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April 23, 2002

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BY COURIER

Mr. Vernon A. Williams
Secretary
Surface Transportation Board
1925 "K" Street, N.W.
7th Floor Reception Desk
Washington, D.C. 20423



**Re: Government of the Territory of Guam v. Sea-Land Service, Inc.,
and Matson Navigation Company, Inc., STB Docket No. WCC - 101**

Dear Secretary Williams:

Enclosed are an original and 10 copies of "Initial Submission of the Government of Guam in Phase II Concerning the Appropriate Methodology for Assessing Rate Reasonableness Under 49 U.S.C. § 13701(a)" in the above-referenced proceeding.

If you have any questions regarding this document, please don't hesitate to call me. Thank you for your assistance in this matter.

Sincerely,

A handwritten signature in black ink, appearing to be "R. Berliner".

Roger A. Berliner, Esq.
**Counsel for Complainant
Government of the Territory
of Guam**

Enclosures

cc: All Parties of Record

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**UNITED STATES OF AMERICA
DEPARTMENT OF TRANSPORTATION
Before The
SURFACE TRANSPORTATION BOARD**

GOVERNMENT OF THE
TERRITORY OF GUAM,

Complainant,

v.

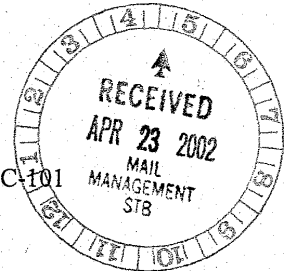
SEA-LAND SERVICE, INC.

and

MATSON NAVIGATION COMPANY,
INC.,

Defendants.

Docket No. WCC-101



**INITIAL SUBMISSION
OF THE GOVERNMENT OF GUAM
IN PHASE II CONCERNING
THE APPROPRIATE METHODOLOGY
FOR ASSESSING RATE REASONABLENESS
UNDER 49 U.S.C. § 13701(a)**



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**On Behalf of the
Government of Guam**

April 23, 2002

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TABLE OF CONTENTS

	Page
I. BACKGROUND	2
A. STB Decision Denying Motion to Dismiss	2
B. Phase II Procedural Schedule	4
II. THE FMC'S G.O. 11 METHODOLOGY FOR ASSESSING RATE REASONABLENESS SHOULD BE ADOPTED BY THE BOARD	4
A. Public Policy Considerations Favor G.O. 11	7
1. Traditional public utility rate regulation is required to protect Guam ratepayers	7
2. G.O. 11 is the only time-tested, court-sanctioned methodology for assessing rate reasonableness	9
B. Given GovGuam's One-Time Right to Challenge the Carriers' Base Rates, This is Not the Time to Experiment with New Methodologies	12
C. G.O. 11 is Ideally-Suited to Regulation of the Guam Trade	13
III. CONSTRAINED MARKET PRICING METHODOLOGY IS INAPPROPRIATE FOR THE GUAM TRADE	15
IV. CONCLUSION	19

TABLE OF AUTHORITIES

CASES

<i>Bragdon v. Abbott</i> , 524 U.S. 624, 118 S.Ct. 2196, 141 L.Ed.2d 540 (1998)	9
<i>Matson Navigation Company v. FMC</i> , 959 F.2d 1039 (D.C. Cir. 1992),	10
<i>Puerto Rico Maritime Shipping Authority v. FMC</i> , 678 F.2d 327 (D.C. Cir. 1982).	10
<i>Skidmore v. Swift & Co.</i> , 323 U.S. 134, 65 S.Ct. 161, 89 L.Ed. 124 (1944).	9

ADMINISTRATIVE DECISIONS

Ex Parte No. 347 (Sub-No. 1) <i>Coal Rate Guidelines</i> , 1 I.C.C.2d 520 (August 8, 1985)	16
<i>Financial Reports of Common Carriers by Water in the Domestic Offshore Trades</i> , 19 Shipping Reg. Rep. (P&F) 1283 (FMC 1980).	10
<i>Government of the Territory of Guam, et al. v. Sea-Land Service, Inc. and American President Lines, LTD.</i> , 28 Shipping Reg. Rep. (P&F) 252 (FMC 1998)	10, 15
<i>Matson Navigation Co. - Proposed Overall Rate Increase</i> , 23 Shipping Reg. Rep. (P&F) 1216 (FMC 1986)	10
<i>Sea-Land Service, Inc., et al., Proposed General Rate Increases in the Puerto Rico and Virgin Islands Trades</i> , 20 Shipping Reg. Rep. (P&F) 1627 (1981), <i>aff'd</i> , 678 F.2d 327 (D.C. Cir. 1982)	10

STATUTES

Intercoastal Shipping Act, Amendment of 1978, Pub. L. No. 95-475 (1978)	9, 10
Interstate Commerce Commission Termination Act (ICCTA), Pub. L. No. 104-88, 109 Stat. 803 (1995)	<i>passim</i>

Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act), Pub. L. No. 94-210, 90 Stat. 31 (1976).	16
Staggers Rail Act of 1980 (Staggers Act), Pub. L. No. 96-448, 94 Stat. 1913 (1980).	16, 17
49 U.S.C. § 10701(a)	16
49 U.S.C. § 10707	17
49 U.S.C. § 10709.	16
49 U.S.C. § 13701	5
49 U.S.C. § 13701(a).	1, 2, 3
49 U.S.C. § 13701(d)(1).	3, 13
49 U.S.C. § 13701(d)(4).	3
49 U.S.C. § 14701(b).	2, 4

FEDERAL REGULATIONS

46 C.F.R. § 552	5
---------------------------	---

LEGISLATIVE MATERIALS

H.R. Rep. No. 95-474 (1977).	10
H.R. Rep. No. 96-1430 (1980).	16

MISCELLANEOUS

“The Guam Trade Study, Comments of the Government of Guam,” <i>In the Matter of Request for Public Comment on Competition in the Noncontiguous Domestic Maritime Trades</i> , DOT (No. OST-96-1066, April, 1996)	<i>passim</i>
Alfred E. Kahn, <i>The Economics of Regulation</i> , 1998	6

GOVERNMENT OF THE)
TERRITORY OF GUAM,)
)
Complainant,)
)
v.) Docket No. WCC-101
)
SEA-LAND SERVICE, INC.)
and)
MATSON NAVIGATION COMPANY,)
INC.,)
)
Defendants.)

-1-

I. BACKGROUND

On September 10, 1998, the Government of Guam acting on behalf of all Guam shippers pursuant to 49 U.S.C. § 14701(b), filed a complaint against the ocean carriers serving Guam. That complaint alleges that the defendant carriers charged unreasonable water rates in the Guam trade in violation of the rate reasonableness statutory requirement of 49 U.S.C. § 13701(a). The underlying theory of the complaint is that the carriers are earning excessive overall revenues in the Guam trade.

The defendant carriers filed answers to the complaint denying all of the allegations and claims of the Government of Guam. Defendants also filed a Joint Motion to Dismiss raising legal challenges to every aspect of the complaint. Upon the filing of the answers and the Joint Motion to Dismiss, complainant Government of Guam and the defendant carriers entered into a stipulation regarding a proposed procedural schedule for this proceeding. Recognizing the unprecedented nature of the proceeding, the stipulation, later adopted by the STB, provides for a three-step process in the disposition of the complaint. Phase I focused on the threshold legal issues raised in the Motion to Dismiss. Phase II addresses the appropriate methodology for assessing rate reasonableness under 49 U.S.C. § 13701(a). Phase III will involve the litigation of the merits of the complaint using the rate methodology or rate methodologies authorized by the Board in Phase II.

A. STB Decision Denying Motion to Dismiss

On November 15, 2001, the STB issued a decision on the defendant carriers' Joint

Motion to Dismiss that fundamentally sustained GovGuam's complaint.¹ It held that:

- 49 U.S.C. § 13701(a) allows the filing of complaints challenging the entire rate structure of the carriers on the basis of the revenues generated by the rates in the aggregate, just as the FMC had concluded when faced with a similar challenge.

- If the aggregate revenues generated by a carrier's rate structure are found to be unreasonable, the Board is authorized to award reparations in an amount equal to all sums assessed and collected that exceed a reasonable rate structure as provided in 49 U.S.C. § 13701(d)(4).

- The "Zone of Reasonableness" (ZOR) provision of ICCTA, 49 U.S.C. § 13701(d)(1), did not operate to totally immunize the carriers' present rates from complaints. While the ZOR allows carriers to increase rates by 7.5% annually without suspension or investigation, the Board found that Congress did not intend to insulate carriers' base rates (those in effect before the ZOR is applied) from regulatory scrutiny. The Board found that GovGuam's complaint addresses such "base" rates in the Guam trade and therefore states a valid basis to investigate the reasonableness of the defendants' rate structures.

- The complaint of the Government of Guam may properly challenge the water portion of all rates in the Guam Trade, including the water portion of intermodal rates.

¹ The only substantive issues in which the Board agreed with defendants pertained to the right of GovGuam to bring a discrimination claim under the Interstate Commerce Commission Termination Act, ("ICCTA"), Pub. L. No. 104-88, 109 Stat. 803 (1995), limiting the statute of limitations to two years (from September 10, 1996 to September 10, 1998) and, as a result of the latter, dismissing GovGuam's claims against APL (which had left the trade by then).

B. Phase II Procedural Schedule

Pursuant to the Board's November 15 Decision, Phase II initial submissions were originally scheduled to be filed on January 9, 2002 and replies were originally scheduled to be filed on February 25, 2002. By an Order dated December 20, 2001, the Board approved a joint stipulation that extended this schedule by 90 days. In response to a motion by GovGuam, a further two-week extension of this filing schedule was granted. Initial submissions are now due April 23, 2002 and replies are due June 8, 2002.

II. THE FMC'S G.O. 11 METHODOLOGY FOR ASSESSING RATE REASONABLENESS SHOULD BE ADOPTED BY THE BOARD

The choice the Board makes in this phase of the proceeding is critical given GovGuam's limited right to a one-time challenge of the defendants' base rates. The methodology selected by the Board will have the single greatest influence upon whether the defendants will ever be held accountable for charging unreasonable rates in the Guam trade.²

² GovGuam set forth in detail the extent to which the carriers serving Guam were able to shield themselves from regulatory oversight over the years in its comprehensive filing before the Department of Transportation in Docket No. OST-96-1066. As GovGuam stated then, "[i]t is a history characterized by legally sanctioned price fixing and a complete evasion of regulatory scrutiny." *The Guam Trade Study*, p. 10 (Appendix C). Even the relatively recent conclusion by the Federal Maritime Commission that the Guam carriers' rates were unreasonable failed to effect justice in that the Commission limited reparations to the shipments made by the four named complainants, who collectively represented less than 1% of the traffic to Guam. Thus, notwithstanding the finding of unreasonableness, the carriers serving Guam will, unless overturned on appeal, be able to retain 99% of their ill-gotten gains. ICCTA prevents such an unjust result by explicitly recognizing the right of governmental authorities to bring an action on behalf of the trade as a whole. 49 U.S.C. § 14701(b).

The Board, in effect, is being asked to look into the regulatory toolbox and select the tool that is most appropriate for the task before it.³ GovGuam's position in this phase of the proceeding has been known from the day GovGuam filed this complaint. As set forth in section III of the complaint,

Complainant therefore petitions this Board to adopt and apply in this proceeding those standards of reasonableness promulgated by the Federal Maritime Commission and applied to carriers in the Guam trade prior to the effectiveness of 49 U.S.C. § 13701, as set forth in Part 552 of 46 CFR, formerly and commonly referred to as the Federal Maritime Commission General Order No. 11 ("G.O. 11").

It is, without question, the most appropriate regulatory tool available to the Board that will satisfy its statutory obligations.

GovGuam's submission in this phase incorporates the views of two leading regulatory economists; Dr. Nadel, one of the nation's leading authorities on the application of G.O. 11 to the Guam trade; and Mr. Burris, one of the nation's leading experts in the application of Constrained Market Pricing by this Board to captive rail shippers. Their submissions, attached as Appendix A and B respectively, reinforce and expand upon the central theme advanced herein that the rate methodology designed and employed for ocean carriers is a vastly superior means of ensuring rate reasonableness than the application of one designed, in a completely different context, for the rail industry.

³ GovGuam argued in Phase I that the legislative history of ICCTA compels the conclusion that Congress intended this Board to use the then "currently" employed rate reasonableness methodology of the FMC. The Board declined to adopt this view of ICCTA's legislative history. Accordingly, for purposes of this pleading, GovGuam accepts the Board's agnostic view of Congressional intent regarding the standard to be employed.

As the preeminent regulatory economist of our time, Alfred E. Kahn, concluded at the end of his reintroduction to his classic treatise, *The Economics of Regulation*, “industries differ one from the other, and the optimal mix of institutional arrangements for any one of them cannot be decided on the basis of ideology alone.”⁴ Ocean carriers are very different from railroads, and ocean carriers serving the Guam trade are very different than ocean carriers serving other non-contiguous domestic offshore trades.

Within the non-contiguous domestic offshore trades, Guam is unique. Guam is the only Jones Act protected trade served exclusively through a “back-haul,” “passby” service integrated into the competitive, foreign trades in the Far East. It is also the only Jones Act protected trade in which, as a result of the distance between the U.S. mainland and Guam, there is a complete absence of competitive pressures from barges, tugs, or other entities that could provide similar services. See, *Guam Trade Study*, pp. 20-34 (Appendix C).⁵

These unique aspects of the Guam trade are what prompted GovGuam to resist the Caribbean Shippers intervention in this proceeding.⁶ GovGuam seeks, and believes it has the legal right to, a determination of the appropriate rate reasonableness methodology for

⁴ Alfred E. Kahn, *The Economics of Regulation*, p. xxxvii (1998).

⁵ Chapters I-III of the *Guam Trade Study* comprehensively addresses the absence of competitive pressures in the Guam trade. GovGuam incorporates by reference this official document and attaches Chapters I-III as Appendix C for the convenience of the Board.

⁶ See Response of Complainant GovGuam in Opposition to the Petition for Intervention by the Caribbean Shippers Association, Inc.

the Guam trade alone.⁷

A. Public Policy Considerations Favor G.O. 11

Having dispensed with the arguments advanced by defendants that this Board is precluded as a matter of law from utilizing G.O. 11, Phase II focuses on the public policy considerations that should guide the Board in determining the appropriate rate reasonableness methodology to apply in assessing the rates charged Guam shippers. GovGuam believes that the overwhelming weight of the relevant public policy considerations compels the conclusion that this Board should adopt the G.O. 11 methodology for purposes of this proceeding.

1. Traditional public utility rate regulation is required to protect Guam ratepayers

GovGuam seeks this Board's fidelity to the most fundamental aspect of the regulatory compact: in the absence of effective competition, either intra or intermodal, ratepayers shall be protected from exploitation. GovGuam submits that under the circumstances presented here, the only means of protecting ratepayers is through the use of traditional public utility rate of return regulation.⁸

⁷ While GovGuam appreciates that this is a case of first impression, it is a complaint proceeding and not a generic rulemaking. GovGuam does not have the burden of convincing this Board of the rate reasonableness methodology that could be applicable for other shipper challenges, if any ever arise, but solely what is the most suitable rate methodology for purposes of this specific challenge.

⁸ In Phase I, defendants attacked GovGuam's invocation of this indispensable obligation as unlawful under ICCTA, a position rejected by this Board. It is not only permitted by the law, it may be the only means by which the statute's rate reasonableness standard may be given legal effect in the Guam trade.

As discussed in greater detail in the *Guam Trade Study*, GovGuam submits that there is a complete absence of competitive forces in the Guam trade:

A fundamental tenant of economics is that a duopoly . . . will extract monopoly rents in the absence of meaningful competitive pressures. Such competitive pressure are completely missing in the Guam trade. Neither the transportation services themselves nor the commodities shipped are subject to substitution -- the people of Guam are truly captive shippers. With respect to ocean carrier transportation services, notwithstanding the excessive level of profits extracted from the Guam trade, there are substantial barriers to entry in terms of capital costs government restrictions, and the economies of scale and scope required to effectively compete. Nor do alternatives to ocean carriers exist. Guam is too far away to use barge operations, and air cargo is not a cost-effective alternative for the nature of goods shipped on ocean carriers. With respect to the substitution of goods, and assuming it is not the official position of the Department of Transportation that Guam should be induced to reduce its \$1.6 billion a year purchase of U.S. goods, most of the high value goods purchased from the United States are not substitutable.⁹

This lack of competitive pressure is, as GovGuam noted in Phase I,

further exacerbated by the Jones Act. While Guam's location would make it amenable to competitive service by foreign carriers, the Jones Act eviscerates any such competition with its requirement that US goods must be carried by US flagged ships. Indeed, 'Guam is the Poster Child of the Jones Act' (citation omitted). GovGuam recognizes that honorable people may disagree with respect to the overall efficacies of the Jones Act, and is not raising this issue here to debate the matter. Its sole purpose in doing so is to underscore the concomitant responsibility the United States Government assumes when it imposes policies on one of its territories that preclude vigorous competition — the responsibility to ensure that those companies that benefit from such government policies do not abuse their protected position by exploiting it.¹⁰

GovGuam submits that it is beyond debate that the essential predicate to public utility-

⁹ *Guam Trade Study* at 2.

¹⁰ Answer in Opposition to Motion to Dismiss Complaint, p. 9.

type regulation is present here.

It should be equally beyond debate that a rate of return on rate base analysis is no less appropriate today than it has been for the better part of the past century in ensuring rate reasonableness for ocean carriers serving Guam.¹¹ The purpose, design, and effect of G.O. 11 achieves the very examination required of this Board; to judge the reasonableness of defendants' aggregate revenues made in this trade. Therefore, GovGuam submits that there should be a presumption in favor of retaining G.O. 11, and that the defendants bear a very heavy burden as to why this agency should cast aside the specific regulatory tool conceived for the task at hand.¹²

2. G.O. 11 is the only time-tested, court-sanctioned methodology for assessing rate reasonableness

G.O. 11, the only methodology ever used to assess rate reasonableness for ocean carriers, was carefully developed to regulate the overall revenues carriers earned in each trade. Originally issued in 1964, G.O. 11 in its current form was prompted by Public Law 95-475, wherein Congress directed the FMC to "promulgate methodology guidelines for determining an appropriate rate of return . . ." and that such "guidelines should be

¹¹ *Id.*, pp. 20-24. ("A rate of return analysis is the traditional method of evaluating carrier rates in the domestic offshore trades.")

¹² See *Bragdon v. Abbott*, 524 U.S. 624, 640, 118 S.Ct. 2196, 2207, 141 L.Ed.2d 540 (1998) ("It is enough to observe that the well-reasoned views of the agencies implementing a statute 'constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance.'" citing *Skidmore v. Swift & Co.*, 323 U.S. 134, 139-140, 65 S.Ct. 161, 164, 89 L.Ed. 124 (1944)).

given substantive effect and be followed rigidly in each rate proceeding.”¹³ Congress did not believe that it served the public interest for basic rate methodological issues to be debated and re-debated every rate case.¹⁴

Shortly after P.L. 95-475 was enacted, the FMC obeyed Congress’ directive by holding a broad and lengthy rulemaking in Docket No. 78-46 to “establish methodologies” to be used to evaluate rates in the domestic offshore trades. See, *Financial Reports of Common Carriers by Water in the Domestic Offshore Trades*, 19 SRR 1283 (1980). Carrier interests, among others, participated fully in that process. After due regard for the comments of all parties, the FMC promulgated G.O. 11. Subsequent to its promulgation, the FMC decided numerous rate cases applying G.O. 11¹⁵ and its application has consistently been upheld by the United States Court of Appeals for the District of Columbia.¹⁶

Of greatest relevance, of course, is the fact that the FMC applied it to the Guam trade less than four years ago. *The Government of the Territory of Guam, et al, v. Sea-*

¹³ H.R. Rep. No. 95-474, 95th Cong., 1st Sess. at 10 (1977)

¹⁴ GovGuam submits that this Congressional concern has equal applicability here. There is no more sense now, than there was then, to reopen debate over rate methodologies employed in the Guam trade as recently as 1998.

¹⁵ See e.g., *Matson Navigation Company, Inc. Proposed Overall Rate Increase of 2.5 Percent Between United States Pacific Coast Ports and Hawaii Ports*, 1986 WL 170060 (F.M.C.); *Sea-Land Service, Inc., Trailer Marine Transport Corporation, Gulf Caribbean Marine Lines, Inc. and Puerto Rico Maritime Shipping Authority, Proposed General Rate Increases in the Puerto Rico and Virgin Islands Trades*, 20 SRR 1627 (1981), *aff’d*, 678 F.2d 327 (D.C. Cir. 1982).

¹⁶ *Matson Navigation Company, Inc. v. FMC*, 959 F.2d 1039 (D.C. Cir. 1992); *Puerto Rico Maritime Shipping Authority v. FMC*, 678 F.2d 327 (D.C. Cir. 1982).

Land Services, Inc. and American President Lines, LTD., Docket No. 89-26 (June 1, 1998). As the Board notes in its November 15 decision, p. 4, "it is reasonable to infer" that Congress was well aware at the time it passed ICCTA in 1995 that the FMC was applying G.O. 11 to a major GovGuam case. Yet, nowhere during its passage of ICCTA did Congress indicate any dissatisfaction with G.O. 11.

Given the similarity of the issues and parties, it is instructive to note the manner in which the FMC resolved matters that lie at the heart of this phase before the Board:

- GovGuam is correct that ratepayers can reasonably be expected to compensate a carrier only for the actual costs of providing a service, including the cost of capital. The Commission has never required ratepayers to compensate a carrier for opportunities foregone. pp. 66-67 (emphasis added).
- In cases involving the foreign commerce of the United States . . . , the Commission examined the effect which rates had on the movement of cargo in the commerce of the United States (footnote omitted). The Commission has also examined the effect which individual rates have on the movement of a given commodity. However, the Commission has not relied on such evidence to determine the reasonableness of the general level of rates maintained by a carrier in the domestic offshore trades. To do so would amount to adopting a reasonableness standard based on "what the traffic will bear."

