A. degree in Economics from the University of Hawaii, and I completed all course work and passed the written and oral general and field examinations at the Ph.D. level at Cornell University. I have been a faculty member, either full-time or part-time, at the State University of New York – Cortland, Eisenhower College, Ithaca College, Cornell University, and the Graduate

School of Business Administration of Capital University. Prior to joining the Staff, I taught economics at the Ohio State University.

Q3. By whom have you been retained in this proceeding, and what is the purpose of your testimony?

A3. I have been asked by the Ohio Gas Marketers Group, an ad hoc association of seven certificated natural gas suppliers to provide an economic context for evaluating the objections and issues raised concerning the Commission's order in this docket calling for use of a Standard Choice Offer (SCO) auction to replace the Standard Service Offer (SSO) auction starting in 2012. Specifically, I am focusing on the objections and issues raised by the Office of the Ohio Consumer's Counsel (OCC) and by the Ohio Partners for Affordable Energy (OPAE).

Q4. What are the issues raised by the Office of the Consumer's Counsel?

A4. The OCC has stated, in its objections filed in this case on May 9th, that it "opposes the SCO auction because the SCO will impose quantifiable and unavoidable higher costs on residential consumers, because there are no tangible, objectively quantifiable benefits for residential consumers as a result of the proposed change, and because the change to the SCO results in considerable customer confusion from the sudden appearance of a Marketer's name on a customer's bill." From an economic perspective, the issue is: whether a cost-benefit analysis supports the proposed change from an SSO to an SCO auction.

Q5. What is your cost-benefit analysis of the auction price in an SSO as compared to an SCO auction?

A5. The OCC asserts that the SCO supply price is likely to be higher, because "there are a number of Marketers, including some very large Marketers that are bidders in the SSO retail auction who are not interested in becoming Certified as Competitive Retail Natural Gas Suppliers ("CRNGS"), which is required in order to bid in an SCO retail auction."

I think this economic projection is flawed for several reasons. First, the statement is at odds with the empirical data. During bid years 2009, 2010 and 2011 the Dominion East Ohio Company conducted both an SSO and an SCO auction on the same day, for the same delivery period. In each of the side by side auctions there were more bidders in the SCO auction then the SSO auction.

The outcome of the side by side Dominion East Ohio auction is in line with the survey data I received from the members of the Ohio Gas Marketers Group. In that survey I asked the members of the Ohio Gas Marketers to answer four questions concerning their preference for the long term use of SCO or SSO auctions and the reasons why. I have listed as Exhibit RC 2 the questions that were asked and the tally of the responses. The responses by each of the seven members were not circulated among the members but sent directly by each Ohio Gas Marketers Group member to counsel for my use. I present the survey not as statistical proof that all potential bidders prefer an SCO auction, but rather that a large number of the suppliers that bid in Ohio auctions have a strong preference for the SCO auctions going forward. I think that it is fair to say that it is more probable that in a descending clock auction the higher the number of actively participating bidders the lower the closing price. This information runs counter to OPAE's assertion that the "movement to an SCO does not advance the competitive market."

The OCC's comment stated that unnamed very large Marketers would not participate in an SCO auction because they would not file to become a CRNGS. In response to that comment, one needs to ask is there a benefit to having a supplier be CRNGS certificated. For even if some suppliers would not participate because they refuse to submit to Commission oversight, which could have the effect of increasing the closing price, this may be more than made up by the benefits of Commission oversight. In the end though, the empirical data thus far seems to indicate that there is more bidder interest in an SCO auction than an SSO auction. Thus, the Commission should be more concerned by the loss of SCO bidders if it mandates an SSO auction than the loss of SSO bidders who are unwilling to become CRNGs.

Q6. Aside from auction price, what other issue is raised by the OCC?

A6. The OCC claims that an SCO auction will result in considerable customer confusion as compared to an SSO auction. From an economic perspective, I would think that this should also be considered within a cost-benefit framework. I would agree with the OCC that customer confusion regarding gas charges is an undesirable state. However, the OCC has not submitted any evidence indicating that customers are confused by the appearance of a Marketer's name on a bill. Because the OCC has not demonstrated that customers are confused it is difficult to determine the potential source of confusion and quantify confusion in a way that can be considered in a cost-benefit analysis.