Likewise, the Commission has not relied on comparisons involving rates in different trades in determining the reasonableness of the general level of rates maintained by a carrier in the domestic offshore trades. It is generally difficult, if not impossible, to identify and quantify all of the variables that affect the level of rates in a given trade. Unless the trades being compared share the same variables, a comparison of rates is of little or no value. Given its dubious reliability, it is hardly surprising this methodology has not been adopted by the Commission for use in the domestic offshore trades. pp. 72-73 (emphasis added).

- The question is whether G.O. 11 methodology for the calculation of rate base can be applied to[]the Guam trade due to the peculiarities of its operation. In Docket No. 78-46, the Commission found that use of replacement cost rather than acquisition costs (or book value) for the

calculation of rate base would result in a windfall to carriers. There is no reason to believe that the Commission was incorrect in its conclusion. p. 80.

■ The vessels serving the Guam trade are part of [] Far East service. Thus it is necessary to allocate [] investment in vessels between the Far East service and the Guam trade. [] The Commission has found that allocations based on the cargo-cube (FEU) mile relationship have produced a just and reasonable result in all other domestic offshore trades. Turning to the Guam trade, there are no peculiar conditions that require a different method of allocation. pp. 81, 85.

The G.O. 11 methodology is tried and true. No other methodology can make that claim in relationship to the domestic offshore trades in general and the Guam trade specifically. There is simply no basis in the law or in public policy to reject this time-tested, court-sanctioned methodology.

B. Given GovGuam's One-Time Right to Challenge the Carriers' Base Rates, This is Not the Time To Experiment with New Methodologies

GovGuam gets one shot at the reasonableness of the defendants' base rates. After the reasonableness of defendants' base rates are established, the ZOR kicks in to insulate increases of up to 7.5% annually. The combination of this limited one-time opportunity and the application of the ZOR safe harbor highlights the magnitude of what is at stake. This is not a time to experiment.

The cost of experimentation is simply too high. Any methodology that allows even a small amount of excess revenues to be incorporated into the "base rates" will be multiplied many times over in the ensuing years, since the ZOR is calculated by the application of a percentage formula of the prior period rates. Thus, any excess revenue will be subject to a multiplier effect and will result in a significant amount of excess revenue over time.

This result of the ZOR's flexibility accorded to carrier rate increases must be considered in determining the appropriate methodology for assessing the reasonableness of the defendants' base rates. Applying a flexible rate reasonableness standard to the base rates will give the carriers a double allocation of leeway. The shippers would have little, if any, ability to protect themselves against unreasonable rates. A fair and even-handed approach to rate regulation in the Guam trade would militate in favor of a conservative approach in assessing rate reasonableness for base rates in light of the generous and flexible approach applied to subsequent rate increases under the ZOR provision of 49 U.S.C. § 13701(d)(1).

Thus, GovGuam's proposal to invoke G.O. 11 should be considered in light of the overall statutory framework. Application by the Board of the G.O. 11 methodology as recommended herein will ensure that GovGuam's limited right to establish reasonable base rates will enure to the benefit of Guam's ratepayers.

C. G.O. 11 is Ideally-Suited to Regulation of the Guam Trade

As a substantive matter, and as set forth in Dr. Nadel's submission, the FMC's G.O.11 methodology is extremely well-suited to application in the Guam Trade. The Guam trade is a "back-haul," "passby" service that is very small part of a vast, integrated and extremely competitive transpacific service voyage.

During the time frame relevant for purposes of this proceeding, Sea-Land vessels began their transpacific voyages on the U.S. West Coast and first called at Hawaii before calling at Apra, Guam. These vessels continued westbound and completed their westbound leg of the transpacific voyage by calling at Far East ports in China, Japan and

Korea. They then sailed eastbound and returned to the U.S. West Coast. The Guam service was part of a larger, integrated transpacific trade that benefits from the larger economies of scale and scope.

Similarly, the vessels utilized by Matson to serve Guam were also part of a vast, integrated transpacific voyage. Until January 25, 1998, Matson accomplished this by chartering space to APL for APL's carriage of foreign cargoes, predominantly eastbound from Asia to the U.S. mainland. Since January 25, 1998, Matson's service to Guam continues to be part of a larger, integrated transpacific trade by use of its own vessels and though space charter on two APL vessels. These two APL vessels first call at Guam after leaving the U.S. West coast and then continue eastbound on a voyage itinerary very similar to Sea-Land. By this arrangement, Matson can limit its service to the noncontiguous domestic Guam trade and yet enjoy the economies of scale and scope inherent in a transpacific pass-by service by teaming up with APL's transpacific service.

Thus, one of the critical issues in the regulation of the Guam trade is the utilization of proper allocation methodologies that address the Guam portion of the larger trade and that only assigns to the Guam trade those costs that Guam shippers may legitimately be asked to bear. The robustness of G.O. 11 is its ability to be applied to both carriers in the time period at issue, and provide the tools for an objective assessment of the reasonableness of the revenues obtained from the shippers utilizing the services. Its FEU-mile ratio¹⁷ and Voyage Expense calculations¹⁸ are excellent instruments for

¹⁷ "The FEU-mile ratio is defined as the ratio of 'cargo-cube (FEU) miles for all cargo carried in the trade to total cargo-cube (FEU) miles for all cargo carried in the (continued...)"

achieving the appropriate allocations. While their application can be improved upon, as recommended by Dr. Nadel, they provide the most solid foundation available to the Board to make these crucial allocations.¹⁹

III. CONSTRAINED MARKET PRICING METHODOLOGY IS INAPPROPRIATE FOR THE GUAM TRADE

It would be natural for the Board to consider whether methodologies it has previously employed, such as Constrained Market Pricing (CMP), are as capable as the G.O. 11 methodology in effectuating the statutory requirement for rate reasonableness for ocean carriers in the Guam trade. Certainly GovGuam considered that question. To help answer it, GovGuam retained one of the most experienced consulting firms in the country on CMP. The answer is no. Application of CMP to the Guam trade, as currently applied by the Board, would be akin to trying to put a square peg in a round hole. It

¹⁷(...continued)

service.' 46. C.F.R. Sec. 552.5(n). 'Cargo cube miles means the product of the cargo cube carried between each origin and destination multiplied by the number of nautical miles representing the shortest navigable distance between the two ports.' 46 C.F. R. Sec. 552.5(m)." *The Government of the Territory of Guam, et al, v. Sea-Land Services, Inc. and American President Lines, LTD.*, FMC Docket No. 89-26 (June 1, 1988) fn. 38, p. 81-82.

¹⁸ "Voyage expense is typically the largest deduction from Trade Revenue in the Income Account. [] Moreover, Voyage Expense is used to determine the VER. [] The VER is used to allocate A&G expense and investment in other property and equipment, and as such, is of crucial importance. The two major categories of expense subsumed in Voyage Expense are Vessel Operating Expense ('VOE') and Cargo Handling Expense." *Id.* p. 90-91.

¹⁹ GovGuam fully expects defendants to urge this Board to reject G.O. 11, just as the defendants did before the FMC. The Board will undoubtedly be regaled with a parade of horrors that will ensue if the Board has the temerity to adopt this long established, time-tested methodology, a litany that the FMC found unpersuasive. Rather than anticipate here the precise nature of defendants' views on this matter, GovGuam will address those issues, as appropriate, in its reply submission.

simply does not fit.

From the outset, the CMP methodology was developed in response to the Staggers Rail Act of 1980. Congress expressly observed that:

[t]he overall purpose of the Act is to provide, through financial assistance and freedom from unnecessary regulation, the opportunity for railroads to obtain adequate earnings to restore, maintain and improve their physical facilities while achieving the financial stability of the national rail system.

H.R. Rep. 96-1430, 96th Cong., 2d sess., 80 (1980).

The Staggers Act followed the policy begun under the Railroad Revitalization and Regulatory Reform Act of 1976 ("4R Act") to give the railroads additional rate freedom. Accordingly, under 49 U.S.C. 10701(a), ICC jurisdiction to determine maximum rate reasonableness was limited to situations in which a rail carrier has "market dominance" (as defined in 49 U.S.C. 10709). Congress observed that: "... by allowing the forces of the marketplace to regulate railroad rates wherever possible the financial health of the railroad industry will be improved and will benefit all parts of the economy, including shippers, consumers and rail employees." H.R. Rep. 96-1430, at 89 (1980).

Most importantly, the ICC explicitly acknowledged that its adoption of CMP in 1985 was in response to a Congressional mandate to ensure the financial health of the rail industry: "The Commission has been directed by statute to assist rail carriers in attaining adequate revenues . . . and specifically to exercise its maximum rate jurisdiction with that goal in mind."²⁰

Thus, the entire statutory and regulatory context in which CMP was developed is

²⁰ Ex Parte No. 347 (Sub-No. 1) *Coal Rate Guidelines*, 1 ICC 2nd 520, 521 (1985), n. 5 (emphasis added).

inapposite to the context in which ocean carriers serving non-competitive Jones Act trades operate. There has never been a statutory concern regarding the financial health of the Jones Act carriers²¹ — and certainly not with respect to this trade in particular. Indeed, the revenue needs of the carriers in the Guam trade is hardly the issue: Guam is the “Golden Goose.”²² And when Matson reentered the trade, it advised its shareholders that it fully expected the Guam trade to contribute to its overall profitability.²³

There is no statutory mandate to put the financial health of these carriers before the needs of the ratepayers. There is no statutory requirement to assess “market dominance” as a predicate to the utilization of traditional public utility type regulation for the domestic offshore trades. Moreover, Congress did not prescribe a particular statutory standard as a threshold requirement for the initiation of rate reasonableness assessments such as a particular operating ratio in the Staggers Act for rail carriers. See, 49 U.S.C. § 10707. The only mandate facing the Board here is to ensure that ratepayers pay no more than “reasonable” rates.

Congress tasked the Department of Transportation to analyze competition in those trades when it enacted Section 407 of ICCTA, 109 Stat. 803, 958. Pursuant to Section

²¹ It has been estimated by various sources that the Jones Act confers substantial economic benefits upon these carriers through various subsidies and other financial plums. GovGuam submits that it was never intended that ratepayers would add to that subsidy, and nothing in any legislative history suggests otherwise.

²² *Government of the Territory of Guam, et. al. V. Sea-Land, Inc. & American President Lines, LTD.*, No. 89-26 (FMC) Ex N-VIII-3, Capers. Tr. p. 138.

²³ *Guam Trade Study*, fn. 34, citing Alexander & Baldwin 1995 Annual Report.

407, the Department of Transportation issued a report which concluded, *inter alia*, that there is a high concentration of carrier service in the Guam trade and that tariff filings be retained for the trade. This finding, in and of itself, in the context of a statutory scheme that does not require a finding of market dominance by the individual carriers, is more than sufficient to satisfy any residual obligation the Board may feel regarding this matter.

It should be noted that some critical aspects of CMP are in fact achievable in the context of G.O. 11. For example, the Management Efficiency Constraint of CMP is readily applied in a G.O. 11 analysis. Excess assets can be deducted from a carrier's reported rate base. Similarly, imprudent expenditures can be deducted from reported trade expenses. These determinations are fundamentally based on the judgment and experience of the STB. There is no inherent superiority in CMP over G.O. 11 on this issue.

However, one of the most significant aspects of CMP that is arguably distinct from G.O. 11 is the Stand Alone Cost criteria. G.O. 11 allows the carriers a rate of return equal to the cost of capital based upon their existing service adjusted for any efficiency considerations. CMP allows for further adjustments to allowable revenue based on the relative elasticity of demand of shippers.

It is critical to note that there has already been testimony by carrier witnesses who previously argued for Ramsey Pricing as an alternative to G.O. 11 in the Guam trade that Ramsey Pricing could permit the expropriation of the entire wealth of the island.²⁴ This is

²⁴ *The Government of the Territory of Guam, et al, v. Sea-Land Services, Inc. and American President Lines, LTD.*, FMC Docket No. 89-26, Transcript of Testimony of (continued...)

what regulatory agencies are to guard against, not authorize. And as Mr. Burris points out in Appendix B, the invocation of CMP as currently applied by the Board, in the context of the Guam trade in particular, would be more than problematic. This is because there are extraordinary differences between the Guam rates and the rates in the competitive sector that make percentage reductions across the board impossible.

Thus, while GovGuam has no basis or reason to be critical of CMP as a general proposition in the context of the trades and individual rates to which it has been applied, GovGuam does not believe that CMP should be applied to determine the reasonableness of an ocean carrier's rate structure in terms of aggregate revenues collected in the Guam trade. It is respectfully submitted that there is insufficient justification to try to use a square peg to fit into a round hole when a round peg is available, given (1) the obvious differences in the nature of the transportation systems; (2) the complete absence of Congressional intent to graft a methodology such as CMP onto the domestic offshore trades; (3) that critical aspects of CMP simply do not work in the context of the Guam trade; (4) that other aspects are just as easily accomplished through G.O. 11, and (5) G.O. 11 was designed for this purpose and approved by the courts.

IV. CONCLUSION

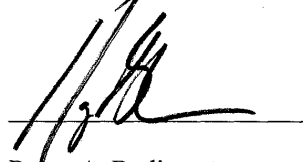
As set forth above, and in the supplemental submissions by Dr. Nadel and Mr. Burris attached hereto, GovGuam submits that existing regulatory standards applicable to the assessment of rate reasonableness in the noncontiguous domestic trades utilized by

²⁴(...continued)

A. Lawrence Kolbe, Ph.D., June 18, 1993, pp. 924-935 (Attached as Appendix VII to the *Guam Trade Study*, Docket No. OST-96-1066).

the FMC should be carried forward. The FMC's G.O. 11 methodology was carefully crafted for these trades and was upheld by the courts. Congress originally required the FMC to develop such a methodology, resulting in G.O. 11, and has not precluded its continued use by the STB. Furthermore, adoption of the prior FMC standards is the most rational approach to the regulation of rates in the noncontiguous domestic trades, given specialized considerations in this industry. Therefore, the Government of Guam recommends that the STB adopt the G.O. 11 methodology for purposes of the rate reasonableness standard in this proceeding.

Respectfully submitted,



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April 23, 2002

CERTIFICATE OF SERVICE

I hereby certify that I have, this 23rd day of April, 2002, caused a copy of the foregoing **"Initial Submission of the Government of Guam in Phase II Concerning the Appropriate Methodology for Assessing Rate Reasonableness Under 49 U.S.C. § 13701(a)"** document to be served upon the chief legal officers as follows:

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**GOVERNMENT OF THE
TERRITORY OF GUAM
Complaint**

V.

**SEA-LAND SERVICE, INC. and
MATSON NAVIGATION COMPANY, INC.
Defendants.**

)
)
)
)
) **Docket No. WCC-101**
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)
)

**Verified Statement
of**

**Ernest Nadel
Principal
LECG, LLC**

**On Behalf of
Government of the Territory of Guam**

April 23, 2002

TABLE OF CONTENTS

I. INTRODUCTION AND SUMMARY	4
A. The economic need	4
B. The regulatory solution	5
C. The cost allocation function performed by the GO-11	6
II. GUAM TRADE AND SERVICE	10
A. Legal Factors	10
B. Physical Factors	10
C. Cargo Demand	11
D. Service Needs	12
E. Carriers in the Guam Service	14
1. Service in the late 1970's	14
2. The beneficial impact of GO-11 in 1978	15
3. Carriers since 1987	16
4. The carriers' services during the time frame at issue	16
F. Benefits for the shippers from the carriers' passby service	19
G. The transpacific backhaul benefit of the Guam trade for the passby carriers	20
III. THE GO-11	23
A. The GO-11 Approach to Guam Trade Regulation	23
B. The Major Elements in the GO-11	23
1. Cargo handling	24
2. Vessel costs	24
3. Systemwide, general costs	24
4. Capital costs	24
5. Rate reasonableness	25
C. The Need for Cost Allocations in Guam Trade Regulation	25
1. Allocations to Trade Segments	25
2. Allocation Ratios in the GO-11	27
3. Current GO-11 Treatment of the Costs for Empties	28
IV. RECOMMENDED MODIFICATIONS OF THE FMC APPLICATION OF GO-11	30
A. Introduction	30
B. The Need for Modification of the GO-11 for Guam	31

C. The Economics of an Imbalanced Trade: Joint-Product Economics	33
D. More refined cost allocations of the A&G and the CBCE.	35
E. Conclusion	37
V. NADEL QUALIFICATIONS	38

I. INTRODUCTION AND SUMMARY

My name is Ernest Nadel. I am a Principal with LECG, LLC. The firm's main office is located at 2000 Powell Street, Suite 600, Emeryville, California, 94608.

The Surface Transportation Board (STB) has the responsibility by law to establish maximum rate regulation of the Guam trade. The Guam trade is the smallest and longest of the four major "Jones Act" trades, trades subject to the 1920 Shipping Act, Section 27, as modified by the Intercoastal Shipping Act of 1933. This proceeding will determine the rate reasonableness methodology for the Guam trade.

My testimony is on behalf of GovGuam, in support of their request that the STB select, as the rate reasonableness methodology for the Guam trade, the "GO-11"—the methodology that was applied by the Federal Maritime Commission (FMC) pursuant to its regulations in its Docket 89-26.¹ As I demonstrate below, the GO-11 satisfies extremely well the economic need for regulation in the Guam trade and the long-standing principles of maximum rate regulation in the U.S.

A. The economic need

The Guam trade is (a) Jones-Act protected, (b) highly concentrated, (c) shipper captive, (d) small trade, with (e) high barriers to efficient entry, that is (f) an integral, backhaul part of a significantly larger, competitive international trade service of the carriers serving Guam. Although Guam is a small trade, it is highly desirable and highly profitable to the carriers. The Guam trade will continue to be very profitable to the carriers when subject to GO-11 rate regulation.

The STB has already recognized some of the key features of the Guam trade when it stated in its decision in WCC-101: "... the Department of Transportation has concluded, in 'Competition in the Noncontiguous Domestic Maritime Trades, March 1997', at III-18,

¹ The FMC regulation was codified in "Financial Reports of Vessel Operating Common Carriers By Water In The Domestic Offshore Trades, 46 CFR Part 552". Form FMC-378 is the Statement of Financial and Operating Data required by the regulations. General Order 11 (GO-11) was the name of the FMC regulation before it was codified in the Code of Federal Regulations (CFR) Title 46, Part 512, later revised as Part 552.

that 'concentration is high in the Guam trade.' Since the Department of Justice's Merger Guidelines consider a post-merger HHI (Herfindhal Hirschman Index) of 1800 as highly concentrated, the Department of Transportation's description is an understatement.

In my professional judgment, these characteristics of the Guam trade, argue for the kind of regulatory methodology that the GO-11 provides as the rate reasonableness methodology for the Guam trade. In the body of this submission, I detail the Guam trade facts that underlie each of the qualities identified above. I also detail how GO-11 works and the way in which GO-11 was applied by the Federal Maritime Commission in its last, and only review of costs and rates in the Guam passby trade, wherein it found APL's and Sea-Land's freight rates to be too high. Those excessively high rates are still being charged in the Guam trade today.

B. The regulatory solution

The GO-11 methodology satisfies the dictates of sound regulatory policy as applied to the Guam trade. Based on long-standing, valid, regulatory principles and practices, the Guam trade needs a regulatory methodology that (a) protects the "captive shippers" of Guam from the unreasonably high freight rates that have otherwise resulted, and would otherwise result, from the highly concentrated, protected, carrier duopoly, while (b) still ensuring that the rates are high enough so that the carriers have a profit-based incentive to serve the trade and offer capacity to the trade. The GO-11 has performed, and will continue to perform, that regulatory task extremely well.

GO-11 is built upon two fundamental premises: (1) that traditional utility rate regulation, in which the carrier is assured actual cost recovery plus a return on and of capital, is most appropriate where there is insufficient actual competition or potential competition to control prices to captive customers; and (2) that, in this case of joint product economics, where Guam is served jointly with the rest of the cargoes carried on the voyage round trip, cost allocation issues must be addressed. Traditional regulation bases cost allocation on cost causality.

U.S. regulatory policy has a long history of seeking to protect shippers in a monopoly or, as in the case of the Guam trade, a highly concentrated duopoly (the closest market

situation to a monopoly) situation. The long-standing, still valid, approach is to use cost-based regulation to ensure that carriers do not abuse their market power. GO-11 is a cost-based approach that covers all the carriers' actual costs, including the cost of capital. GO-11 assures that the shippers will be served efficiently, and that the carriers will earn attractive rates of return, but not highly excessive profits. The GO-11 is based on the carriers' actual costs. It is not based on hypothetical costs; it is not based on inferred costs; and, it is not based on rates from other, presumably comparable, trades.

C. The cost allocation function performed by the GO-11

Because Guam, as a small, passby trade, is served jointly with other trades, some of the Guam trade portion of the costs needs to be derived from the total costs incurred by the carriers in all their trades; other parts of the cost are directly known. Where cost derivation must be done, it must be done well, and GO-11 provides the practiced, experienced tools for doing it well. The GO-11 allows the regulator to identify where those allocations are required and to perform that cost allocation at increasing levels of refinement and accuracy.

The cost allocation principle in the GO-11 is cost causation wherever possible, and then reasonable cost-sharing where cost causality cannot be uniquely or directly attributed to the Guam trade. The cost allocation is performed based on the carriers' own, comprehensive charts of accounts, financial accounts, statistical accounts, and, generally, their easily accessible and interpretable computerized databases.

The only regulatory problem that might arise from the application of GO-11 to the Guam trade is that the resulting rates will be too high under GO-11. There is very little likelihood that rates will be too low.

Guam is served on the carriers' transpacific backhaul. It is this backhaul feature of the Guam trade that makes service to Guam so attractive to a carrier, and allows the GO-11 to satisfy the regulatory concern that rates not be so low as to discourage service. On a carrier's backhaul, the incremental costs are extremely low; they can even be zero. Therefore, there is very little practical danger, if any, of the GO-11 yielding rates that are too low to induce the carriers to serve the trade.

In the passby case of Guam, so long as all the incremental costs associated with a Guam call are covered, any share that Guam contributes to covering the common costs is a net benefit to the carrier and an incentive to call Guam. In the Guam situation, most of the incremental costs are direct costs—such as the costs of handling the Guam cargoes in Guam. These costs are automatically covered by the GO-11. Because it is a passby service and because about 90% of the Guam cargoes are Westbound, on the carriers' backhaul, largely empty leg, the vessel costs and the container repositioning costs would be incurred by the carrier anyway, since they are costs that are caused by the fronthaul cargoes, and are not incremental costs for the backhaul. Nevertheless, GO-11 covers those backhaul costs, thereby insuring the carrier far more than adequate revenues. In this respect, the GO-11 yields a result that benefits the carriers, and in my judgment, benefits them excessively.

If Guam were served competitively, Westbound rates to Guam would be bid down towards their incremental cost levels, recognizing that incremental Guam costs are higher than incremental costs to Asian markets because of the extra handling in Guam. In the transpacific trade, which is competitive, Westbound rates have been bid down toward their incremental levels. Currently, Westbound wastepaper rates are under \$250 for a twenty-foot container, sometimes not even covering the carrier's costs of unloading the container in California and offloading it in Asia. This is not irrational for the carrier, because the onload and offload costs are unavoidable costs, they become sunk costs once the carrier makes the decision to carry Eastbound cargo.

These marginal freight rates are extremely low. Yet even the average dry (not refrigerated) cargo rates, at under \$1500 per FEU (a forty-foot container equivalent unit) are very low compared with Guam's dry cargo rates of \$3000 to \$3500 per FEU. The large difference between these two averages is one indicator of the excess of the rates in the Guam trade, under current trade conditions, brought about by the lack of competition.

I invoke these rate comparisons to show the vast difference between a competitive transpacific trade and the non-competitive duopoly that is the Guam trade. In such a duopoly situation, the Guam shippers need, but are not now getting, the protection of a strong, cost-based, rate-of-return, regulation, which the GO-11 provides.

I am not recommending that the Guam rates be set by the principle of incremental cost. The GO-11, with its cost sharing formulae, does not calculate incremental cost. But implicit in sensible regulation is the recognition that rates must be sufficient to attract service, and a carrier will not serve if rates are artificially held down below incremental cost. I recommend that the GO-11 methodology, as last implemented by FMC, should be moved in the direction of more refined cost allocations; should be moved more in the direction of cost causality; and, as a reasonable step in balancing benefits to carriers and shippers, should not allocate costs for empty space to the backhaul Westbound leg.

The GO-11 was the long-standing methodology of the FMC, an agency with long experience in regulating domestic offshore trades. In 1978, the threat of the imposition of a GO-11 analysis ensured that an inherently high-cost turnaround service was replaced by an efficient, low-cost passby service. The GO-11 performed its required regulatory function: it ensured continuing service that was not too costly and not priced too high. That case was interrupted by the carriers' withdrawal of their proposed rate increases, and, therefore, the FMC could not complete its mission.

More recently, the GO-11 was applied to the 1988-1990 rates in FMC Docket No. 89-26. The prospect of that imposition led the carriers to flee the FMC's jurisdiction. Sea-Land left in 1989 and APL left in 1991. A decade later, in a case still ongoing, the FMC ruled that rates were excessive before the carriers had fled. The STB now has an opportunity to properly address the excessively high rates that the Guam shippers today are still paying.

The Guam trade has been referred to, by a carrier representative in deposition in FMC Docket 89-26, as the "Golden Goose" for the carriers. To have a duopolist's share of a protected submarket's fronthaul cargoes on your backhaul leg is the "holy grail" of the liner container transportation business. In lay terms, it is "found money," since the carrier has the unavoidable need to bear the costs to onload and then move the empty containers, move the ship back to the fronthaul location, and then offload the containers there. Effective regulation, through the GO-11 methodology, will prevent the unreasonable exploitation of that duopoly situation. Even when subject to the regulatory rate caps of the GO-11, the Guam trade will continue to be a Golden Goose for the carriers.

II. GUAM TRADE AND SERVICE

Descriptions of the Guam trade and vessel service pattern have been summarized in submissions to the Department of Transportation in DOT Docket No. OST-96-1066. In this section, I focus on the features of the trade that are the most important considerations for selecting a rate reasonableness methodology.

A. Legal Factors

The Jones Act prevents foreign flag carriers from serving the U.S. mainland-Guam trade. The Jones Act also covers the very small cargo volumes in the trade between Hawaii and Guam. Only carriers using U.S.-flag ships, which satisfy U.S. Coast Guard standards and which are manned by U.S. crews, are permitted to serve the Guam trade.

Because the foreign flag transpacific carriers ply routes that could be modified to include a stop in Guam, the Jones Act precludes the most realistic and likely source of potential entrants into the Guam trade. By decision of the Maritime Administrator, based on the terms of the 1905 Act that made Guam a U.S. territory, foreign built ships are permitted in the Guam trade, so long as they become properly registered and qualified as U.S. flag ships. In this regard Guam is unique among the four domestic offshore trades (Hawaii, Alaska, Puerto Rico and Guam). Since at least 1979, there have been only 2 carriers at any time in the trade; entry and exit are permitted and have occurred, but the number of carriers has stayed a duopoly.

B. Physical Factors

Guam is a small island with an excellent harbor. It is 5,031 nautical miles from the U.S. mainland, about 2 ½ times farther than Hawaii, which is 2,091 miles from the mainland. Hawaii's trade route is the second longest of the U.S. domestic trade routes; trade routes to Alaska and Puerto Rico are much shorter than Hawaii's.

Guam is close to major East Asian trading partners of the U.S., roughly 1,200 miles from Taiwan and from Japan. Those trading partners are generally on the same great circle from the West Coast to Hong Kong. Guam's location lies south of that great circle route by a relatively small distance, which allows it to be served economically on the way to Asia. For some routes, such as from California to Manila (which is also south of the

great circle), serving Guam would entail very little deviation. That was the U.S. Lines route and service (later purchased by Sea-Land at the time of U.S. Lines bankruptcy). For other routes, such as the route APL plied in 1990, the year for which its rates were last reviewed by the Federal Maritime Commission in Docket 89-26, the deviation was about 750 miles on the route from Oakland, California to Kaohsiung, Taiwan. Sea-Land stopped at Hawaii en route to Guam and Asia, making the deviation to Guam even smaller.

C. Cargo Demand

The Guam trade is the smallest of the four major domestic offshore trades subject to the Jones Act. The population of Guam is approximately 150,000. In addition to the cargo needs of the permanent population, cargo needs are also generated by a large tourist population and by the military personnel.

In its 1996 submission to the DOT, Sea-Land estimated that westbound cargo levels in the U.S.-Guam trade were about 28,500 FEU per year in 1990, or about 550 FEU per week. Eastbound cargoes, including textile shipments from Saipan to the U.S. via Guam, which Sea-Land did not carry and therefore did not report on, amounted to under 10% of the westbound volume.

These westbound cargo levels, and the extremely low levels of eastbound cargoes, are too small to sustain an efficient, low cost, dedicated turnaround service in competition with passby service. The last such turnaround service was abandoned soon after a proposed GRI (General Rate Increase) in 1978, when the passby carrier withdrew its own rate increase application rather than submit detailed GO-11 operating and financial data. The turnaround service was replaced by a passby service, because the turnaround costs were substantially higher than the costs of the passby service.

In contrast to the Guam trade volumes, the transpacific trade is two orders of magnitude larger, and, importantly for the Guam trade and its carriers, is predominantly eastbound. Therefore, the economically rational way to serve Guam is via a passby service, which is how Guam has been served for over 20 years.

Although the Guam trade is small, it is larger than that of nearby Island nations. Therefore, Guam is able to serve as a "load center" for Saipan and Tinian. This is a benefit for the carriers who serve these Islands via Guam. It is also a benefit for Guam because its status as a transshipment point creates work and revenue for Guam's citizens.

Guamanians, and the U.S. military personnel stationed there, are American citizens and have American tastes with regard to lifestyle and consumption patterns. This generates demand for imports into Guam from the U.S. mainland. Despite being closer to Asia than to the U.S. mainland, Guam consumers have a strong preference for American-made goods. In addition, Guam's imports from the mainland U.S. are similar in pattern to imports from the mainland U.S. into Asia, and so they better match the U.S. mainland export pattern than the Asian export pattern. Thus, there is very little source competition for the Guam consumers.

The major westbound cargoes are foodstuffs (some requiring temperature-controlled containers), beverages, vehicles, and household goods, particularly on behalf of the U.S. military personnel stationed in Guam. Military household goods and vehicles are the major eastbound movement.

D. Service Needs

Guam liner service needs are relatively simple, especially compared with the service needs of the Asian shippers and consignees whose cargoes are served by the same ships that serve Guam. I have described above the relatively small Guam volumes. In contrast, ships serving major Asian ports directly are now commonly in the 2,000-2,500 FEU class.

Weekly service is desired by importers, including importers into Guam. There is very little price competition, as one would expect from a duopoly. However, there is some service competition, as one would also expect from a duopoly. For example, the availability of temperature-controlled equipment is a sales asset for the carriers

The Guam cargo consist includes a demand for service in temperature-controlled containers and flatrack containers, especially for the military and the construction trades. Otherwise, the Guam service needs are, in general, much simpler than the needs of the

transpacific shippers. For example, there are no long inland moves in Guam; and, the Guam cargoes require relatively few long inland (rail) moves to a wide array of locales in the U.S. Thus, there is no Guam need for sophisticated and frequent intermodal service. The simplicity of the cargo consist, with little Guam export or import of time sensitive materials in support of sophisticated production processes, means that there is no need for "just in time" delivery reliability, high service frequency or transit speed, or for sophisticated container tracking. Finally, there is no strong need for a wide variety of equipment heights and lengths. Thus, Guam could not put a significant service burden on its carriers, even though Guam could benefit somewhat from the high service quality those carriers have evolved over the years.

There is virtually no air cargo competition or non-liner competition for the kinds of goods that Guamanians import in liner container service.

The small cargo consist readily explains why Guam has never had a large number of carriers. The Jones Act, the small volumes, and the preference for products of the U.S., explains why there is very little alternative to service from U.S.-flag liner operators.

Although, it has never happened, and it remains very unlikely, in theory, a foreign carrier could incur substantial Jones-Act caused additional costs of reflagging 5 foreign built ships to the U.S. flag, enter expensive contracts with a unionized labor sector with whom he has no current relationships, and become legally able to call at Guam. After incurring that burden, and with no history or relationships in the trade, he would have to overcome the significant advantages of incumbency, incur heavy initial entry price reduction discounts, and endure a likely initial price war, in order to vie for cargo with 2 other established competitors who also have very low incremental backhaul costs, giving him a long run target of, perhaps, carrying 1/3 of a small trade. He would face similar barriers in trying to add U.S. military cargo to his mix, and would never have the prospect of adding Hawaii cargo to his mix, because foreign built ships cannot carry Hawaii domestic cargo. These high costs and daunting prospects have been, and will continue to be, prohibitively high barriers to entry into the Guam trade, giving added stability to the duopoly.

The Jones Act explains the long-term absence of foreign-flag competition to the duopoly of U.S.-flag carriers. The combination of all of the relevant factors explains why there has only been a duopoly of carriers in the trade. The stability of the duopoly clearly indicates that the Guam shippers are "captive shippers" in need of strong regulatory oversight. Additionally, because there is virtually no prospect for a new, additional carrier to enter the trade, the required rate regulation must be aggressive, rather than passive. It cannot depend on the possibility that entry will lower rates, or that the threat of entry will make this a "contestable market."

E. Carriers in the Guam Service

1. Service in the late 1970's

In the late 1970's, there were two carriers serving Guam, and there have been two carriers ever since. One carrier was a "passby carrier" and the other was a "turnaround" carrier. The "passby" carrier was U.S. Lines, which went bankrupt in the mid-1980's for reasons unrelated to its Hawaii/Guam service, and was sold to Sea-Land. The "turnaround" carrier was Matson.

In 1978, both carriers, charging very similar rates, applied for a general rate increase (GRI). The FMC announced that a hearing would be required, which included FMC review of revenues, costs, income, and rate base, according to the GO-11 cost allocations. Inherently, because of service structure, the turnaround carrier, Matson, had far higher costs than did the passby carrier, U.S. Lines—because passby service is unarguably less costly than turnaround service. Matson was, apparently, prepared to explain its GO-11 based need for a rate increase, to cover its particularly high costs.

U.S. Lines, the passby carrier, could not justify a rate increase in the Guam trade, since its rate of return, though not disclosed to the public, was probably much too high. Data from a few years later indicates its profits. U.S. Lines earned a rate of return on rate base of 48.9% in the Guam trade for 1985; the shippers in Guam were paying an extra \$958 per FEU in excess pre-tax profits earned by U.S. Lines. These data are based on the FMC filings of U. S. Lines, in its last year of operation before it went bankrupt and sold its Guam and Hawaii service to Sea-Land, the predecessor to CSX currently in the Guam trade.

In 1978, the highly profitable passby carrier, U.S. Lines, withdrew its request for a rate increase. Thereupon, the turnaround carrier, Matson, withdrew its request for a rate increase. The presumptive reason is that if Matson received its rate increase, those rates would be higher than the passby carrier's, and it would lose significant volumes of its cargo. Fearing that outcome, Matson withdrew its request for a rate increase. Soon thereafter, Matson withdrew from the trade, and was replaced by APL with its own passby service.

This episode set the basis for the level of freight rates ever since: The freight rates have been based on rates set just below what a high cost turnaround carrier needed to cover its costs – even though the carriers ever since have been low cost passby carriers. This is not a consumer-friendly basis for rates. These rates have been, and still are, far higher than the rates that passby carriers need to cover their costs in the Guam trade.

2. The beneficial impact of GO-11 in 1978

The 1978 episode is instructive for this STB hearing on rate methodology. In that episode, active regulatory oversight, and the existence of GO-11 cost allocations, served to lower the overall cost of service. It prevented an unnecessary rate increase. It also induced the entry of an efficient, low cost passby carrier, and it encouraged the exit of a high cost turnaround carrier. Matson's high cost was not a reflection on Matson's assets or its management. It was a reflection of the undesirable turnaround service, and Matson abandoned a service that was no longer appropriate.

The ability of a regulatory methodology to perform such an important desiderata of regulation—an efficiency-based capacity and operator adjustment—is extremely admirable. The only other time that GO-11 was permitted to impact rates was on June 1, 1998, when the FMC reached its decision in FMC Docket 89-26, and the GO-11 again lived up to its regulatory responsibility. In that case, FMC evaluated the Guam freight rates of APL and Sea-Land, and found that APL's rates were excessive compared to its costs in 1988, 1989, 1990, and that Sea-Land's rates were excessive, compared to its costs, in 1988 and in 1989.

3. Carriers since 1987

In about 1987, Sea-Land purchased the Hawaii/Guam service, and some of the ships, of U.S. Lines, which went bankrupt for reasons unrelated to its Hawaii/Guam service. After that, Guam was served by both APL and Sea-Land as a “passby” along their respective transpacific services. Sea-Land’s service included Hawaii, while APL’s did not.

APL had many transpacific services (“strings”) to and from Asia. APL’s “system” included several transpacific “strings” of ships, feeder services in Asia, and an elaborate rail system in the U.S. for moving transpacific cargoes across the U.S. continent; it also had a service that handled purely domestic cargoes on its rail system. APL also had other services, including a maritime terminal business. Sea-Land’s services were broader than APL’s, because Sea-Land was a major participant in virtually all the East-West U.S. trades, including the transatlantic and the transpacific. Sea-Land also served in the Alaska and the Puerto Rico trades. Thus, APL and Sea-Land each had a rather complex system, and the Guam port-to-port trade was a small part of that system—albeit among the most profitable.

4. The carriers’ services during the time frame at issue

The time frame at issue here, in GovGuam’s complaint, is September 10, 1996 to September 10, 1998. This is the period for which “base freight rates” are to be established.

In late 1995, in a deal that was completed in February 1996, APL’s Guam service and ships were sold to Matson under a 10-year alliance described in the “Matson-APL Space Sharing Agreement” (“MASSA”), #11506, initially filed with FMC on August 25, 1995. Matson owned and operated the vessels and had the use of substantially all of the Westbound (WB) capacity, and APL had the use of substantially all of the Eastbound (EB) capacity from Asia to the US Pacific Coast and made payments to Matson for the use of that capacity. Matson then had its newly bought ships call at Hawaii on the way to Guam.

In December, 1999, after the time frame at issue, CSX took over Sea-Land's domestic service, after selling Sea-Land's international services to Maersk. CSX served domestic markets, and Maersk/Sea-Land served foreign markets, in an arrangement very similar to the APL/Matson alliance.

APL's service last submitted its costs and rates in the Guam trade for FMC review for year 1990. After that, APL dropped its all-water service and offered only FMC-regulation-exempt intermodal service. Thus, Matson has inherited APL's service to Guam and the basic elements of the freight structure that APL had in place.

While the ownership of the assets changed for the APL/Matson arrangement compared to APL's sole ownership, the underlying economics did not: it remained a passby for Guam. The Guam trade thereby remained a trade served by two carriers, Matson and Sea-Land, with similar operations *vis-à-vis* Guam. Each carrier offered weekly service to and beyond Guam, with ships that make a 35-day round trip between the U.S. mainland (California) and Asia, including calls at Guam and Hawaii. A 35-day turn time, using 5 ships in rotation, allows a carrier to offer a weekly call at each port on the route. Sometimes a 6th ship will substitute for one of the five, such as when that one needs to go into dry dock.

The ships generated very large revenues from their carriage of EB transpacific cargo from Asia. The ships carried WB domestic cargo to Hawaii and Guam, and WB foreign trade cargo to Asia including U.S. military cargo reserved for U.S.-flag ships—another protected market similar to the protections that the Jones Act affords the carriers in the Guam and Hawaii trades.

For the period until January 25, 1998, the GO-11 allocations continue to work perfectly well for Matson. The GO-11 does not rely on the income earned from the non-Guam-regulated cargoes; it relies on allocating some of the vessel costs to the non-Guam-regulated cargoes. This is important because this initial period will serve as the period for which "base freight rates" in the Guam trade will be established in this proceeding. And, the GO-11 has already shown that it is capable of evaluating the rate reasonableness of the services deployed at that time.

There was an additional change in the Matson service and in Matson's arrangements with APL, which itself had been acquired by Neptune Lines, a foreign carrier. The new arrangements are described in modifications, effective January 25, 1998, in the MASSA Agreement #11506. This arrangement covers the last 8 months of the time frame at issue in this proceeding.

While the service still uses 5 ships (and may use up to 6 ships), two of the ships have been replaced by APL/Neptune-owned ships that were foreign-built and foreign-flagged, presumably pursuant to the contractual arrangements between APL and Matson. These ships were then reflagged to the U.S. flag. However, the replacement ships no longer call Hawaii, since the 2 reflagged ships are foreign built and legally cannot serve Hawaii due to a provision of the Jones Act.

Matson still owns the remaining three ships in the service, the C-9's it bought from APL in 1996, and time charters these 3 ships to APL. Because it is a time charter, Matson pays for the crew, fuel and sailing costs and receives an undisclosed fee from APL. Thus, APL apparently has control of all 5 ships. APL charts space on these 5 ships to Matson, at undisclosed terms and conditions, for Matson's carriage of Guam cargo. The net effect of these changes is that the itineraries of, and presumably the cargoes carried on, the ships used in Matson's service are little changed from what they had been when APL had sole ownership and operation of the service and its ships; in particular, the ships no longer call Hawaii.

Matson now owns only 3 of its 5 ships that call Guam. For the remaining 2 ships, Matson may not know the volumes of the cargoes, and empties, serving both domestic

and foreign trades. This represents a new feature of the unchanged underlying economic features of the trade, which the GO-11 methodology may need to accommodate.

So, for the period January 25, 1998 to September 10, 1998, the Matson/APL ships still pass by Guam, the GO-11 cost allocations are still relevant, but there is more choice available. For Matson, the charter fees it paid and received might be the measure of the vessel cost that serves the various trade segments in the service, assuming that the charter payments and other fees for services are arm's length fees. Further analysis will be required when the precise confidential arrangements are made available, if necessary, in this STB proceeding, presumably in discovery.

F. Benefits for the shippers from the carriers' passby service

The Guam trade produces benefits for the carriers and for the shippers. The carriers benefit from the revenues and profits, and from the contributions that Guam's volumes make to the carriers' economies of scale and scope. The shippers benefit from the availability of the service. Whether the Guam shippers derive an appropriate share of the benefits from the economies of scale and scope of the carriers depends ultimately on the rates they have to pay for the service they receive. The share of total costs they must bear, and therefore the rates they must pay, depend on the manner in which the trade is regulated, since competition between the duopolists cannot be relied upon.

The passby carrier has (1) an efficient cargo-handling system, (2) a vessel and route system that includes Guam as an integral component, and (3) a large economic system, with many ships, service strings, ports of call, terminals, containers, container depots, etc. Guam shippers participate proportionately in each of these systems. With respect to cargo-handling, in a cost-based regulatory system, Guam shippers pay an average cost for the handling from which they benefit, based on the per-unit cost; the Guam shippers pay the entirety of the costs of handling in Guam. For their non-Guam costs, the shippers benefit from the carrier's economies of scale, just as all American customers benefit from the economies of scale in the American economy.

In the vessel and route system, under the GO-11, the FEU-mile factor is the factor of proportionality determining the vessel expense: Guamanians pay their share of the vessel

expense, based on the benefit they derive, as measured by the direct-route miles of their cargoes. The fact that ships are larger than Guam would need if served by a dedicated, turnaround carrier means that Guam benefits from the economies of scale of the carrier's ship size and low average cost per FEU-mile.

Guam's shippers participate as integral components of a large economic system. Under the GO-11, the Voyage Expense Ratio (the percentage overhead factor) is the factor of proportionality for the expense. Guamanians pay their share of the system expense, based on the benefit they derive, as measured by their share of the common overhead. The Guam shippers derive a benefit from the economies of scale and scope that the large carrier has achieved.

In sum, the Guam shippers derive benefits from the service. One of the goals of regulation is to ensure that shippers are not being charged at rates that eat up their "consumer surplus." Being charged for consumer surplus is not the predominant experience in the U.S. economy, where, through competitive pricing, or through vigilant regulation, all U.S. consumers derive enormous consumer surplus from the scale, technological progress and competitive efficiencies in the economy.