On the other hand, there is the quality of avoidability to consider: what would be the resource cost of preventing confusion from "the sudden appearance of a Marketer's name on a customer's bill"? Very possibly, this confusion could be avoided by having a clear explanation printed alongside the sudden appearance of a marketer's name, with, perhaps, a telephone number or additional resources made available. Consumers have access to a number of resources to educate themselves, and thereby avoid confusion, about choosing a competitive supplier and how to understand their energy bill. The possibility of customer confusion should not be viewed as a reason to forgo moving from an SSO system to an SCO system. Instead, the focus should be on the type of education program that is needed. I note that both Dominion East Ohio and Vectren had an educational program. Such programs have a cost and also benefit in education the public. The Commission needs to find the balance between the amount to be spent on education and the value of such.

Q9. What is the Tax issue when you consider the costs and benefits of an SSO as compared to an SCO auction?

A9. Under an SSO system, the gas is provided by a supplier on a wholesale basis to the utility for sale by the utility to the retail customer. According to Ohio law, this transaction is subject to a 4.75% compounding (4.987%) gross receipts tax. However, under an SCO system, the gas is provided by a marketer directly on a retail basis to the customer. According to Ohio law, this transaction is subject, not to the gross receipts tax of a utility, but to the commercial sales tax applicable to all transactions at a location. The OCC has claimed that sales tax rate consists of a 5.5% state sales tax and a county tax rate ranging from 1.0% to 2.25%.

Q10. How does this tax issue affect the decision regarding adopting an SCO?

A10. It really should not have much effect on the decision. The historical task of the public utilities commissions has been to prevent suppliers from exercising monopoly power and charging excessive prices. Making tax policy is a legislative function, not a regulatory one. Conceptually, if you picture the total economic benefit from utility services as a big pie, the job of public utility regulation is to provide the smallest possible slice of the pie to the suppliers, subject to the requirement that they be able to continue to produce pies in the future. The greater the economic surplus remaining, the more is available for the public . The political process determines how much consumers keep directly and how much they receive indirectly, though government.

Q11. The OCC has concluded that "the public interest demands that the PUCO take the course of action that assures residential customers of the lowest possible gas price. That is the SSO wholesale auction." Do you agree with this conclusion?

A11. From an economic perspective, the conclusion is unwarranted. The lowest possible gas price might be inconsistent with total net benefits, not just in a societal sense, but even for the residential consumers themselves. Looking only at the final price to the consumer is an incomplete analysis. The public interest responsibility of the PUCO, both analytically and historically, is to obtain the lowest supply price.

Q12. Please explain.

A12. The explanation will require a certain amount of theoretical economics, including a diagram. Fortunately, it is the economic theory taught in Econ 101, basic micro theory. The imposition of a tax on the consumption of a product results in a loss in economic welfare, but the loss of welfare is <u>not</u> the amount of the tax revenue. Rather it is the loss of the "consumer surplus" caused by the reduced consumption of the product. This can be seen on the diagrams shown in attachment (RC 1[1]). If the demand for the product is

[1] RC 1 is publicly available as part of a website lecture on economics from Kent State University. The full text can be found at the following website address: http://www.personal.kent.edu/~cupton/Lectures%20in%20Microeconomics/powerpointslides/Micro%20PDF/Consumer%20Surplus%20and%20Deadweight%20Loss.pdf

price-inelastic (as is the case for natural gas), then this amount of consumer surplus loss would be relatively small.

Q13. What of the amount paid in taxes?

A13. The amount paid in taxes is initially a transfer to the government. However, to evaluate the welfare implications would also require looking at the use of the tax revenues. Thus, for example, if the customer pays the county a dollar's worth of tax and gets a dollar's worth of snow removal, the welfare implication of the tax is zero. Even without examining the use of the tax revenues, there is a more fundamental flaw in treating taxes as pure cost while making what purports to be a public interest argument. While the Federal government has the ability to run deficits and even, with help of the Federal Reserve, to monetarize the debt (print money), state and local governments cannot. So sales tax payments to state and local governments either enable other taxes to be lower or prevent the reduction of services provided by these governments.

As an example, suppose pre tax that gas could be obtained for $5 under an SSO but only $3 under an SCO auction. However, due to the differential tax treatments, the SSO price would be increased by only $1, while the SCO price would go up by $3.10. The end result would be $6.10 under the SCO, but only $6.00 under the SSO. According to the OCC's argument that "the public interest demands that the PUCO take the course of action that assures residential customers of the lowest possible gas price," the PUCO should decide in favor of keeping the SSO. But I think that common sense would dictate that the public interest would lie in obtaining gas for $3.00 instead of for $5.00. There would be no question that the lowest possible supply price was the best choice if it were not for the matter of the different tax treatments. I agree with the OCC that the

Commission's decision should be based upon its determination of what would be in the public interest. But it is totally illogical and flat-out wrong to consider taxes solely as a cost element in the determination of the public interest.