G. The transpacific backhaul benefit of the Guam trade for the passby carriers

What makes the Guam trade particularly attractive for the U.S.-flag carriers is that Guam cargo is a backhaul cargo for them, and reserved only for them, by the Jones Act, against any foreign-flag competition. This is Westbound, backhaul cargo on a transpacific trade that is predominantly an Eastbound trade. With the significant long term trade imbalance in the foreign transpacific trade, carriers who do not serve Guam experience very low backhaul utilization and very low backhaul rates for the cargoes they do carry Westbound.

Thus, the carriers calling Guam operate on relatively equal terms with their foreign competitors, at competitive rates in the transpacific trade that are sufficient, over the long run, to sustain them and their competitors—but with an extra advantage for the U.S.-flag carriers. That advantage is access to reserved domestic cargoes; and Guam cargoes are the most advantageous because of their enormously high rate levels. It is no wonder,

therefore, that an APL employee, in deposition during FMC Docket 89-26, referred to Guam as a "Golden Goose" for APL, and that Sea-Land documents revealed during discovery identified their Hawaii/Guam service as the most financially attractive compared to any other of their worldwide services.

The extent of the underlying trade imbalance can be seen from the data in Table 1A. The annual freight rates in Table 1A are derived from the quarterly rates in Table 1B. The volume data is derived from the Journal of Commerce and Drewry Consultancy. The rates are taken from analysis by Containerization International, a recognized source in the industry. The trade being covered is extremely broad, since it includes all of Asia, all three U.S. coasts, and intermodal cargo as well. The rates, in both directions, are higher than the rates for port-to-port cargoes, often called "local." The trade that FMC regulated in Guam was only the Guam "local" trade, and local cargoes are a higher portion of the Guam trade than of the international transpacific trade.

In recent years, while Eastbound volumes have been slightly more than double Westbound volumes, Eastbound rates have been more than double Westbound rates. As a consequence, Eastbound revenues have been close to 5 times as high as Westbound revenues.

The imbalance means that capacity is geared toward the Eastbound trade, and the Eastbound cargoes pay for the vast majority of the round-trip expenses of the services—including the expenses of the U.S.-flag carriers. This imbalance leads to the following:

- the carriers incur the Westbound portion of the round-trip mainly to reposition their ships and containers to Asia;
- the Westbound portion of the trip causes very little of the round trip expense; and
- the Westbound marginal freight rates are very low, or even zero.

Thus, for the U.S.-flag carriers, Asian cargo rates, that are the alternatives to the rates that the U.S. carriers earn in Guam, are always very low and, depending on particular circumstance, may be zero if there is empty space on the ships.

The U.S.-flag carriers also derive benefits from the carriage of reserved U.S. military cargo Westbound, as well as Hawaii cargo. But the benefits are greatest for the Guam cargo, since the rates have been maintained at the highest level among these U.S.-flag protected trades.

In 1990, APL's Guam rates, a trade I studied extensively, were \$4,116 per FEU; Sea-Land's rates, last reported to FMC for the first half of 1989, were somewhat lower. I expect that the recent port-to-port rates in the U.S. mainland-Guam trade have been in the range of about \$3,500 to \$4,000 per FEU.

The Guam rates are much higher than Westbound rates elsewhere on the Asian routes, especially the marginal local cargo rates which are under \$500 per FEU. Mainland U.S. Westbound rates to Guam are much higher than current military rates for U.S. military cargoes.² Military rates are determined in a negotiated competitive procedure. The current local military contract rates of the low bidder (whose rates are slightly lower than the rates of the other bidder) in each cargo category, are as follows: for dry cargo in 40-foot containers, to Japan, \$959; to Korea, \$1,025; and to Okinawa, \$1,525. For cargo in 40-foot reefer containers, to Japan, \$2,759; to Korea, \$2,950; and to Okinawa, \$3,627. U.S. Westbound local rates to Guam are higher than even the local Eastbound rates, which is on the U.S.-flag carriers' heavy leg, in the current military contracts. These Eastbound rates are, for dry cargo from Japan, \$2,125; from Korea, \$1,900; and from Okinawa, \$2,809.

The military rates to and from Asia are lower than the military rates to and from Guam, as I have observed in previous studies. The military rates are competitively, secretly, bid, with the lion's share going to the low bidder, while the Guam rates are publicly filed. Publicly filed rates make tacit coordination between the carriers very easy. In addition, the military is itself a large shipper, arguably the largest in the world, and so it has significant countervailing power in its negotiations with the carriers, while the Guam shippers and consignees have very little leverage over the carriers.

² The rates were taken from the website of the Military Traffic Management Command, at www.mtmc.army.mil.

III. THE GO-11

A. The GO-11 Approach to Guam Trade Regulation

The GO-11 is an actual-cost-based approach to rate reasonableness. Based on the capital and operating costs actually incurred by the carriers, the GO-11 generates a “revenue requirements” model. It sets the maximum rate level sufficient to allow the carrier enough revenue in the trade to cover the carrier’s expenses in serving the trade, plus a return on and of capital in serving the trade.

Application of GO-11 prevents the carriers from earning excess profits, and ensures that the carriers earn a proper rate of return. It mandates that the Guam shippers pay a fair share of the common costs that were incurred for the service jointly provided to them with service to the other shippers served by the ships and by the carrier. The Guam shippers benefit because they avoid the high costs of dedicated turnaround service in unbalanced trade, and, they share in the carriers’ economies of scale, as do the other foreign trade shippers served by these carriers. The GO-11 provides that the Guam shippers pay substantially more than the incremental cost of serving Guam, and thereby provides financial benefits to the carriers.

The GO-11 approach does not address the rate structure within the Guam trade—the relationship of individual commodity rates to each other: which commodity rates should be higher than average and which commodity rates should be lower than average. Therefore, the GO-11 does not involve dealing with the difficulties related to Ramsay pricing.

The GO-11 focus on average rates is appropriate for this proceeding since the STB is interested in setting a proper “base level” of rates to which the Zone of Rate Reasonableness (ZOR) may then be applied.

B. The Major Elements in the GO-11

The following are the major elements of the GO-11:

1. Cargo handling

The GO-11 estimates cost per unit of cargo handling from cargo pools which spread the cost over each unit handled—a reasonable approach since most cargo handling is standard, routine, automated, and simplified via the containerization revolution of four decades ago. It spreads all of the costs of handling empty containers proportionately among the loaded containers.

2. Vessel costs

The GO-11 allocates joint vessel costs to all of the revenue-paying cargo on the ship using the FEU-mile relationship. It spreads all of the costs of moving vessel container cells that are empty, with no revenue-earning loads, proportionately among the loaded containers. Thus, the GO-11 ignores the practical economics of an unbalanced round trip: the fronthaul cargo must, by profit-maximizing, competitive behavior, pay the cost of repositioning the ship (including the portside lift-on in the U.S. and lift-off in Asia of the container) back to the source of the fronthaul cargo—*i.e.* Asia.

3. Systemwide, general costs

The GO-11 spreads the remaining costs (essentially treated as an aggregated “overhead” expense) on a pro rata basis (a basis that is equivalent to a companywide percentage-markup of “overhead” expenses), using a Voyage Expense Ratio based on the cost estimates and allocations described in the prior 2 steps.

4. Capital costs

Until 1994, the GO-11 computed a rate of return on rate base, which it then compared to a comparable earnings standard, based on a risk-adjusted comparison to the historical rates of return of a comparable set of firms in comparable industries. In 1994, FMC Docket 94-07 changed the comparable earnings standard to a Weighted Cost of Capital approach.

5. Rate reasonableness

The GO-11 indicates excess in the rates by the excess of the after-tax return.

Economic logic measures the amount or excess in the rates by computing the pre-tax excess equivalent of the after-tax return, and spreading this return across all the cargoes moved. FMC performed the penultimate step: it calculated the after-tax excess return. I performed the ultimate step in the damage phase of FMC Docket 89-26, and I calculated the pre-tax excess return, by dividing the after-tax excess return by the fraction of 1 minus the tax rate. Excess pre-tax return equals excess pre-tax revenue, equals excess in the freight rates.

C. The Need for Cost Allocations in Guam Trade Regulation

1. Allocations to Trade Segments

The Guam trade situation requires separating domestic from foreign cargoes. The Guam trade, both the port-to-port segment and the intermodal segment, is served as part of a much larger “service,” which is itself part of a much larger “system.” The ships in the particular 5-ship service that includes Guam on the itinerary also carry foreign cargo. (In the case of APL, in 1990, foreign cargoes were about 85% of the total.) The service that includes Guam – which APL called its “PIX” service – is only one of several services that form the carriers’ entire “system.” Thus, the Guam trade is served as part of a service, and that service is part of a system.

The GO-11 recognizes that carrier expenses and assets can be split into expenses for the carriers’ system; expenses for a particular service within the carrier’s system; and, expenses for a trade within a service. A system usually comprises more than one service and more than one trade. A service usually serves more than one trade. A trade may be served by more than one service, such as occurs with the two CSX services today—one turnaround and one passby, that serve Hawaii; Guam is served by only 1 service for each carrier.

The systemwide expenses and the capital assets they use are allocated to each of the services. Within each service, the expenses and assets are allocated to the regulated trade portion of the service versus the unregulated portion. For the services encompassing the

Guam trade, the STB unregulated portion, in 1990, included some domestic intermodal cargoes; it also encompassed international cargo, which is by far the largest portion.

(a) Trade expense

Some expenses are incurred only for one particular trade in a service. Thus, for example, the port expenses incurred in Guam are incurred only to handle the Guam trade cargo. (A further distinction can be made between the port-to-port Guam trade and the intermodal Guam trade.) The GO-11 uses some "direct allocations." Thus, for cargo handling at a port terminal that serves many trades, the expenses can be put into various cost pools, such as the expenses for lifting the containers onto and off of the ships, or for moving containers around in the yard. Then, the costs are distributed evenly among the various trades that were served, proportionately to the amount of cargo moved in each trade.

(b) Service Expense

Other expenses and assets are specific to a service. These are mainly the expenses for the acquisition and operation of vessels in that service. Services are now usually called "strings." Service operations include payments for crew, fuel, stores, vessel insurance, vessel M&R, etc.

(c) System Expense

Expenses incurred and assets used throughout the carriers' "system" apply, in varying degrees, to all of the carriers' services and trades. The degree of application can be determined. Examples of these system expenses are:

- system-wide strategic planning;
- high-level executive salaries;
- sales, advertising, promotions, and marketing;
- legal expenses;
- the purchase and maintenance of containers that circulate throughout the carriers' various trades and terminals;
- container location tracking; and

- terminal expenses at terminals that serve many services and many trades.

2. Allocation Ratios in the GO-11

The GO-11 develops allocation formulas and procedures to identify expenses that are properly or fairly attributed or allocated to a particular trade that is subject to regulation. The formula that allocates service expenses to a particular trade is called the FEU-mile ratio, a measurement of the miles traveled by each loaded container, where the loaded containers are measured in Forty-foot-Equivalent Units. And, the formula that allocates system expenses to a particular trade is called the Voyage Expense Ratio (VER).

In the FEU-mile ratio, the mileage is based on the distance between the cargo's maritime origin and the destination points, ignoring any variance from that shortest distance. Thus, for cargo that moves from Guam to Los Angeles, the carrier loads the cargo in Guam and then carries it Westbound to Asia; there the ship turns Eastbound toward the U.S. and continues to carry the container to L.A. Although the distance moved can be about 8,000 miles, the GO-11 uses the port-pair shortest distance, or 5,311 miles. In so doing, the GO-11 is measuring the benefit derived by the shipper, not the particular routing chosen by the carrier.

An "FEU" is a forty-foot equivalent unit; so, for example, 10 TEU (twenty-foot equivalent units) would equal 5 FEU. The FEU-mile is the cubic analog to a ton-mile; it is analogous to a car mile in the rail sector. By convention, containers are divided by the GO-11 into only 2 types: 20's and 40's; variance in height is ignored, and a container longer than 40 feet—say, a 45-foot container—is considered a 40-footer. The GO-11 can be adjusted to account for these dimensional variances. The focus is on the external dimensions of the container, not the amount of space occupied by the cargo. The GO-11 can be modified to account for the internal use, the cargo's use of the container, whether measured by the cube of the cargo or the weight of the cargo.

The GO-11 contains additional ratios and provisions that are of secondary importance. These include:

- a working capital ratio used to attribute working capital to the trade investment base;

- an interest ratio used to allocate annual interest expense to trades;
- a voyage days ratio used to allocate, to each service, annual vessel voyage expense for a vessel and investment in a vessel that is used in more than one service; and,
- a provision for a waiver from filing a GO-11 when there is a General Rate Increase (GRI) less than 3%—a provision similar to the 7.5% ZOR.

3. Current GO-11 Treatment of the Costs for Empties

In the international transpacific trade, the Eastbound (EB) direction has been the dominant leg. It is usually called the “heavy leg,” even though the cargo is not as dense (pounds per cubic foot) as the cargoes in the Westbound (WB) direction. The EB is much larger than the WB leg in volume; about half of the loaded EB containers must be returned (“repositioned”) to Asia (after the cargoes have been discharged in the U.S.) via the WB movement. Thus, a very large share of the containers on the WB leg are empty containers. The EB is also substantially higher in average revenue per FEU. This has occurred for the last 20-plus years.

In contrast, the two pacific domestic trades (Guam and Hawaii), and the military trades (such as Okinawa), have the opposite directional imbalance: they are predominantly WB trades. They are also restricted by U.S. law to U.S.-flag vessels. Thus, a U.S.-flag carrier’s ability to marry a predominantly EB Asian transpacific trade with a predominantly WB (albeit smaller) domestic (and military) transpacific trade is a great economic advantage. It affords revenue enhancement for the carrier, compared to the revenue opportunities of that carrier’s foreign-flag competitors in the transpacific trade. It also affords cost savings for the carrier.

The cost-savings arise from the “backhaul” advantage—the ability to use otherwise empty, unutilized space. In the foreign, competitive, unregulated trade, the backhaul advantage results in lower backhaul rates for comparable WB cargoes. (Cargoes requiring specialized equipment, such as temperature equipment, which move predominantly WB, pay a premium to cover that additional cost.)

The GO-11 does not fully account for this advantage and allocates it to the WB domestic cargo, because the GO-11 does not explicitly allocate cost to the empty containers carried in the service. Instead, implicitly, the cost of moving the empties is distributed proportional to the FEU-miles traveled by all the loads. From a causal economic perspective, this can be considered an error. It is an error that can easily be corrected.

In addition, the GO-11 does not explicitly allocate costs for landside handling empty containers. Since handling empties at the terminals and inland is not costless, the expense is implicitly shared among all the loaded containers. From a causal economic perspective, this, too, can be considered an easily correctable error.

In sum, the GO-11 does not distinguish fronthaul expense allocation from backhaul expense allocation, whereas such distinctions are commonly made by the operators in this trade, in other maritime trades, and in any transportation mode.

IV. RECOMMENDED MODIFICATIONS OF THE FMC APPLICATION OF GO-11

A. Introduction

Since this STB proceeding begins the process of establishing a regulatory standard for the Guam trade, I recommend that now is an appropriate time for the GO-11 to be modified and updated. The modifications will better reflect the predominant economics of the Guam passby trade, a predominance that is unique among the 4 major domestic offshore trades. Also, the modifications will better reflect the modern ability to more accurately measure and allocate trade costs using computerized carrier databases. The modifications represent a better application of economic principles. They also represent a more reasonable balancing of the interests of shippers and carriers in the Guam trade .

Their application will lead to reasonable results, in keeping with the stated intent of GO-

11. Based on my analysis and research, I propose the following modifications:

1. The GO-11 should allocate the backhaul costs of empty space on the ships, and the backhaul handling of empty containers at the terminals, to the fronthaul cargoes for whose sole benefit the expenses for the empties are incurred.

It is my understanding that such a proper accounting for empties is used by the STB. The typical STB model develops a ratio, by rail car type, of empty miles to loaded miles and increases the costs associated with a loaded move to cover the car related costs for the empty move. The typical STB model can always be adjusted to reflect the actual circumstance for a specific move rather than by using system average.

2. A more refined cost allocation should be used in the treatment of what the GO-11 over-broadly treats as "system" expenses. These refinements can extend to cost allocations by container size (variations by length and height) and container equipment type (dry container versus temperature-controlled versus flatrack).

B. The Need for Modification of the GO-11 for Guam

The modifications are warranted because the GO-11, as currently written, does not allocate the costs of carrying and handling empties directly; instead, that cost is borne by all the cargo loads. A better economic approach is to recognize that empties are transported and handled onto and off the ship in the backhaul direction for the purpose of being repositioned to the fronthaul location where the empties will be filled with cargo. Therefore, the transportation and handling of empties can be properly allocated to the fronthaul cargoes, rather than to all the cargoes. This treatment of empties reflects the economic calculus and decision-making that all transportation firms, in all transportation sectors, employ.

The economic analysis underlying the GO-11 insufficiently accounts for the joint-product economics of a transpacific service, whose "overhead" cost pools are larger and more aggregated than necessary. Adopting modifications to account for these will make the GO-11 correspond more closely to cost causality, be more accurate and reasonable, and produce a fairer sharing of the costs and benefits between shippers and carriers in the Guam trade.

This backhaul-related approach, and its refinement of the systemwide cost allocations, will reduce the Guam rates below those resulting from the conventional GO-11, which themselves are below current rates charged by the carriers. This will give Guam shippers a fairer share of the benefits of the service compared with the enormous benefits that accrue to the carriers under GO-11. The need for modification is acute given that the ZOR in the future will only work to hurt the shippers as each year goes by, and the statute does not appear to provide any relief from the ZOR.

The GO-11, as currently implemented by the FMC, allocates backhaul, joint-product costs to the fronthaul EB cargoes and to the backhaul WB cargoes, instead of to only the cost-causing fronthaul EB cargoes. The reason lies in the underlying premise of GO-11: that joint costs should be borne approximately proportional to the benefits received by each container of cargo, regardless of causality. Since WB cargoes, jointly with the EB cargoes, receive voyage benefits, the GO-11 judges that WB cargoes should be allocated

a cost. In this, the GO-11 invokes a benefits-based methodology, and not a cost-causality methodology.

It is a reasonable compromise to allocate to the backhaul WB cargoes an FEU-mile-based cost for the vessel space *that those cargoes use* and a cost for the loading of the containers in California – even though there is no economic WB-causality involved in either case. This is an extra financial benefit to the carrier – a lagniappe – for which the carrier incurs no incremental cost. There is some corresponding benefit to the WB Guam shipper. But there is no such benefit to the WB Guam shipper when empties are loaded in California, carried on the voyage, and then offloaded in Taiwan. Therefore, it is not reasonable to charge the WB Guam shippers an FEU-mile share of the cost for the empty space and the empties' handling.

The need for this modified treatment of empties is far less urgent and compelling for the other regulated domestic offshore trades, because they are predominantly served by turnaround service. In a turnaround service, *the cargoes in both directions are regulated cargoes*. In the Guam service, the Guam Westbound shippers are shippers protected only by regulation, but the Eastbound direction shippers are, predominantly, shippers in the *unregulated Eastbound foreign trade* who have vigorous, multiparty competition to protect them from excessive freight rates.

In the domestic turnaround trades, shippers protected by regulation must bear the cost burden of the empties, whether the burden is ascribed to the fronthaul shippers or to fronthaul and backhaul shippers. Also, the cost burden by direction is not an issue because the regulation, such as the GO-11 regulation, does not interest itself in the distribution of freight rates among the individual shippers of different cargoes, including differences by direction of cargo movement. That distribution is left to the participants in the trade to determine, subject to established standards for individual rates—but subject to the overall regulatory cap on revenues so that they do not exceed a just and reasonable standard. This hearing is interested in established the overall revenue requirements that must be borne by all the regulated shippers in the trade, taken as a group.

C. The Economics of an Imbalanced Trade: Joint-Product Economics

GO-11 should be modified to recognize that the transpacific trade is seriously imbalanced, with the Eastbound trade being the dominant leg, as reflected in higher EB cargo volumes, higher average revenue per FEU, and therefore higher EB revenue. This is true for the port-to-port segment and for the intermodal segment as well. In the transpacific trade, vessel and container capacity is designed for, and put into the water to serve, the inbound trade. Therefore, many Westbound (WB) costs are incurred only because the Eastbound (EB) cargo mandates that those costs be incurred. And, therefore, the WB movement to Guam (and to Asia) involves a joint-product—the empty repositioning of the ship and the containers, and the delivery of cargo loads to Guam (and to Asia). This impacts vessel cost, cargo-handling cost for empties, and container-days cost.

The simple and appropriate modification necessary for GO-11 is to allocate the cost of empty vessel space, empty FEU-miles, the handling of these WB empties, and the WB container-days' use cost to the EB cargo shipments, rather than the current system which spreads the cost across EB *and* WB cargo shipments.

Every container, whether with cargo loaded in it or empty, moves between a port pair. When the movement is an empty, its cost should be attributed by the GO-11 to the load that will follow the empty movement, since that is the purpose for which the empty is moved in the first place. A similar rule should apply to the handling of the containers at the port.

So, for example, if a ship carries 1400 loads Eastbound and 800 loads plus 600 empties Westbound, the EB cargo must cover the cost of 2,000 moves—1400 loads EB plus 600 empties WB. Similarly, when the empties are loaded back onto the ship in California and the Pacific Northwest, their expense is allocable to only the EB loads—since the only reason they are being loaded back onto the ships is to “reposition” them to Asia, where they will be loaded with EB cargoes. This kind of economic cost calculus is what all transportation firms consider as they plan new capacity and as they establish their pricing strategies in a competitive market.

Some additional considerations that would apply in the modified cargo cost allocation include the following:

- Guam EB cargo should be treated the same as Asian EB cargo. Guam EB cargo uses a relatively scarce EB transpacific container slot and should share in the cost of the WB empties.
- The reefer (temperature-controlled) cargo in the transpacific trade, and in the Guam trade as well, is imbalanced in the opposite direction, WB, compared with the imbalance in the dry cargo. Reefer containers may be used for compatible dry cargo in the return or may return empty. When they return empty, their cost should be attributed to the WB (fronthaul for reefer) direction. It is my understanding that in rail matters, the STB takes into account different railcar types; I recommend that it do so in this analogous case of container type as well, with the appropriate modification of the GO-11.
- Stevedoring cost, the cost of moving containers between the wharf and the ship, should be allocated to all movements, not just loaded movements. The cost allocated to the empty movements should be allocated to the loaded movements in the opposite direction. The GO-11 work papers of APL in FMC 89-26 showed loaded containers moved on and off the ship. It is a reasonable approximation that the number of empty containers handled is the difference between containers moved off and containers moved on.
- The GO-11 regulations direct that a standard container size can be used if no dimension of a particular container exceeds the dimension of the standard container by one foot. If there is a dimension in excess of one foot, the actual outside cube should be used to calculate TEU or FEU equivalents. The 45-foot containers are more expensive than the 40-foot containers and are moved loaded relatively more to and from the Far East rather than to Guam, and the GO-11 should be modified to take this into account.

- At the carrier's convenience, the carrier sometimes supplies a 40-foot container when a 20-foot container would suffice, with no additional charge to the shipper for the larger equipment. The reason is that the carrier has insufficient 20-footers available, and that is mainly because the container consist is geared towards the EB trade, which has a great preference for "high cube containers"—longer and taller than others. Thus a shipment to Guam may move in a 40-foot container when the cargo cube inside could fit in a 20-foot container. If rate regulation took this into account, there would be an incentive for the shippers to economize on space. Importantly, when the carriers report their loadings to the STB, they should be required to state that the larger equipment was provided "for the carriers' convenience," and the loads should be measured as 20-foot loads, not 40-foot loads. Unless this adjustment is made, the cost allocation will be artificially exaggerated and will allocate improperly large costs to the Guam (and Hawaii) trades. As it now stands, this is a good example of the Guam shippers inappropriately paying for the high cube service needs of the transpacific shippers.

D. More refined cost allocations of the A&G and the CBCE

The system costs need not be allocated from a very large expense pool, as is now done. That pool can be broken down into smaller aggregates, and better cost allocations can then be made. Administrative and General (A&G) and Cargo barge container expense (CBCE) functions can be easily tracked and reasonably associated with the cargo subsets that derive direct benefits from the services provided by the activities summarized in these accounts.

There has been a great change in computerized data-processing since the last revision of the GO-11; computers can make more "direct" allocations than could be done 20 years ago. It is no longer necessary to allocate huge aggregates of expenses such as A&G and CBCE on the basis of a simplistic Voyage Expense Ratio.

Costs can be more closely allocated to the trades. Costs can also be allocated to sub-trades like reefer, flatrack, and bulk cargoes. In the following, I discuss many of the categories of expense in the GO-11:

- The category "System Expenses" – a term used in the GO-11 – is not really systemic. Many expenses such as sales, ship maintenance supervision, local terminal management expense, are geographically and functionally identified in the carrier accounts. These could be easily recognized in the computer-generated cost allocations. With a more refined allocation, the VER would be used only on system expenses and not on expense items which can be allocated to shipments in various trades.
- Cargo barge container expenses (CBCE), are closely related to the days of use of the containers, and the days of use are generated by individual shipments. Local shipments involve less CBCE expense than intermodal shipments or shipments using intra-Asia feeders. In addition, some trades have barges; Guam's does not. For example, Matson uses cargo barges in its transshipment service to the Outer Islands and there are cargo barges in the Puerto Rico trade. There are no cargo barges in the Guam trade.
- Administrative and General expenses can, in part, be allocated by location and function; only the remaining system costs need be allocated by the Voyage Expense Ratio (VER). For example, sales and marketing and promotional expenses can be attributed to particular trades; planning and vessel acquisition can be associated with different trade segments; integration of the linehaul service with Asian feeders and the U.S. rail system can be differentially allocated. Also, some of the A&G expenses may be related to the length of a cargo movement, while others may be related to the revenue earned.

E. Conclusion

My analysis demonstrates that the GO-11 is based on: actual costs; a fair allocation of costs by causality when possible; practical accounting and statistical procedures; and a fair standard of reasonableness for rate of return. It is flexible enough to handle variations in shipping circumstances that can call for adjustments to the allocation formulas, and the required work papers provide the documentation needed to judge the fairness of the procedures in a specific case.

The modifications I have suggested above demonstrate the flexibility of the GO-11 and enhance its fairness when applied in the Guam trade. They encourage more accurate cost allocations; they reflect the economic realities of the transpacific trade; and they provide a fairer balancing of the interests of the shippers and the carriers in the trade.

I strongly urge the STB to adopt GO-11, as modified herein; or, in the alternative, to adopt GO-11 unmodified.

V. NADEL QUALIFICATIONS

I, Ernest Nadel, am a Principal with LECG, LLC. LECG is a leading economic finance consulting services firm, providing sophisticated economic and financial analysis, expert submission, litigation support, and strategic management consulting to a broad range of public and private enterprises. LECG consultants are renowned academics, recognized industry leaders, and former high-level government officials supported by a highly educated and experienced professional staff.

We are further described at www.lecg.com. My C.V., including a list of my expert witness submission and litigation support work, is also on our website. That C.V. is also attached to this submission.

I am an economic consultant, specializing in maritime economics since 1975. I have a PhD in Economics (1969) from the University of Chicago. Before becoming a consultant, I was Assistant Professor of Economics at University of California, Berkeley.

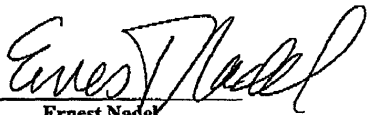
In my consulting career, I have been hired by, and testified on behalf of, maritime carriers and shippers and government agencies. My professional experience includes having worked for, and testified on behalf of, GovGuam in FMC 89-26. It also includes having worked for, and testified on behalf of, Sea-Land, before its purchase by CSX. And, it also includes having worked for, and testified on behalf of, Matson, in the 1987 Maritime Administration Case (S-801) wherein APL sought, but did not receive, permission to call at Hawaii on the way to Guam.

Attachments: Nadel C.V.; Table 1A; Table 1B

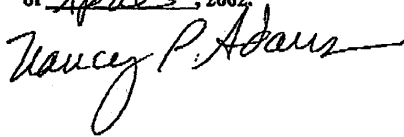
VERIFICATION

STATE OF CALIFORNIA)
)
CITY OF EMERYVILLE)

ERNEST NADEL, being duly sworn, deposes and says that he has read the foregoing statement, knows the contents thereof and that the same are true as stated.


Ernest Nadel

Sworn to and subscribed
before me this 23rd day
of April, 2002.



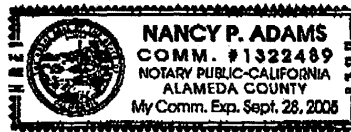


Table 1A Annual Transpacific Freight Rates and Volumes, 1993 to 2001

Year	RATES			Transpacific Volumes				Revenues			
	E/B US\$/TEU	W/B US\$/TEU	Ratio	Eastbound TEUs 000	Westbound TEUs 000	Ratio	Eastbound % of total	E/B	W/B	Ratio	E/B % of total
1993				3,499	2,394	1.46	59%				
1994	\$1,732	\$1,280	1.35	3,837	2,837	1.35	57%	\$6,647	\$3,630	1.83	65%
1995	\$1,815	\$1,431	1.27	3,869	3,131	1.24	55%	\$7,021	\$4,480	1.57	61%
1996	\$1,638	\$1,415	1.16	3,892	3,094	1.26	56%	\$6,375	\$4,377	1.46	59%
1997	\$1,403	\$1,292	1.09	4,435	3,148	1.41	58%	\$6,221	\$4,066	1.53	60%
1998	\$1,495	\$994	1.50	5,212	2,725	1.91	66%	\$7,791	\$2,708	2.88	74%
1999	\$2,007	\$814	2.46	5,849	2,915	2.01	67%	\$11,739	\$2,374	4.95	83%
2000	\$2,013	\$852	2.36	6,663	3,204	2.08	68%	\$13,411	\$2,731	4.91	83%
2001	\$1,754	\$849	2.07	6,784	3,087	2.20	69%	\$11,901	\$2,621	4.54	82%

Basis: JOC & Drewry
Volume Data covers all US Cargo flows but does not include Canada and Mexico port volumes.

Table 1B Quarterly Transpacific Freight Rates

Period	E/B US\$/TEU	W/B US\$/TEU	Ratio of Rates
1Q 94	\$1,758	\$1,246	1.41
2Q 94	\$1,718	\$1,255	1.37
3Q 94	\$1,727	\$1,315	1.31
4Q 94	\$1,726	\$1,302	1.33
1Q 95	\$1,698	\$1,323	1.28
2Q 95	\$1,826	\$1,356	1.35
3Q 95	\$1,870	\$1,571	1.19
4Q 95	\$1,865	\$1,473	1.27
1Q 96	\$1,746	\$1,339	1.30
2Q 96	\$1,628	\$1,428	1.14
3Q 96	\$1,630	\$1,508	1.08
4Q 96	\$1,548	\$1,384	1.12
1Q 97	\$1,473	\$1,280	1.15
2Q 97	\$1,407	\$1,277	1.10
3Q 97	\$1,369	\$1,428	0.96
4Q 97	\$1,362	\$1,182	1.15
1Q 98	\$1,345	\$1,119	1.20
2Q 98	\$1,459	\$1,015	1.44
3Q 98	\$1,561	\$999	1.56
4Q 98	\$1,614	\$842	1.92
1Q 99	\$1,619	\$832	1.95
2Q 99	\$2,018	\$871	2.32
3Q 99	\$2,203	\$818	2.69
4Q 99	\$2,188	\$736	2.97
1Q 00	\$2,125	\$751	2.83
2Q 00	\$1,953	\$852	2.29
3Q 00	\$2,041	\$939	2.17
4Q 00	\$1,932	\$867	2.23
1Q 01	\$1,874	\$877	2.14
2Q 01	\$1,765	\$869	2.03
3Q 01	\$1,624	\$801	2.03

Source:

Containerisation
International's Freight
Rate Indicators

Notes: Information
sourced from six of
the trades' major liner
companies. All rates
are all-in, including
the inland intermodal
portion, if relevant. All
rates are average
rates of all commo

ERNEST NADEL Ph.D.

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EDUCATION

Ph.D., International Economics, UNIVERSITY OF CHICAGO, 1969

M.A., Economics, UNIVERSITY OF CHICAGO, 1967

B.A., Economics and Political Science, MCGILL UNIVERSITY, Montreal, Canada, 1964

PRESENT POSITION

LECG, LLC, 1997-present
Principal

Areas of Specialization

Maritime and Rail Economics

Policy options in regulation
Regulation of rates, services, and carrier agreements
Cost and capacity analyses
Worldwide cargo flow analysis and forecasting
Port feasibility analysis

Litigation Support and Economic Analysis

Asset and business valuation, breach of contract damages, antitrust violation
Applied microeconomic theory, forecasting, cost models, price benchmarking

Petroleum Economics

Oil Pricing, netback models, indexed prices, royalty contracts
Crude, product and LNG tanker economics: rates, costs, carriage

PRIOR PROFESSIONAL EXPERIENCE

BARAKAT & CHAMBERLIN, INC., 1986-April 1997

Principal

Performed and directed economic analysis, litigation support, valuation, pricing and market assessment studies for public and private clients in the maritime, petroleum, cable television and other industries. Prepared and delivered expert witness testimony on U.S. maritime regulation issues, assessments of economic damages, antitrust, and valuation issues. Advised State government in the U.S. and Provincial government in Canada regarding the design and audit of petroleum royalty contracts.

MANALYTICS, INC., 1975-1986

Manager of Economics

International economics specialist for a firm consulting in the transportation area covering maritime and rail. Led studies in trade forecasting for public and private clients, economic and financial feasibility studies for carriers, shippers and ports. Prepared and presented expert testimony for submission before numerous administrative forums.

UNIVERSITY OF CALIFORNIA, BERKELEY, 1968-1975

Assistant Professor of Economics

Instruction and research in introductory economics, international economic relations, monetary economics, and macroeconomic theory.

PUBLICATIONS

"International Trade and Capital Mobility." *The American Economic Review*, Vol. 61(3), Part 1, June 1971.

"Capital Goods, Intermediate Goods, and the Volume of Trade." *The Canadian Journal of Economics*. May 1971.

"Testing the Forecasters." *Journal of Maritime Law and Commerce*. October 1976.

"Forces Shaping International Maritime Transport." *The World Economy*. March 1984.

Outlook for the Liberalization of Maritime Transport. With Elliot Schrier and Bertram Rifas. London: Trade Policy Research Center, 1985.

The Cost of Cargo Preference to the DoD, June 1, 1993 to May 31, 1994, a Report for the U.S. Military Sealift Command, July 7, 1995.

PRESENTATIONS

"International Trade and Capital Mobility." 1968 meeting of the Econometric Society, Evanston, Illinois.

EXPERT WITNESS TESTIMONY

1999-2000	Provided deposition and oral testimony in a civil antitrust case in Hawaii in Federal Court regarding a tied sale in the container service of Sea-Land between California and Hawaii. (Sea-Land Service, Inc. v. Atlantic Pacific International, Inc., et al. Civil No. 98-00369 DAE, United States District Court for Hawaii.)
1998-2000	Provided written testimony on behalf of the Territory of Guam in GovGuam's successful Appeal of the ALJ's decision in Federal Maritime Commission Docket No. 89. Also prepared calculations of the reparation amounts owed by American President Lines and Sea-Land resulting from FMC's final decision on liability.
1999-2000	Fleming Companies and API. Provided deposition and oral testimony in a civil antitrust case regarding a tied sale in the container service of Sea-Land between California and Hawaii.
1998-1999	US Joint Traffic Management Organization. Provided written expert report critical of the claims by a tug-barge carrier operating in the Seattle-Aleutian Islands trade; carrier alleged damages suffered from unexpectedly low cargo levels.
1998	State of Hawaii, Division Consumer Advocacy. Prepared an evaluation of the inter-island tug-barge service of Young Brothers, Inc. Made recommendations for improving the service so as to lower costs, raise profitability, lower rates, and improve service to shippers.
1996 - 1997	Cotchett & Pitre. Provided written and oral testimony in an Arbitration regarding breach of contract, fraud and breach of fiduciary responsibility in a dispute involving a three-year venture capital start-up of a managed health care imaging carveout.
1996	San Francisco Bay and Harbor Pilots, State of California Administrative proceeding. Provided oral testimony on behalf of pilots concerning productivity of pilots, and history of pilot actual revenues in nominal and real terms.
1990-1996	Federal Maritime Commission Docket No. 89-26. Territory of Guam. Provided written direct and rebuttal and oral testimony regarding rate levels in the U.S. mainland-Guam liner trade.
1985-1995	State of Alaska. Provided written direct and rebuttal and oral testimony and extensive litigation support and settlement offer analyses to the State Department of Revenue and to the State Attorney General in several administrative hearings for the State's audit of oil companies for severance tax and income tax purposes.
1995	San Francisco Bay and Harbor Pilots, State of California proceedings. Provided oral testimony on behalf of pilots concerning productivity of pilots, history of pilot actual revenues in nominal and real terms, and comparable pilot earnings elsewhere.

- 1989 Federal Maritime Commission Docket Nos. 88-5, 88-14, 88-18, 89-12. Prepared testimony for non-vessel-operating common carriers (NVOCCs) to measure the extra costs and lost business suffered by the plaintiffs as a result of illegal tariff discrimination by ocean liner operators. This case involved the "50-mile rule," a carrier practice that was rejected by the Federal Maritime Commission and the U.S. Supreme Court.
- 1989 Federal Maritime Commission Docket No. 88-15. Provided testimony on behalf of California Shipping Lines, Inc., regarding damages resulting from a breach of contract between two maritime transportation companies—a carrier, Yang Ming Marine Transport Corporation, and our client, an NVOCC, who was denied a service contract.
- 1988 Maritime Administration Docket No. S-801. Provided direct and rebuttal testimony on behalf of Matson navigation Company regarding a Section 805(a) application by American President Lines to serve Hawaii. Testimony dealt with the public policy consequences and unfairness to Matson of approving APL's application.
- 1983 Federal Maritime Commission. Provided testimony in support of an application for approval of Agreement 9973-9 by Johnson ScanStar. Analyzed the size, economic conditions, and needs of the trade served by JSS; the role of a joint service in serving those needs; the particular role in the trade played by JSS; the economic viability and competitive contributions of the JSS joint service in the trade; and the economic significance of the proposed extended term for the JSS joint service agreement.
- 1983 Maritime Subsidy Board Docket No. S-746 Sub 1. Provided testimony for Ragan & Mason, representing Sea-Land Service, Inc., analyzing the cargo and capacity adequacy issues on Trade Route 29.
- 1982 Federal maritime Commission Docket No. 81-74. Provided testimony on issues involved in an application by the Japan-4 (J Line, K Line, Mitsui, and Y-S Line) for additional capacity by replacing old, small ships with new, big ships.
- 1982 Federal Maritime Commission Docket No. 80-22. Provided theoretical and empirical testimony evaluating the currency adjustment factor (CAF) in the Pacific Westbound Conference tariff and evaluating the suit by International Paper (IP) claiming that the ad valorem CAF discriminates against IP.
- 1982 Federal Maritime Commission. Provided testimony on FMC Agreement 9973-8 regarding Johnson ScanStar (JSS) operations. Described the trades in which JSS then participated and in which it proposed to participate and analyzed the likely economic impacts and the expected transportation and public needs that the service authority modifications proposed to satisfy.

- 1981 Federal Maritime Commission Docket No. 81-27. Provided testimony on the impact on competition of the proposed joint service operations of Bank and Savill Line, Ltd., and The Shipping Corporation of New Zealand in the US Gulf-Australian liner trade.
- 1981 Federal Maritime Commission Docket No. 81-10. Provided direct testimony, rebuttal testimony, and surrebuttal testimony on the appropriate rate of return for regulated carriers in the US-Puerto Rico and Virgin Island trades and on the forecasts of carrier rates of return made by other witnesses.
- 1981 Private client, Superior Court, County of Sacramento, Docket No. 271770. Provided testimony evaluating the economic cost of the delay of graduation from university.
- 1980 Federal Maritime Commission Docket No. 78-32. Provided testimony on the economic effects of Pacific Westbound Conference policy regarding transshipments of Portland cargo through Seattle.

REGULATORY AND LITIGATION SUPPORT

- 1997 - 1998 State of Hawaii. Retained by Division of Consumer Advocacy to evaluate a regulated shipping operation in the state of Hawaii and make recommendations to improve operations and increase profitability.
- 1997-1998 Confidential. Retained, in a class action litigation, to examine the operation, membership, and excess profits of a price-fixing cartel manufacturing and selling an industrial chemical in the U.S. market.
- 1998 Government of Guam. Retained to support a petition, to the Federal Court of Appeals, regarding the Federal Maritime Decision in Docket 89-26, which decision found in favor of the government of Guam's complaint, for which Dr. Nadel was the expert economic witness. The appeal concerns the insufficiency of the award of reparations for damages experienced by shippers because of the unreasonably high freight rates in the Guam trade.
- 1997 U.S. Department of Defense. Retained by the Joint Traffic Management Office to evaluate alternative contractual arrangements for the pricing of international maritime container transportation services in the event of a Stage I, Stage II, or Stage III military emergency.
- 1996 - 1997 Province of Newfoundland. Retained to assist in the Province's negotiations on a royalty contract with producers, focusing on how to value the oil for use in calculating royalties for the Tera Nova project.

- 1996 Confidential. Retained to assist in settlement negotiations with several producers in a class action involving an antitrust violation among producers in a major U.S. product market, where publicly discussed damage estimates exceed \$100 Million.
- 1991-1996 State of Alaska. Provided economic and litigation support to the Department of Law in its evaluation of the Exxon Oil Spill settlement and in its allocation of the monies in the Exxon Valdez Oil Spill Fund, which are used, in part, to provide remediation through the purchase of forest and other lands to be held free from economic development.
- 1992 Crowley Maritime. Provided expert support for Crowley's application for a tugboat franchise for Port Everglades, Florida.
- 1991 Preston, Rouvelas & Meeds. Retained to analyze and provide litigation support involving a claim before the Federal Maritime Commission (Docket No. 90-16) concerning alleged discrimination against a west coast port terminal operator.
- 1990 Blasingame, Burch, Garrard & Bryant. Developed an estimate of market share held by a manufacturer in the sale and use of asbestos at various sites in Texas over the period 1962 to 1972 for use in the allocation of total damages among defendants.
- 1989 State of Alaska. Provided the Department of Law with various analyses in support of the damage claims against Exxon Corp. resulting from the Exxon Valdez oil spill of March 24, 1989.
- 1989 Province of Newfoundland. Retained to assist the Province in its negotiations on a royalty contract with producers, focusing on how to value the oil for use in calculating royalties for the Hibernia project.
- 1989 Alborg & Dictor. Retained to prepare analysis and testimony in support of litigation concerning the evaluation of a railroad easement in Santa Clara County, California.
- 1987 Barker & McKenzie. Assessed economic damages to a distributor and manufacturer of orange-juicing equipment resulting from a termination of the distributor's contract. Analyzed the manufacturer's financial records, depositions, and other discovery material, including the details of a bulk asset sale.
- 1986 Lempres & Wulfsberg. Retained in connection with a lawsuit filed by B&T Hydraulics, Inc. against Eaton Corporation. Prepared a critique of the plaintiff's calculation of alleged economic damage. Developed economic intelligence regarding various firms' market share and sales levels in California and the US.

- 1986 Lillick, McHose & Charles. Retained in the matter of Delta Steamship Lines vs. The City and County of San Francisco. Analyzed Delta's alleged economic damages suffered as a result of a pier fire, focusing on a review of the inventory of the quantity and value of the items involved.
- 1985 Federal Maritime Commission Docket No. S-749. Provided litigation support for attorneys for Sea-Land Service, Farrell Lines and Prudential Lines regarding the capability of the U.S. flag liner fleet to carry forecasted levels of cargo flows on the inbound leg of Trade route 10 in 1990.
- 1983 Federal Maritime Commission Docket No. 82-54. Provided litigation support for Ragan & Mason, attorneys for Sea-Land Service, Inc. on the issues in the Order of Investigation in FMC Docket No. 82-54, to determine whether seven Japanese charter and revenue pooling agreements are in compliance with the 1916 Shipping Act.
- 1983 United States House of Representatives. Provided support during hearings before the Committee on Judiciary Subcommittee on Monopolies and Commercial Law on a bill that eventually became the Shipping Act of 1984. Performed an economic assessment and analysis of HR 1878, 98th Congress; concluded that it offers "enhanced opportunities for efficiency and countervailing assurances of a continued pro-competitive environment in the US liner trade."
- 1983 Federal Maritime Commission. Provided litigation support for Kominers, Fort, Schlefer & Boyer, representing Delta Steamship Lines, Inc., regarding liner rates in the US Gulf Coast/Brazil trade and other US foreign trades.
- 1982 Federal Maritime Commission Docket Nos. 82-1, 82-10. Requested by PMA council to prepare testimony in FMC Docket Nos. 82-1 and 82-10. Testimony (1) analyzed the PMA CFS Fund Program Agreement and its economic effects on PMA employee benefit cost obligations and assessments; (2) analyzed the likely impact on the ILWU as a group and PMA as a group and on individual PMA sectors and obligations; and (3) reviewed the assessment system changes since 1979 and analyzed how the CFS Program Fund Agreement relates to those changes.