A logical solution to the dilemma of choosing between an SSO and an SCO would be to simply make sales of commodity natural gas subject to the same tax rate, whether sold directly by a marketer or indirectly through a utility. However, the PUCO does not have such authority, and making a decision based upon tax treatment instead of lowest supply price would be confusing regulatory and legislative responsibilities.

Q15. Does this conclude your testimony?

A15. Yes, it does.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and accurate copy of the foregoing document was served by regular U.S. mail, postage prepaid, or by email, where applicable, this 8th day of July, 2011, on the following:

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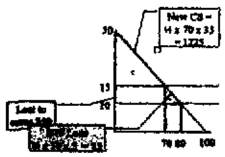
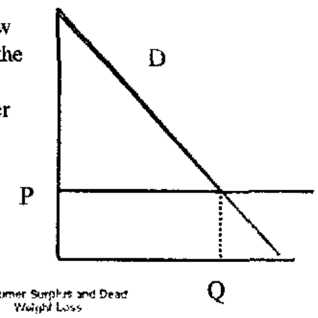
Consumer Surplus and Deadweight Loss



KENT STATE — Lectures in Microeconomics-Charles W. Upton

An Application

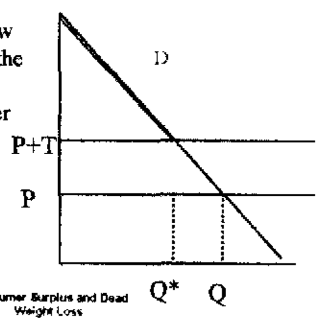
- The government now imposes a tax T on the product. What happens to consumer surplus?



KENT STATE — Consumer Surplus and Dead Weight Loss

An Application

- The government now imposes a tax T on the product. What happens to consumer surplus?
- Consumer Surplus Declines

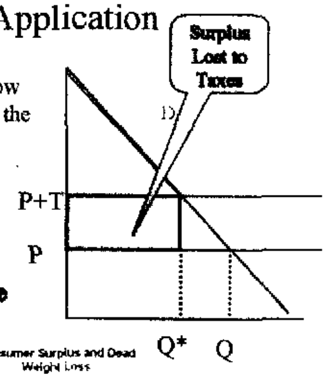


KENT STATE — Consumer Surplus and Dead Weight Loss

An Application

- The government now imposes a tax T on the product. What

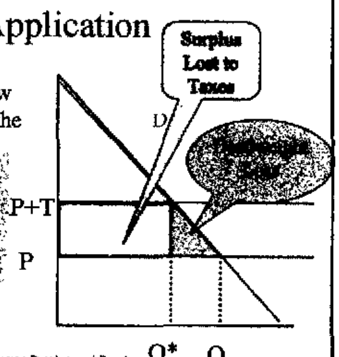
This is not a loss. The money is transferred to the government, and thus takes the place of other taxes.



KENT STATE — Consumer Surplus and Dead Weight Loss

An Application

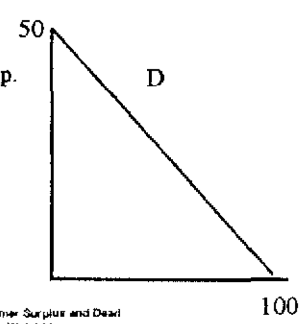
- The government now imposes a tax T on the product. What



KENT STATE — Consumer Surplus and Dead Weight Loss

An Application

- The demand for a product is Q = 100-2p.



KENT STATE — Consumer Surplus and Dead Weight Loss

EXHIBIT RC - 2

Survey Questions

Question One: Have you participated in an SSO or SCO supply auction for an Ohio local distribution company. [note we are not asking if you won a tranche only if you signed up to bid in any of the East Ohio, Vectren or Columbia SSO or SCO auctions].

Question Two: Do you have a preference as to whether all future auctions are SCO or SSO. If so state your preference and any reasons for your taking this position.

Question Three: If the Commission ruled that hence forth all auctions would be SSO style, would you be more inclined, less inclined or indifferent to participation?

Question Four: If the Commission ruled that hence forth all auctions would be SCO style, would you be more inclined, less inclined or indifferent to participation?

Survey Results

Question One: 7 out of 7

Quesetion Two: 7 out of 7

Question Three: 7 less inclined

Question Four: 7 more inclined