March, 2002

**GOVERNMENT OF THE
TERRITORY OF GUAM
Complaint**

Docket No. WCC-101

Verified Statement
of

Philip H. Burris
Senior Vice President
L.E. Peabody & Associates, Inc.

On Behalf of
Government of the Territory of Guam

April 23, 2002

TABLE OF CONTENTS

	<u>PAGE</u>
I. INTRODUCTION	1
II. BACKGROUND	3
III. SUMMARY AND FINDINGS	5
IV. DEVELOPMENT OF CONSTRAINED MARKET PRICING PRINCIPLES ..	7
V. UNIQUE NATURE OF THE GUAM TRADE	12
VI. CMP AS CURRENTLY APPLIED IS NOT APPROPRIATE FOR USE IN THIS PROCEEDING	18
VII. CONCLUSIONS	20

LIST OF EXHIBITS

<u>Exhibit No.</u>	<u>Exhibit Title</u>
1	Qualifications of Philip H. Burris

I. INTRODUCTION

My name is Philip H. Burris. I am Senior Vice President of L.E. Peabody & Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314. My qualifications are attached as Exhibit __ (PHB-1).

The Government of the Territory of Guam ("GovGuam") has filed a complaint with the Surface Transportation Board ("STB" or "Board") challenging the reasonableness of the rates, rules, classifications, and practices for all transportation by water (including the water portion of intermodal transportation) provided by Sea-Land Service, Inc. ("Sea-Land" or "CSX Lines")¹, and Matson Navigation Company, Inc. ("Matson") in the noncontiguous domestic trade² to and from Guam.³ GovGuam also seeks reparations and damages.

GovGuam has requested that I comment on the use of Constrained Market Pricing ("CMP") principles as a regulatory standard to determine maximum reasonable rates in this proceeding. I have been requested to provide these comments because of my extensive familiarity with CMP principles for determining maximum reasonable rail rates before the STB, and its predecessor agency the Interstate Commerce Commission's ("ICC"). L. E. Peabody & Associates, Inc. has participated

¹Sea-Land's parent company, CSX Corporation sold its international segment of the business to A.P. Moller - Maresk Line in 1999. CSX Corporation retained its domestic offshore trade business and renamed this business CSX Lines, LLC

²The noncontiguous domestic trade involves domestic water transportation (that is, transportation between states, United States territories, or U.S. possessions) that originates or terminates in Alaska, Hawaii, or a U.S. territory or possession. See 49 U.S.C. 13102(15). It is sometimes referred to as the "domestic offshore" trade.

³American President Lines ("APL") was also named as a defendant in this proceeding, however, the Board determined in its November 15, 2001 decision that if the complaint succeeds on its merits that reparations would be limited to the two years prior to filing the Complaint or September 10, 1996. As APL left the trade before September 10, 1996, the Board dismissed APL as a defendant in the November 15, 2001 decision.

in every proceeding before the ICC and the STB where CMP principles were developed and subsequently used to determine maximum reasonable rate levels. I am thoroughly familiar with the regulatory standards and procedures accepted by the STB/ICC in proceedings where CMP principles were applied. The purpose of my verified statement is to demonstrate that use of CMP principles and specifically, the Stand-Alone Cost Constraint, as currently applied by the Board in recent maximum rail rate proceedings, is inappropriate for determining maximum reasonable rates in this proceeding.

The balance of my statement is organized as follows:

- II. Background
- III. Summary and Findings
- IV. Development of Constrained Market Pricing Principles
- V. Unique Nature of the Guam Trade
- VI. CMP as currently applied is not appropriate for use in this Proceeding
- VII. Conclusions

II. BACKGROUND

Historically, jurisdiction over rates in the domestic offshore trade was bifurcated. The FMC had jurisdiction over complaints challenging the reasonableness of "port-to-port" rates, i.e., rates that did not involve the services of an inland U.S. railroad or motor carrier. The ICC had jurisdiction over complaints challenging the reasonableness of joint rates in the domestic offshore trade, i.e., rates held out jointly by water carriers and inland rail or motor carriers.

Effective January 1, 1996, Congress, in the ICC Termination Act of 1995 ("ICCTA"), abolished the ICC and transferred certain ICC functions to the Board. The ICC functions transferred to the Board included the responsibility to handle complaints challenging joint rates in the noncontiguous domestic trade. Congress also transferred to the Board FMC's jurisdiction over complaints challenging the reasonableness of port-to-port rates in the noncontiguous domestic trade.

This complaint, involving a challenge to the overall level of all of defendants' domestic water rates to Guam, is similar to a pre-ICCTA complaint also filed by GovGuam, among others, before the FMC. In Government of the Territory of Guam, et al. v. Sea-Land Service, Inc., et al., 28 S.R.R. 252 (FMC 1998) ("FMC Decision"), the FMC permitted GovGuam to challenge defendants' overall rate structure for their Guam services, notwithstanding Defendants' argument that the statute that governed at the time permitted only challenges to specific rates. In its decision, the FMC found that Defendants' overall revenues were unreasonable, based on its General Order No. 11 ("GO 11") standard.

The purpose of Phase II of this proceeding is to develop the rate standard that is appropriate to determine maximum reasonable rates for the movement of goods between the 48 contiguous states and Guam.

III. SUMMARY AND FINDINGS

The Board's current application of CMP, and specifically application of the Stand-Alone Cost Constraint, is not an appropriate application for determining maximum reasonable rates in the domestic offshore Guam trade. CMP was developed by the ICC under a Congressional mandate that required the ICC to improve the financial viability of the railroad industry.

Unlike with the railroad industry, Congress' regulatory concern in the noncontiguous domestic trade appears to be more with protecting the captive shipper from market power rather than enhancing the revenues of an industry in bankruptcy and with an enormous accumulated capital requirement in order that it may become viable.

Further, the STB is not required to consider the Defendants' revenue adequacy when determining maximum reasonable rates for Guam trade and for that matter is not even required to establish a revenue adequacy standard. There is no requirement that the Board formally find market dominance in order to have jurisdiction over the rates charged in the noncontiguous trade. CMP was created in response to the Congressional mandates facing the ICC for regulating the railroad industry. The STB does not face these same mandates with regard to establishment of maximum reasonable rates in the offshore domestic trades.

Moreover, the Board's current method for allocating stand-alone costs to captive traffic is not appropriate for the Guam trade because it fails to protect the captive shipper in a situation, such as the Guam trade, where the captive traffic rates were established at monopolistic levels that are vastly higher than the highly competitive rates charged to other traffic volumes that would be available to a hypothetical stand-alone competitor.

The current rates charged to Guam shippers were set by carriers with antitrust immunity that have substantial market power resulting from artificial barriers to entry. These barriers include the provisions of the Merchant Marine Act of 1920 (" Jones Act") and the lack of substitutes for the goods being shipped into this market because of both U.S. and local laws and regulations. These artificial barriers to entry provide Defendants substantial market power, the result of which is rate levels which far exceed those that would be paid by the residents of Guam were they to have access to the competitive market place.

The Board's current application of CMP and the Stand-Alone Cost Constraint in evaluating maximum rates for captive rail shipments would fail to protect the residents of Guam from these artificially created monopoly prices.

IV. DEVELOPMENT OF CONSTRAINED MARKET PRICING

A. BACKGROUND

The financial status of the railroad industry before 1980 was poor and seemingly getting worse. The railroad's share of intercity freight traffic declined from about 75 percent in 1929 to about 38 percent in 1980. During the 1970's the profitability of Class I railroads was among the lowest of major industries. Many railroads had gone bankrupt or were on the verge of bankruptcy.⁴ A 1978 report to Congress from the U.S. Department of Transportation ("DOT")⁵ indicated that in 1976 about one-third of Class I railroads were earning a negative return on investment.

Not only were the railroads going bankrupt, but the condition of their rail plant and equipment was poor. Years of declining profit had led to deferred maintenance and, over time, deteriorated plant and equipment. Protracted deferrals in maintenance affected safety and the quality of rail service. According to the 1978 DOT Report, the Class I railroads had over \$4.0 billion in deferred maintenance in 1976 and the Federal Railroad Administration estimated that if the railroad's financial condition did not improve the industry would accumulate a capital shortfall of between \$13 billion and \$16 billion by 1985.⁶

With the enactment of the Regional Rail Reorganization Act of 1973 ("3R Act"), Congress began to react to the financial problems of the rail industry. Title 1 of the 3R Act, states as its Declaration of Policy,

⁴*Railroad Regulation, Economic and Financial Impacts of the Staggers Rail Act of 1980*, United States General Accounting Office, Report to Congressional Requesters, May 1990, pp 10-11 ("GAO Report").

⁵*A Prospectus for Change in the Railroad Freight Industry*, DOT, October 10, 1978.

⁶*Ibid*, note 4.

“Essential rail service in the midwest and northeast region of the United States is provided by railroads which are today insolvent and attempting to undergo reorganization under the Bankruptcy Act. This essential rail service is threatened with cessation or significant curtailment.....This rail service is operated over rail properties which were acquired for public use, but which have been permitted to deteriorate and now require extensive rehabilitation and modernization.....These needs cannot be met without substantial action by the Federal Government.”⁷

In 1976, Congress sought to eliminate needless or harmful regulation of railroads by enacting the Railroad Revitalization and Regulatory Reform Act (“4R Act”). Its purpose was to restore the financial stability of the nation’s rail system and to improve the operation and structure of the railroad industry through rate-making and regulatory reform. The ICC was *required* to develop standards for determining whether the railroads were earning revenues adequate to cover their operating costs and provide a reasonable return on capital. The 4R Act encouraged the ICC to assist railroads in attaining adequate revenues.⁸

In 1980, finding the railroad earnings were still insufficient to generate funds required for capital improvements, Congress enacted the Staggers Rail Act of 1980. The Staggers Act further deregulated the railroad industry and made it federal policy to have railroads rely on competition and the demand for services (“differential pricing”) rather than on regulation to establish reasonable rail rates. The Staggers Act also elevated the importance of revenue adequacy and *required* the ICC to consider the revenue adequacy standards when it reviewed the reasonableness of rail rates.⁹

⁷The Regional Rail Reorganization Act of 1973, Sec. 101 (a).

⁸GAO Report, pp. 13-14.

⁹Ibid, p. 14.

Through the 3R Act, 4R Act and Staggers Act, Congress made it abundantly clear that the ICC must substantially improve and ensure the financial viability of the railroad industry. With this Congressional mandate as a back drop the ICC developed CMP principles.

B. DEVELOPMENT OF CONSTRAINED MARKET PRICING PRINCIPLES

Prior to 1985, the ICC was faced with an undefined standard of reasonableness in regulating rail rates. Rail carriers serve shippers which have various individual demands for the services the rail carriers supply. They include shippers which have no service alternatives, shippers that may have a single alternative to the rail carriers service and shippers which have multiple alternatives to the carrier's service.

Under the 4R Act and the Staggers Act, the prices charged by the railroads are to be set by the competitive environment for each individual shipment and these prices in turn provide varying levels of contribution to the carrier's overall profitability. Only in those limited, and demonstrated, instances where the railroads have market dominance was the ICC to even consider establishing a maximum reasonable rate level. In these situations, the ICC was required to balance the revenue needs of rail carriers with the protection for the captive rail shippers. Faced with the need to substantially improve the financial needs of the railroad industry, the ICC developed the CMP principles. CMP was adopted by the ICC in Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520 (1985) ("Rate Guidelines").

CMP provides alternative methodologies for examining the reasonableness of a carrier's rates. These methodologies determine what an efficient carrier would need to charge, with cross-subsidies and inefficiencies eliminated, in order to earn revenues that are sufficient to cover all of its costs,

including a sufficient return on investment to enable it to compete in capital markets for financing to maintain and replace its needed facilities.

More specifically, the “top-down” approach examines the carrier’s existing system to determine whether the carrier is “revenue adequate”, i.e., already earning sufficient funds to cover its costs and provide sufficient return on investment – the Revenue Adequacy Constraint. 1 I.C.C. 2d 535-536. Alternatively, the Management Efficiency Constraint is intended to determine if the carrier would be revenue adequate after eliminating unnecessary costs from specifically identified inefficiencies and cross-subsidies in its operations.

In contrast, the “bottom-up” approach, i.e., the Stand-Alone Cost Constraint, calculates the revenues a hypothetical, highly efficient carrier would need in order to serve the complainant shippers.

The Stand-Alone Cost Constraint produces the aggregate revenues that must be charged for a least cost most efficient rail competitor to earn a fair return on investment. Once this has been accomplished, a rate structure for the various shippers using the service of the hypothetical carrier must be determined and the amount of the stand-alone cost to be borne by each shipper in the stand-alone group must be determined. Rate Guidelines indicates that this is best accomplished on the basis of Ramsey Pricing principles. Rate Guidelines also indicates that this should be accomplished on a case-by-case basis. 1 I.C.C. 2d 546. In any event, a captive shipper’s rate should be no higher than the level at which a shipper would discontinue using the incumbent and perform the service itself. However, that alternative must be feasible and be able to provide the service required by the shipper.

The Board's current application of the Stand-Alone Cost Constraint in evaluating rail rates is not an appropriate way to apply the Stand-Alone Cost Constraint in determining maximum reasonable rates in the domestic offshore Guam trade. The Board's application of the Stand-Alone Cost Constraint fails to recognize the unique market that consists of the Guam traffic and the resulting extraordinarily high rates that were established in the absence of competition and that are vastly higher than truly competitive rates.

V. UNIQUE NATURE OF THE GUAM TRADE

Several unique features of the Guam trade are critical to understanding the economics of the trade within the context of determining why the Board's current application of the Stand-Alone Cost Constraint should not be used to determine maximum reasonable rates for this trade. First, Guam is a U.S. territory and the residents of Guam are U.S. citizens. Guam is located approximately 5,000 miles from the U.S. West Coast. The only economical way for the residents of Guam to receive goods from the U.S. Mainland is via ocean vessel.

Second, instead of having access to a competitive Maritime Industry, by Federal Law, Guam receives U.S. produced goods only via U.S. Flag ocean carriers. In 1920, Congress enacted the Merchant Marine Act, section 27 of which provides:

“...no merchandise shall be water, or land and water....between points in the United States, including Districts, Territories, and possessions thereof embraced within the coastwise laws, directly or via a foreign port, or for any part of the transportation, in any other vessel than a vessel built in and documented under the laws of the United States and owned by persons who are citizens of the United States....”

By limiting service in the offshore domestic trades to U.S. Flag carriers, the Jones Act excludes Foreign Flag carriers from competing in this service and thereby limits the alternative carriers available to the citizens of Guam for the movement of U.S. produced goods to Guam. In doing so the Jones Act created substantial market power for the U.S. Flag carriers participating in this trade.

The Jones Act regulation requires the carriers providing the service to be U.S. Flag carriers and in most instances utilize vessels that are constructed in the United States. U.S. Flag vessels must be manned by U.S. crews and are required to meet U.S. Coast Guard regulations and inspections. The

U.S. Maritime Administration determined that the U.S.-built component of the Jones Act does not apply to the Guam trade.

Third, Guam is served by the ocean vessels in what is know as "pass-by" service, i.e., a service whereby transpacific vessels stop at Guam on the westbound leg of their round trip voyages from the U.S. to the Far East. These vessels also call at ports in countries such as Taiwan, China, Korea and Japan. In other domestic offshore trades, such as service between the U.S. Mainland and Alaska, Puerto Rico and for the majority of Hawaii traffic, service is provided in a "turn around" service where all or nearly all of the costs of the service are attributable directly to a particular domestic offshore trade.

Because Guam is served in pass-by service the cost of providing the service is shared with the other volumes handled by the same vessels. However, unlike the traffic moving between Guam and the U.S. Mainland, nearly all of the non-Guam traffic handled by these vessels can be moved by other than U.S. Flag carriers. Moreover, the transpacific trade is highly competitive, with up to 20 competing companies at any given time. Guam on the other hand historically has been served by only two companies at any given time. As a result while the non-Guam cargo in the transpacific trade moves at very low, i.e., highly competitive rates, Guam cargo moves at very high duopoly rates.

Fourth, the major commodities transported to Guam from the U.S. Mainland are automobiles, auto parts, auto tires, fresh fruits and vegetables, meat, poultry and eggs, air conditioners and other manufactured goods for Federal contracts.

As U.S. citizens the residents of Guam are subject to many U.S. laws and regulations. For example, the Guam Department of Transportation requires that only U.S. specification vehicles, i.e. left hand drive cars, be used on the island. Few Asian countries produce left hand drive cars except for the U.S. Mainland market and many of these automobiles are actually produced in the U.S. by foreign companies. Further, as U.S. specification cars are required to be used on Guam, the auto parts to maintain these cars also come from the U.S.¹⁰

Moreover, because of customs entry restrictions the majority of fresh fruits and vegetables, meat, poultry and eggs must come from U.S. sources. Finally, the manufactured goods imported for Federal contracts must comply with Buy American Act and be produced in the U.S.¹¹

Thus, U.S. laws and Guam regulations require that the major commodity groups imported to Guam come from U.S. markets and the Jones Act requires that all U.S. goods moving to Guam be shipped via U.S. Flag vessels and not via any Foreign Flag competitors.

The Defendant's market power created by these Jones Act and other Federal and local regulations is evidenced by a comparison of the rates currently charged by CSX Lines and Matson for movement in the domestic offshore trades with the average rates charged by carriers for the rest of the transpacific trade which is a highly competitive market. Table No. 1 below compares the average rate charged by CSX Lines and Matson for the predominate commodities¹² moved to and from Guam with the current rates in transpacific service as shown in the accompanying verified

¹⁰*The Guam Trade Study, Under Section 407 of the ICC Termination Act*, Office of the Governor of Guam, The Honorable, Carl T.C. Gutierrez, April 1996, pp. 35-36.

¹¹Ibid

¹²The average current rates shown to and from Guam in Table No. 1, exclude rates for goods moving in refrigerated containers and motor vehicles, because these movements require specialized equipment.

statement of Dr. Ernest Nadel.¹³ Table No. 1 also provides a comparison of the average rates charged by Sea-Land in 1995 (then owned by CSX, Inc.) both for movements between the U.S. Mainland and Guam and for movements in the transpacific trade.¹⁴

¹³Accompanying Verified Statement of Dr. Ernest Nadel, Table 1A. Dr. Nadel's rates are average rates per TEU basis and have been doubled to represent average rates per FEU. From this amount \$770 and \$505 per FEU have been subtracted for the intermodal portion of the move based on amounts reported in *Global Container Markets, Prospects and Profitability in a High Growth Era*, Drewry Shipping Consultants, 1996.

¹⁴Ibid, note 12, Appendix 1, p. 9..

Table No. 1
Comparison of Rates per FEU
in the Transpacific Trade

<u>Year</u> (1)	<u>Port/Pair</u> (2)	<u>Westbound</u>		<u>Eastbound</u>		<u>Average</u>	
		<u>Rate</u> (3)	<u>Index</u> <u>to Guam</u> (4)	<u>Rate</u> (5)	<u>Index</u> <u>to Guam</u> (6)	<u>Rate</u> (7)	<u>Index</u> <u>to Guam</u> (8)
1. 2002	US/Guam	\$3,545	1.000	\$4,716	1.000	N/A	N/A
2. 2001	Transpacific	\$1,193	.337	\$2,738	.581	N/A	N/A
3. 1995	Sea-Land/ Guam	N/A	N/A	N/A	N/A	\$4,383	1.000
4. 1995	Sea-Land/Pacific	N/A	N/A	N/A	N/A	\$2,681	.612

N/A = not available

As is evident from the rates shown in Table No. 1, the rates currently paid in the Guam trade, are far greater than those paid in the transpacific trade,¹⁵ which reflects a competitive market environment. Moreover, in 1995 when Sea-Land moved traffic between Guam and the US, the rates charged on the Guam trade far exceeded those Sea-Land charged in the competitive transpacific market. As stated previously, the vessels that call at Guam are en route from the United States to Asia and these vessels are carrying the transpacific traffic at the far lower rates shown in Table No. 1. This is true both today and in 1995 when Sea-Land was participating in the Guam trade. The ability of the carriers serving Guam to charge rates for that service that are far higher than they charge to shippers in the competitive transpacific trade is a clear demonstration of their substantial market power which is the sole result of the Jones Act and other Federal and local regulations.

¹⁵This is true in spite of the fact that the distance to Guam from the U.S. west coast is substantially shorter than the distance between most Asian ports and the U.S. west coast.

**VI. CMP AS CURRENTLY APPLIED IS NOT
APPROPRIATE FOR USE IN THIS PROCEEDING**

As stated previously, the Stand-Alone Cost Constraint produces the aggregate revenues that must be charged for a least cost most efficient competitor to earn a fair return on investment. Once this has been accomplished, a rate structure for the various shippers using the service of the hypothetical carrier must be determined and the amount of the stand-alone cost to be borne by each shipper in the stand-alone group must be determined. Rate Guidelines indicates that this is best accomplished on the basis of Ramsey Pricing principles. Rate Guidelines also indicates that this should be accomplished on a case-by-case basis. 1 I.C.C. 2d 546.

In recent applications of the Stand-Alone Cost Constraint to determine maximum reasonable rail rates, the Board has determined that when the aggregate revenues produced by the incumbent's rates exceed stand-alone costs, all rates in the stand-alone shipper group are assumed to be reduced by the same percentage reduction such that the reduced rates in aggregate produce the stand-alone costs. As shown below, the Board's current method of allocating stand-alone costs will not protect the Guam trade from the Defendants' monopoly pricing practices.

Because of the great distance between Guam and the U.S. west coast and the requirement for weekly service, any hypothetical stand-alone carrier must handle more than the issue traffic in order to efficiently utilize its vessels capacity. All the volumes moving in the transpacific trade, other than the domestic offshore trade, can be handled by both U.S. Flag and Foreign Flag carriers and are therefore moving in a highly competitive market. Moreover, the domestic offshore trade is only a very small portion of the overall transpacific trade.¹⁶

¹⁶According to the documents underlying APL and Sea-Land most recent G.O. 11 filings with the FMC, these two carriers handle approximately 800,000 forty-foot equivalent units ("FEU")

This combination of factors will necessarily result in any hypothetical carrier developed under the Stand-Alone Cost Constraint having a shipper group comprised of both traffic with highly competitive rates and the issue traffic with extraordinarily high rates which are the result of artificial barriers to entry.

The Board's current application of the Stand-Alone Cost Constraint is not an appropriate standard for determining maximum reasonable rates in the domestic offshore Guam trade because it fails to recognize the fact the captive traffic rates were established in the absence of competition and are vastly higher than rates produced in the competitive market. The current rates charged to Guam shippers were set in an unregulated environment by carriers that have substantial market power that is a result of artificial barriers to entry.

Using the Board's recent methodology of reducing rates on *all* traffic in the stand-alone group by an equal percentage to yield aggregate revenues equal to aggregate costs would fail to provide protection to the captive Guam traffic protection from extremely high rates which were based on artificial barriers to entry. Clearly, such application will not simulate competitive price levels for the Guam shipper, who if it had access to Foreign Flag carriers would enjoy the same competitive prices as other shippers in the transpacific trade.

VII. CONCLUSION

In conclusion, the Jones Act created a barrier to entry in the noncontiguous domestic trades, which has created substantial market power for the U.S. Flag carriers who participate in this trade.

annually in the transpacific trade. Of this amount the Guam trade represents approximately 30,000 FEU's or 3.8 percent of the total. Further APL and Sea-Land are only two of numerous carriers participating in the transpacific trade.

This is especially true with regard to the Guam domestic offshore trade as only two carriers provide service between the U.S. Mainland and Guam. Because of this increase in market power, Congress has required the Board to provide regulatory oversight regarding the level of the rates charged in the noncontiguous domestic trades.

Unlike with the railroad industry, Congress' regulatory concern in the noncontiguous domestic trade appears to be more with protecting the captive shipper from market power created by the Jones Act, rather than enhancing the revenues of an industry in bankruptcy and with an enormous accumulated capital requirement in order that it may become viable.

Further, unlike the regulation of the railroad industry, the STB is not required to consider the Defendants' revenue adequacy when determining maximum reasonable rates for Guam trade and for that matter is not even required to establish a revenue adequacy standard. There is no requirement that the Board formally find market dominance in order to have jurisdiction over the rates charged in the noncontiguous trade. CMP was created in response to the Congressional mandates facing the ICC for regulating the railroad industry. The STB does not face these same mandates with regard to establishment of maximum reasonable rates in the offshore domestic trades.

In conclusion, as a result of the Jones Act and other Federal and local laws and regulations, the citizens of Guam are currently forced to pay a substantial subsidy to the Defendants in a what otherwise would be a competitive market place. CMP as currently applied by the Board will not replace the competitive market place that exists in the transpacific trade and will not protect the Guam trade from the historic or future effects of duopoly pricing.

VERIFICATION

COMMONWEALTH OF VIRGINIA)
)
CITY OF ALEXANDRIA)

PHILIP H. BURRIS, being duly sworn, deposes and says that he has read the foregoing statement, knows the contents thereof and that the same are true as stated.

[Handwritten signature]

Philip H. Burris

Sworn to and subscribed
before me this 5th day of April, 2002.

Witness my hand and official seal.

AKwashaw to

Anthony V. Evanshaw III

My Commission Expires: September 30, 2003

QUALIFICATIONS OF PHILIP H. BURRIS

PROFESSIONAL EXPERIENCE

Mr. Burris has twenty-four (24) years experience in the field of transportation economics as it pertains to transportation supply alternatives, plant location analysis, regulatory policy and dispute resolution before regulatory agencies as well as state and federal courts. He has designed, directed and executed analyses of the costs of moving various commodities by different modes of transportation including rail, barge, truck, air, pipeline and intermodal. The commodities considered in these studies included coal, phosphorus, soda ash, grain, automobiles, cold rolled steel, iron ore, limestone, copper coil and sheet, pulpwood, woodchips and water.

Mr. Burris has performed economic analyses of maximum reasonable rate levels for the movement of coal, phosphorus, soda ash, grain and water using the Surface Transportation Board's ("STB") Constrained Market Pricing ("CMP") standard and specifically the stand-alone cost constraint. Mr. Burris has submitted evidence regarding maximum reasonable rate levels using the stand-alone cost constraint to the STB, its predecessor, the Interstate Commerce Commission ("ICC") and the State of Colorado District Court for the City and County of Denver. Mr. Burris' firm, L. E. Peabody & Associates, Inc. participated in the development of the stand-alone cost constraint and has submitted testimony to the Commission using the stand-alone cost constraint on behalf of shippers in numerous ICC proceedings subsequent to the development of CMP by the Commission.

In addition to development of cost of moving various commodities by different modes of transportation, Mr. Burris has performed evaluations of the economic viability and financial health

QUALIFICATIONS OF PHILIP H. BURRIS

of short line railroads. These studies were performed on behalf of state agencies to determine the financial viability of the railroads or on behalf of investors considering the purchase and operation of short line railroads. Mr. Burris has also conducted studies of railcar lease and purchase options and negotiated rate reductions on behalf of shippers resulting from the use of shipper provided equipment. He has determined both the costs and profits attributable to the performance of services subject to specific transportation contracts. Mr. Burris has performed studies and written draft reports for the Railroad Accounting Principles Board, an independent body created by Congress to establish cost accounting principles for use in implementing the regulatory provisions of the Staggers Act of 1980.

The transportation studies designed and executed under Mr. Burris' direction have been commissioned for the purpose of negotiating with transportation companies, for use in dispute resolution before various regulatory agencies and state and federal courts and on behalf of electric utility companies in prudence examination. Mr. Burris has testified before the STB, the ICC, the Railroad Commission of Texas, the Colorado Public Utilities Commission, the Illinois Commerce Commission, the Public Service Commission of Nevada, various state and federal courts and arbitration panels. Mr. Burris has also negotiated transportation rates and service on behalf of shipper clients.

PREVIOUS RELATED EXPERIENCE

Mr. Burris has worked in the consulting industry for a period of twenty-four (24) years. In addition to his current position as a Senior Vice President of L. E. Peabody & Associates, Inc.,

QUALIFICATIONS OF PHILIP H. BURRIS

Mr. Burris has been an employee of the following consulting firms; A. T. Kearney, Wyer Dick & Associates, Inc. and George C. Shaffer & Associates.

EDUCATION

Mr. Burris received a BS in Business Administration from Virginia Polytechnic Institute and State University in 1971 and a MBA from the American University in 1978, specializing in transportation economics.

QUALIFICATIONS OF PHILIP H. BURRIS

TESTIMONY AND PUBLICATIONS

STB Docket No. 42054, PPL Montana, LLC v The Burlington Northern and Santa Fe Railway Company, December 14, 2000 and May 7, 2001.

STB Docket No. 42051, Wisconsin Power and Light v. Union Pacific Railroad Company; September 28, 2000.

STB Docket No. 42022, FMC Corporation and FMC Wyoming Company v. Union Pacific Railroad Company; January 15, 1999, March 31, 1999 and April 30, 1999.

Finance Docket No. 33388, CSX Corporation and CSX Transportation, Inc. Norfolk Southern Corporation and Norfolk Railway Company - - Central and Operating Lease/Agreement - - Conrail Inc. and Consolidated Rail Corporation; October 21, 1997, February 2, 1998 and July 14, 2000.

Finance Docket No. 33290, Nevada Public Service Commission, Sault Ste. Marie Bridge Co... Acquisition Exemption - Lines of Union Pacific Railroad Company; January and September 1997 Nevada Public Service Commission, Docket Nos. 95-7021, 95-5062, 95-5063; Nevada Power Company; March 1996 and September 1996.

U.S. District Court for the Northern District of Iowa, Eastern Division, Case No. C91-2086; Rail Intermodal Specialist, Inc. vs. General Electric Capital Corporation; February 1994 and May 1995.

State of Colorado District Court, City and County of Denver, Case No. CV 13042; Bear Creek Water and Sanitation District, et al. vs. The City and County of Denver; July 1992 and April 1993.

Illinois Commerce Commission Docket 89-0351; Reconciliation of Revenues Collected Under Fuel and Gas Adjustment Charges with Actual Cost; April 1992 and March 1993.

ICC Docket No. AB-1 (Sub-No. 230);; Chicago and North Western Transportation Company - Abandonment - Between Norfolk and Chadron, NE; January 1992.

ICC Docket Nos. 37809 (Sub-No. 1) and 37815S; McCarty Farms, Inc., et al. vs. Burlington Northern, Inc.; November, 1986, August 1987, and October 1987, May 1988, May 1989, July 1989, December 1989 and July 1991.

QUALIFICATIONS OF PHILIP H. BURRIS

ICC Docket No. 37038; Bituminous Coal, Hiawatha, Utah to Moapa, Nevada; and ICC Docket No. 37409; Aggregate Volume Rate on Coal, Acco, Utah to Moapa, Nevada; January 1985, March 1988, July 1990 and April 1991.

Railroad Accounting Principles Board; Staff Issue Paper on Reporting Costs and Outputs; June 1985.

Railroad Accounting Principles Board; Staff Issue Paper on Movement Parameters; May 1986. Virginia Department of Highways and Transportation, Rail and Public Transportation Division; Light Density Line Analysis Seaboard System Railroad, Suffolk to college Park, and South Suffolk to Nurney; September 1985.

Colorado Public Utilities Commission, Docket No. 6397; Colorado-Ute Electric Association vs. Denver & Rio Grande Western Railroad Company; June 1984.

ICC Docket No. AB6 (Sub-No. 175F), Burlington Northern Railroad Company Abandonment in Fergus, Judith Basin and Chouteau Counties, Montana; February 1984.

Ex Parte 431; Adoption of the Uniform Rail Costing System for Determining Variable Costs for Purposes of Surcharges and Jurisdictional Threshold Calculations; September 1983.

Co-authored Influence of Transportation Factors in the Site Selection of a United States Mazda Automobile Assembly Plant; September 1983.

Ex Parte 347 (Sub-No. 1); Coal Rate Guidelines - Nationwide; July 1983.

ICC Docket No. 38823; R. A. Williams, Inc. vs. Illinois Central Gulf Railroad Company; April 1983.

Montana Department of Commerce; Montana Rail Cost Data Base; December 1982.

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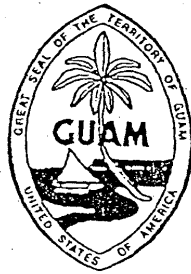
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THE GUAM TRADE STUDY

Office of the Governor

The Honorable Carl T.C. Gutierrez
Governor of Guam

UNDER SECTION 407 OF THE
ICC TERMINATION ACT



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TABLE OF CONTENTS

	<u>PAGE</u>
I. Introduction and Executive Summary	1
II. A Historical Perspective: The Rates To Guam Have Either Been Subject To Rate Agreements Exempted From Anti-trust Review or Not Subjected to Regulatory Scrutiny	10
III. Carrier Competition in Both the Regulated and Unregulated Portions of the Guam Trade	18
A. Summary	18
B. The Guam Trade is Unique	20
C. The Guam Trade is Completely Dominated By a Duopoly	22
D. The Existence of Windfall Profits and the Absence of New Entrants Are Not Inconsistent: There Are Substantial Barriers to Entry	24
1. The Guam Trade Is Profitable in the Context Of Larger, Transpacific Service, Not On A Stand-Alone Basis	24
2. High Capital Costs Represents A Substantial Barrier To Entry: A New Entrant Into The Transpacific Trade Would Require A Commitment Of Approximately \$700 Million	27
3. The Jones Act Represents A Substantial Barrier To Entry	30
E. Guam Shippers Are Captive: There Are No Meaningful Substitutes For Either the Transportation Services or the Goods Transported	34
IV. The Rate Structure in the Guam Trade	39
A. Summary	39

TABLE OF CONTENTS

	<u>PAGE</u>
B. The Real Problem is Commodity Rates Not Based on Costs	40
C. Guam's Commodity Rates Are Unreasonable When Examined on the Basis of FEU Revenue	42
D. Guam's Commodity Rates Are Unreasonable When Examined on the Basis of Rate Comparisons	43
E. Distortion in the Rate Structure	48
V. The Impact of Tariff Filing on Marine Carrier Pricing	52
A. Summary	52
B. The Positive Effects of Tariff Filing - Accurate Pricing Information for Shippers and the Competitive Consequences	52
C. The Negative Effects of Tariff Filing - Carriers Exchange of Pricing Information and the Anticompetitive Consequences	53
D. The Regulatory Solutions - Tariff "Discounts" and Effective Rate Regulation Based on Carrier Costs	55
VI. The Extent of Parallel Pricing and Its Impact on Competition	57
A. Summary	57
B. Competition is a Function of the Number of Competitors - Not the Public Dissemination of Pricing Information	58
C. The Regulatory Solution is Again Effective Regulation	60
VII. The Impact on Domestic Cargo Pricing of Foreign Cargo Services	63
A. Summary	63

TABLE OF CONTENTS

	<u>PAGE</u>
B. Cross-subsidization By U.S. Flag Carriers Between the Domestic Offshore Trade to Guam and the Transpacific Trades Exists and Should Be Prevented	63
C. The Solution to Cross-subsidization is Again Effective Regulation by the Federal Agencies Authorized to Perform That Function	66
VIII. Additional Protections Needed to Protect Shippers From The Abuse of Market Power	67
A. Summary	67
B. Eliminating The Barriers To Entry Created By The Jones Act is a Necessary Precondition For Light-Handed Regulation	69
C. Protecting Shippers Through Effective Rate Regulation	75
D. Protecting Shippers Through Effective Utilization of Market Forces	80
IX. Proposed Statutory and Regulatory Changes	81
A. Summary	81
B. Statutory Changes Must Be Made - The ZOR Must Be Repealed	82
C. DOT Should Seek Other Statutory Modifications	89
D. Other Regulatory Changes The STB Should Undertake	92
1. Clear Standards Need To Be Promulgated	92
2. General Revenue Standards Should Be Promulgated	93
3. Commodity Rate Standards Should Be Promulgated	96

TABLE OF CONTENTS

	<u>PAGE</u>
4. Fair Procedures Should Be Established	102
5. The STB Should Promulgate Rate Reasonableness Standards Through The Use of Negotiated Rulemaking Procedures	103
6. The Exemption Authority of the ICC Termination Act Must Be Used Only Very Sparingly	105
X. Conclusion	107
Appendix I - Freight Rates in the Guam Liner Trade - Overview by Ernest Nadel, Ph.D.	I
Appendix II - Freight Rates vs. Costs in the Guam Liner Trade Presentation by Ernest Nadel, Ph. D. To the Guam Chamber of Commerce	II
Appendix III - The Cost of Cargo Preference to the DOD - A Study by Ernest Nadel, Ph.D.	III
Appendix IV - Port Authority of Guam Overview	IV
Appendix V - Legislative History of P.L. 95-475 (H.R. Rep. No. 94-1577 and S. Rep. No. 95-1240)	V
Appendix VI - The Hirfindahl Hirschman Index	VI
Appendix VII - Excerpt of Transcript of Testimony (Public Version) Of A. Lawrence Kolbe, Ph.D. In FMC Docket No. 89-26 "The Guam Rate Case" June 18, 1993 Cross-examination by John M. Binetti, Esq. Pp 924-935	VII

TABLE OF CONTENTS

PAGE

Appendix VIII - Copy of Motion For Declassification Of Information Classified As Confidential Under the Protective Order in FMC Docket No. 89-26 - "The Guam Rate Case", filed by the Government of Guam on March 22, 1996	VIII
Appendix IX -Copy of Letter of V.Adm. W.A. Earner, Deputy Chief of Naval Operation (Logistics) to Sen. L. Pressler, dated December 15, 1995	IX
Appendix X - Copies of Letters of Matson Navigation Co. et al., dated December 18, 1995 and of Brady & Berliner, dated January 8, 1996, regarding "Zone of Reasonableness" Provision of ICC Termination Act; Copy of ICC Order of May 13, 1994 regarding General Rate Increase of American President Lines, Ltd.	X

TABLE OF AUTHORITIES

	<u>PAGE</u>
 <u>Court Cases</u>	
<u>Baton Rouge Marine Contractors v. Cargill, Inc.</u> , 21 F.M.C. 968, <u>vacated and remanded</u> , 655 F.2d 1210	97
<u>Coal Rate Guidelines - Nationwide</u> , 1 I.C.C. 2d 520 (1985), <u>aff'd</u> , <u>Consolidated Rail Co. v. U.S.</u> , 812 F.2d 1444 (3rd Cir. 1987)	29, 75
<u>Government of Guam v. Federal Maritime Commission</u> , 329 F.2d 251 (D.C. Cir. 1964)	11
<u>Matson Navigation Co., Inc. - Proposed General Rate Increase of 3.6% Between U.S. Pacific Coast Ports and Hawaii Ports</u> , 25 S.R.R. 1192 (1990); <u>affm'd sub nom., Matson Navigation Company, Inc. v. Federal Maritime Commission</u> , 959 F.2d 1039, 26 S.R.R. 283 (D.C. Cir. 1992)	77
<u>National Association of Recycling Industries v. FMC</u> , 658 F.2d 816, <u>reversing and remanding</u> , 21 F.M.C. 834	100
<u>Puerto Rico Maritime Shipping Authority v. Valley Freight System</u> , 856 F.2d 546 (3d Cir. 1988)	78
 <u>Agency Cases</u>	
<u>Agreement No. 102-008454 - Guam Rate Agreement</u> , 25 S.R.R. 385, 387 (1989)	13, 25
<u>Agreement No. 102-008454 - Guam Rate Agreement</u> , Order of Investigation and Hearing, FMC Docket No. 89-05, served Feb. 14, 1989, 54 Fed. Reg. 7276 (Feb. 17, 1989)	13
<u>Baton Rouge Marine Contractors v. Cargill, Inc.</u> , 21 F.M.C. 968, <u>vacated and remanded</u> , 655 F.2d 1210	97

TABLE OF AUTHORITIES

	<u>PAGE</u>
<u>Burlington Industries, Inc. v. Dart Container Line, Co., Ltd., FMC Docket No. 74-8, 22 S.R.R. 713 (Initial Decision, 1984)</u>	99
<u>Coal Rate Guidelines - Nationwide, 1 I.C.C. 2d 520 (1985), aff'd, Consolidated Rail Co. v. U.S., 812 F.2d 1444 (3rd Cir. 1987)</u>	29, 73
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<u>Government of Guam, et al. v. Sea-Land Service, Inc. And American President Lines, Ltd., FMC Docket No. 89-26, Complaint, Count II (1989)</u>	40, 50
<u>Government of Guam et al. v. Sea-Land Service, Inc. And American President Lines, Ltd., FMC Docket No. 89-26, Protective Order of Confidentiality, April 20, 1990</u>	16
<u>Hemisphere Navigation Co., Inc. v. Sea-Land Service, Inc., FMC Docket No. 87-29, 25 S.R.R. 56 (FMC 1989)</u>	78
<u>Initial Decision of ALJ Seymour Glanzer, 17 S.R.R. 145 (1977)</u>	84
<u>Joint Policy Statement of the ICC and the FMC -- Jurisdiction Over Trucking Services, SR Current Service ¶ 530:50, p. 530:205, Dec. 5, 1991</u>	78
<u>Maritime Administration, Notice of Voluntary Intermodal Sealift Agreement, 60 Fed. Reg. 54144 (Oct. 19, 1995)</u>	72
<u>Matson Navigation Co., Inc. - Proposed Changes in Rates Between the U.S. Pacific Coast and Hawaii, FMC Docket No. 73-22, 73-22 (Sub. No. 1), 74-36 (Sub. No. 1), 17 S.R.R. 145 (Initial Decision, 1977)</u>	49

TABLE OF AUTHORITIES

	<u>PAGE</u>
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<u>Matson Navigation Company, Inc. and American President Lines, Ltd. Space Sharing Agreement, Agreement No. 224-010889-003, filed with the Federal Maritime Commission on July 20, 1995 (60 Fed. Reg. 37447, July 20, 1995)</u>	23
<u>Military Sealift Command v. Matson Navigation Company, Inc., 21 S.R.R. 459 (1980)</u>	85
<u>Part 512. Financial Reports of Common Carriers By Water in the Domestic Offshore Trades, FMC Docket No. 78-46, 19 S.R.R. 1283 (FMC 1980) (Notice of Final Rule)</u>	8
<u>PRMMI Trucking, No. MC-C-30168 (ICC, Nov. 20, 1990)</u>	78
<u>Proposed General Rate Increases in the Guam Trade, FMC Docket Nos. 77-49 and 77-51 (1977)</u>	11
<u>Puerto Rican Rates, 2 U.S.M.C. 117, 119 (1939)</u>	97
<u>Rate Guidelines - Non-Coal Proceedings - Ex Parte No. 347 (Sub. No. 2) 1995 ICC LEXIS 301 (Nov. 22, 1995)</u>	75
<u>The Government of Guam et al. v. Sea-Land Service, Inc. and American President Lines, Ltd., F.M.C. Docket No. 89-26 (1989)</u>	5, 14
<u>Trailer Marine Transport Corp. v. Philadelphia Export Consolidators, Inc., No. 88-4634, 1991 WL 17772 (D. N.J. Feb. 8, 1991)</u>	78

TABLE OF AUTHORITIES

	<u>PAGE</u>
59 Fed. Reg. 42466 (August 17, 1994)	72
61 Fed. Reg. 6057 (February 15, 1996)	1
 <u>Statutes</u>	
5 U.S.C. §§ 561-570 (Supp. V 1993)	104
10 U.S.C. § 2687 (1995)	38
41 U.S.C. §§ 10a-10d	36
46 U.S.C. §§ 801-835	30
46 U.S.C. § 808	30
46 U.S.C. § 12105	34
46 U.S.C. § 1707(b)	55, 91
46 U.S.C. § 1707(c)	55
48 U.S.C. § 1421-1428e (1987)	1
49 U.S.C. § 13101(a) (1) (D)	92, 97, 101
49 U.S.C. § 13101(b)	6
49 U.S.C. § 13521	78
49 U.S.C. § 13541	105
49 U.S.C. § 13541(e) (2)	105
49 U.S.C. § 13701	<i>Passim</i>
49 U.S.C. § 13701(a)	<i>Passim</i>
49 U.S.C. § 13701(c)	103
49 U.S.C. § 13701(d)	9, 83
49 U.S.C. § 13701(d) (2)	85
49 U.S.C. § 13702	78

TABLE OF AUTHORITIES

	<u>PAGE</u>
49 U.S.C. § 13702(b) (6)	103
49 U.S.C. § 13702(c) (5)	103
49 U.S.C. § 14101	91
5 U.S.C. App. I (1988)	104
46 U.S.C. App. § 817(a)	14
46 U.S.C. App. §§ 844-845a	12, 14
46 U.S.C. App. § 883	30, 31
46 U.S.C. App. § 1707(b)	57
46 U.S.C. App. § 1707(c)	57
ICC Termination Act § 101	66
ICC Termination Act § 201	66
ICC Termination Act § 321	68
ICC Termination Act § 407	5
Regulatory Reform For the Domestic Waterborne Trades Measure of 1978, P.L. 95-475.	9, passim

Regulations

19 C.F.R. § 67.47	30
46 C.F.R. § 15.525	30
46 C.F.R. § 502.67	13
46 C.F.R. § 514.17(d)	90
46 C.F.R. Parts 2.01, 2.10, 2.20, 2.50, 2.75, 2.85, 2.90, 2.95	30
46 C.F.R. Parts 15.100, 15.300, 15.400, 15.500, 15.600, 15.700, 15.800, 15.900, 15.1000	30

TABLE OF AUTHORITIES

	<u>PAGE</u>	
46 C.F.R. Part 221	31	
46 C.F.R. Part 514	91	
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 <u>Articles</u>		
 <u>East-West Protest Grows to Jones Act,</u>		
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<u>Maritime Cabotage</u> , Maritime Cabotage Task Force (March 6, 1996)	32, 70, 74	
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Navy News & Undersea Tech., March 6, 1995, Vol. 12, No. 9, ISSN 8756-1700	38	
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Jane's Defence Weekly, July 1, 1992, Vol. 25, No. 7, p. 638	37	
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TABLE OF AUTHORITIES

	<u>PAGE</u>
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Alexander & Baldwin 1995 Annual Report	26, 89
BSEC deliberations at 11.23.94 RP-0455-F8	38
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DOD Directive 4500.9	24
FMC Tariff TWRA-020, Service Contract No. SC#96-25	47
H.R. Rep. No. 2149, § 301, 104th Cong., 1st Sess. (1995)	66
H.R. Rep. No. 94-1577, 94th Cong. 2d Sess., 3 (1976)	85
H.R. Rep. No. 104-311, 104th Cong. 1st Sess. 113, 116-117 (1995)	15, 78, 91
H.R. Rep. No. 104-422, 104th Cong. 1st Sess. 168 (1995)	75
MSC Worldwide Container and Shipping Agreement, RG-42	52
P. Samuelson and W. Nordhaus, <i>Economics</i> , (12th Ed. 1985) at 530-537	22
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**BEFORE THE DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
MARITIME ADMINISTRATION**

IN THE MATTER OF	)	
REQUEST FOR PUBLIC COMMENT ON	)	Docket No. OST-96-1066
COMPETITION IN THE NONCONTIGUOUS	)	
DOMESTIC MARITIME TRADES	)	

COMMENTS OF THE GOVERNMENT OF GUAM

The Government of Guam hereby files comments in response to the Request for Public Comment in Docket No. OST-96-1066, Competition in the Noncontiguous Domestic Maritime Trades, issued by the Office of the Secretary, Maritime Administration on February 14, 1996 (61 Fed. Reg. 6057, February 15, 1996).

I. INTRODUCTION AND EXECUTIVE SUMMARY

The Government of Guam (hereinafter "GovGuam") is the Government of the Territory of Guam constituted under the Organic Act of Guam (1950), 48 U.S.C. §§ 1421-1428e (1987), and as such has special standing to comment on matters affecting the noncontiguous (domestic offshore) trade between the Territory of Guam and the United States in that the Territorial Government is entrusted by Congress to represent the overall economic interests of the people of Guam. The Government of Guam has a particular interest in the implementation of the ICC Termination Act and the resulting amendments to Title 49, United States Code. That interest is the result of many years of relatively fruitless attempts by the Government of Guam to protect its citizens from the substantial and adverse economic consequences of the abuse of

market power exercised by the only two ocean carriers serving its domestic trade.

That the carriers serving Guam exercise market power cannot be questioned. A fundamental tenant of economics is that a duopoly, which has, practically speaking, always existed in the Guam trade, will extract monopoly rents in the absence of meaningful competitive pressures. Such competitive pressures are completely missing in the Guam trade. Neither the transportation services themselves nor the commodities shipped are subject to substitution -- the people of Guam are truly captive shippers. With respect to ocean carrier transportation services, notwithstanding the excessive level of profits extracted from the Guam trade, there are substantial barriers to entry in terms of capital costs, government restrictions, and the economies of scale and scope required to effectively compete. Nor do alternatives to ocean carriers exist. Guam is too far away to use barge operations, and air cargo is not a cost-effective alternative for the nature of goods shipped on ocean carriers. With respect to the substitution of goods, and assuming it is not the official position of the Department of Transportation that Guam should be induced to reduce its \$1.6 billion a year purchase of U.S. goods, most of the high value goods purchased from the United States are not substitutable.¹

¹ For example, it is obviously very difficult to purchase a left-hand driven car from Japan.

Thus, consistent with the fundamental laws of economics, where market power is exercised by a duopoly, and in the absence of effective regulation, monopoly rents flow to the carriers. This axiom has been amply illustrated by the unjust and unreasonable returns earned by the carriers in the Guam trade. In Appendix I, Dr. Ernest Nadel, Ph.D., Barakat & Chamberlin, Inc.,² shows that in 1985 U.S. Lines enjoyed a rate of return in the Guam trade of 48.9%! Dr. Nadel also establishes on the basis of publicly available documents that average rates in the Guam trade are about \$1,300 to \$1,500 per FEU higher than a reasonable cost standard would provide. If based on a comparison to average rates that might be achieved in a fully competitive market open to all transpacific carriers, with aggressive service contract bidding, the excess rate being paid by the Guamanians may be as high as \$1,700 per FEU. These excess costs total at a minimum \$40,000,000 per year.³ Thus, based on publicly available information, the windfall profits earned by the carriers in the Guam trade exceeds 30% of revenues, and costs the Guam economy anywhere from \$40 million to more than \$50 million a year. The entire burden of this \$40-50 million hidden tax (the "incidence" in technical, economic parlance) is borne by the shippers and

² Dr. Nadel has been deeply involved in the Guam trade shipping rates issues for years in support of the Government of Guam and has examined this issue from virtually every conceivable angle. See, Appendix I, Attachment 1.

³ Appendix II reaches a similar conclusion in an abbreviated format, presented to the Guam Chamber of Commerce on December 24, 1995. Appendix III illustrates a similar problem that results with military cargo when subject to the legal restrictions of the cargo reservation laws which also preclude foreign carriers from competing for DOD shipments.

consignees on Guam, and therefore by the citizens of Guam, and is estimated to cost each family on Guam at least \$1,139 a year.

The unjustified drain on Guam's economy is not only felt by the Guamanian people, but it has a ripple effect on the larger U.S. economy as well.⁴ As noted, Guam currently imports approximately \$1.6 billion a year of goods from the U.S. mainland. But for the excessive cost of shipping, this figure could be substantially higher. Instead, on isolated high rated commodities (e.g., watches), Guam is forced to look to foreign suppliers for goods, (e.g., airlift from Europe), that it would prefer to and could buy from the U.S. Similarly, Guam's economy was recently dealt a severe blow when the Military Sealift Command concluded that it would substantially reduce its presence on Guam -- in favor of a foreign port -- in significant part due to the excessive cost of ocean shipping that MSC experienced.

Thus, Guam's appeal to the Department of Transportation for redress is not only based on overriding equities and the fundamental, bedrock tenants of regulation as applied to a non-competitive trade, but also on the basis of larger U.S. economic, political, and public interests. These broader interests, in combination with the overwhelming evidence demonstrating the extent to which the existing regulatory system has failed the people of Guam, clearly outweigh the private interests of the two

⁴ GovGuam would observe that all of the economies throughout the Pacific, including, but not limited to the islands of Micronesia, are equally affected by the unnecessary expense associated with the cost of ocean transportation.

carriers serving Guam.

GovGuam believes that it is precisely this type of broader and fresh assessment that Congress had in mind when it mandated this study in Section 407 of the Interstate Commerce Commission Termination Act. Of particular significance is the directive that DOT analyze "each of the noncontiguous domestic trades" (emphasis added). This explicit directive ensures that the particular, and perhaps unique, dynamics that affect the Guam trade will not be diluted or otherwise discounted in a study that lumps all of the trades together. Insofar as Guam has struggled for more than 30 years without ever having obtained the benefit of a thorough and independent economic assessment of the Guam trade by any part of the United States Government, this study is very welcome.⁵

The focus of the study, as directed by Congress, is equally compelling. DOT is called upon to analyze competitive conditions in the Guam trade and ascertain whether additional protections are needed to protect shippers from the abuse of market power by water carriers serving Guam. Indeed, Section 407 specifically indicates a Congressional willingness to consider statutory and regulatory changes in order to further the transportation policy of section 13101 of Title 49, which necessarily includes the

⁵ As discussed below, GovGuam has been attempting to obtain a determination as to the reasonableness of rates in the Guam trade in a proceeding before the Federal Maritime Commission since 1989. The Government of Guam et al. v. Sea-Land Service, Inc. and American President Lines, Ltd., F.M.C. Docket No. 89-26, December 7, 1989. No investigation of the rates in the Guam trade has been completed since 1964. See, footnote 11.

public interest standard specified in the transportation policy provision.⁶

As the material presented herein demonstrates, neither the public interest standard nor the fundamental regulatory compact that the United States Government has with all of its citizens is being met in the context of the Guam trade. That regulatory compact, whether it is in the context of energy, telecommunications, or transportation, is that if the market is characterized by meaningful competition, then light-handed regulation or even deregulation is preferred, and if there is an absence of competitive forces, then the Government itself, through regulatory scrutiny, will ensure that ratepayers pay only just and reasonable rates. Regrettably, there has been an absence of applied regulation in the Guam trade for many years, creating the worst of all worlds, monopoly pricing power exercised by a carrier duopoly with no effective countervailing regulatory oversight. In reality, by express antitrust immunity until 1988 and thereafter by the device known as "parallel pricing" (a specific concern of the Congress) the carriers have

⁶ See, P.L. 104-88, § 103, 109 Stat. 803, 853 (49 U.S.C. § 13101(b)). GovGuam notes that the Notification of Open Docket for Public Comment in this proceeding appears to embrace a narrower scope than that which Congress has required. For example, the notice asks for comments on "the extent to which there needs to be continued reliance on tariff filing and rate regulation", while the statutory language compels DOT to assess "the extent to which statutory and regulatory changes should be made to further the transportation policy of section 13101 of title 49, United States Code". See, 61 Fed. Reg. at 6057 (February 15, 1996). Compare, P.L. No. 104-88, section 407, 109 Stat. at 958.

effectively colluded to establish rates at monopoly levels.⁷

The relief sought by the Government of Guam is the implementation of either an effective deregulatory approach to the Guam and Hawaii trades or an effective regulatory approach to the Guam trade. The goal of either approach is to achieve one and only one objective -- to reduce shipping rates to just and reasonable levels. This can be accomplished by a direct mandate from DOT under the authority of the STB to roll back rates to levels that are just and reasonable. Alternatively, DOT can establish a mechanism, whether market-determined or regulatorily imposed, to create just and reasonable freight rate results. The mechanism can be opening the trade to increased carrier competition by reducing artificial statutory and regulatory barriers to entry or it can simply establish cost based or revenue based regulatory limits on carrier rates.

The Government of Guam suggests several possible approaches to remedy the rate level problem in the Guam trade. The first option is to eliminate the negative effects of the Jones Act on the Guam trade through either a total or partial exemption for Guam and its related Pacific domestic offshore trading partners, notably Hawaii. This is the effective market-oriented approach insofar as it would create the conditions under which competitive options would be commercially feasible. Alternatively, and until

⁷ Although technically categorized as a "duopoly", the Guam trade is rated under the Herfindahl Hirschman index at between 5000 (50/50 market share split) and 5200 (60/40 market share split), as close to a true monopoly as is possible. For regulatory purposes the threshold for determining that a given market is noncompetitive is approximately 2000 to 2500. See, Appendix VI.

such time as competitive conditions are demonstrably present, the STB has an obligation to use its regulatory authority in a manner that protects the captive shippers on Guam from being exploited by an abuse of market power. This responsibility can be exercised in a variety of ways: (1) it can rigorously monitor Guam's rates on a cost-based principle similar to the FMC's "G.O. 11"⁸ regulation implemented under the Regulatory Reform For the Domestic Waterborne Trades measure of 1978, P.L. 95-475; or (2) the STB could rigorously monitor Guam shipping rates on a comparable average rate principle.

The former option is, of course, the implementation of a regulatory system, which the FMC and ICC should have always had in place in the Guam trade, where profitability is determined on the basis of a review of the actual revenues the carriers receive in accordance with a reasonable cost allocation methodology, such as that adopted by the FMC in the form of GO-11's. The latter option is almost identical to that proposed by the transpacific U.S. flag carriers to the Department of Defense, the so-called Uniform Commercial Rate, wherein DOD is charged the average revenue per container obtained from commercial customers of the

⁸ 46 C.F.R. Part 552 - Financial Reports by Carriers in the Domestic Offshore Trades (FMC General Order No. 11)(hereafter "GO 11"). G.O. 11 is the regulation promulgated by the Federal Maritime Commission under the Congressional directive contained in P.L. 95-475 by which the financial data of carriers in the domestic offshore trades is reported and analyzed. The financial data is used to calculate the carriers' revenues, expenses and resulting profits (rate of return). The regulation also specifies the method by which the reasonableness of the carriers' profits (rate of return) is determined. See, Part 512. Financial Reports of Common Carriers By Water in the Domestic Offshore Trades, FMC Docket No. 78-46, 19 S.R.R. 1283 (FMC 1980) (Notice of Final Rule); see also, S. Rep. No. 1240, 95th Cong. 2d Sess. 13 (1978), reprinted in 1978 U.S. Code Cong. & Admin. News 3331, 3343.

U.S. flag carriers in the transpacific trades.

Finally, the Government of Guam submits there are significant statutory and regulatory initiatives that are required, including, but not limited to, repealing the Interstate Commerce Commission Termination Act provisions establishing the 7.5% "zone of reasonableness" (hereinafter "the ZOR") for all water carrier tariffs serving the domestic offshore trades.⁹ Additionally, the STB should undertake extensive rulemaking efforts to establish specific standards and procedures for application of the reasonableness standard of section 13701 of the Act in the context of both the carriers' general revenues obtained from a domestic offshore trade and the specific commodity rates charged in the trade.

GovGuam is not asking for special favors or preferential treatment. From Guam's perspective, such special interest privileges appear to be the private domain of the carriers. GovGuam is asking only to be treated fairly and with the respect that its citizens deserve. That modicum of respect from the Federal Government in this context would be consistent with Guam's future status as a Commonwealth of the United States of America. DOT has the unique opportunity here and now to undertake a course that would represent a truly new beginning in the relationship between the Federal Government and Guam, a relationship that recognizes the full citizenship of Guamanians

⁹ See, P.L. 104-88, § 103, 109 Stat. 803, 867 (49 U.S.C. § 13701(d)).

and that is not linked to Guam's colonial past.¹⁰

II. A HISTORICAL PERSPECTIVE: THE RATES TO GUAM HAVE EITHER BEEN SUBJECT TO RATE AGREEMENTS EXEMPTED FROM ANTI-TRUST REVIEW OR NOT SUBJECTED TO REGULATORY SCRUTINY

In order to fully understand the perspective of GovGuam in this proceeding it is necessary to provide the STB with a very brief overview of the regulatory history of the Guam trade before the Federal Maritime Commission, the principle Federal agency involved in the regulation of carriers in the domestic offshore trades up to and including the 1990's. It is a history characterized by legally sanctioned price fixing and a complete evasion of regulatory scrutiny.

The Territory of Guam has seen few carriers operating in its trade with the U.S. mainland over the past 30 years and those few carriers have consistently operated in a highly noncompetitive regulatory environment. Prior to 1979, the island was served by United States Lines, Ltd. (U.S. Lines) and Matson Navigation Company, Inc. (Matson) and, intermittently, American President Lines, Ltd. (APL). Matson served the island on the basis of a dedicated turnaround service while U.S. Lines served Guam on a pass-by basis as part of its transpacific trade service. In 1978 Matson discontinued its dedicated service to Guam and withdrew

¹⁰ It is not fully appreciated by U.S. government policy makers, the negative impact that Guam's status as a "colony" of the United States has on the people of Guam. Indeed, even fewer U.S. policy makers are even aware that Guam is officially classified as a "colony" of the United States by the United Nations, a shocking fact of life not readily discernable from Guam's current "territory" designation under U.S. law.

from the trade. APL rejoined the trade in 1979, on a pass-by basis, and continued to serve the trade until very recently. Sea-Land Service, Inc. (Sea-Land) entered the trade in August of 1987 after purchasing the assets of U.S. Lines. Matson has now reentered the trade in 1996, taking over APL's pass-by service to the island. Thus, since at least 1979, the Guam trade has been served by a "duopoly", the most noncompetitive market supply structure short of a monopoly.

From 1960 until June of 1989, the carriers serving Guam operated under a joint tariff published pursuant to the authority of the Guam Rate Agreement, an agreement among common carriers in the domestic trade of Guam, approved by the Federal Maritime Commission under the Shipping Act, 1916. This agreement provided the carriers with antitrust immunity and allowed the carriers to meet, agree on rates, and enforce those rates in a joint tariff filed with the FMC. Prior to 1977, there appears to be only one reported case, in 1964, of the FMC ever investigating the rate and practices of the Guam Rate Agreement.¹¹

In 1977, the FMC initiated an investigation of a general rate increase proposed that year by the Guam Rate Agreement.¹² However, shortly before the date set for the filing of required financial data from the carriers on rates, costs, and rate of return in support of the rate increase, U.S. Lines withdrew its

¹¹ See, Government of Guam v. Federal Maritime Commission, 329 F.2d 251 (D.C. Cir. 1964).

¹² See, Proposed General Rate Increases in the Guam Trade, FMC Docket Nos. 77-49 and 77-51 (1977).

proposed rate increase. It was at this time that Matson withdrew its proposed rate increase. Soon thereafter, Matson discontinued its dedicated "turn around" service to Guam in the face of its inability to maintain sufficient profitability because its rates were equalized, or set, by the much lower cost "pass-by" service of U.S. Lines.

Since 1978 Guam has been served exclusively by carriers operating a "pass-by" transpacific service, a type of service which dramatically reduces the effective costs of transportation to Guam. However, because rates remained set at levels that were based on the much higher cost "turn around" service of Matson, the existing 1978 rate levels resulted in windfall profits to APL and Sea-Land. Rate levels remained at the 1978 levels because the "duopoly" of APL and Sea-Land had no effective or potential competition from foreign carriers due to the protection of the Jones Act.

Between 1979, when APL entered the trade, and 1984, the applicable trade rates were increased ten times by 2.9% and once by 2.5%, thereby taking full advantage of the 5% "no suspend zone" provisions of the 1978 amendments to the Intercoastal Shipping Act of 1933, P.L. 95-475.¹³ In 1988, APL and Sea-Land announced two general rate increases, each in the amount of 2.9%, to become effective June 1, 1988 and September 1, 1988. The

¹³ See, Intercoastal Shipping Act of 1933, §§ 2-4, 46 U.S.C. App. §§ 844-845a; 46 C.F.R. 502.67. Guam would note that this provision is strikingly different from the ZOR recently included in the ICC Termination Act, insofar as the "no suspend zone" provision did not preclude a legal challenge to the rate increase.

Government of Guam protested these rate increases and, in April of 1988, the FMC ordered an Investigation under the Intercoastal Act of 1933, as amended. However, once again the carriers in the Guam Rate Agreement withdrew the proposed rate increases immediately prior to the final due date for filing the financial data justifying the proposed rate increases, June 7, 1988.

While the FMC did not require the disclosure of financial data in support of the withdrawn rate increases, it did order a full investigation into the practices of the Guam Rate Agreement.¹⁴ GovGuam again intervened in the proceeding and initiated discovery procedures to require financial disclosure by the carriers. However, once again the carriers elected to unanimously vote to terminate the Guam Rate Agreement rather than allow an investigation to go forward and requested that the FMC discontinue the proceeding. GovGuam objected to this procedure and requested the Investigation be redirected to determine whether the carriers were maintaining just and reasonable rates. The FMC denied this motion as not falling within the purview of the original Order of Investigation, but provided Guam with the opportunity to file a separate complaint case under section 22 of the Shipping Act, 1916.¹⁵

¹⁴ Agreement No. 102-008454 - Guam Rate Agreement, Order of Investigation and Hearing, FMC Docket No. 89-05, served Feb. 14, 1989, 54 Fed. Reg. 7276 (Feb. 17, 1989).

¹⁵ Agreement No. 102-008454 - Guam Rate Agreement, 25 S.R.R. 385, 387 (1989).

Thus, in 1989 GovGuam initiated a complaint case against the carriers serving the Guam trade at that time, challenging the reasonableness of the rates under the statutory "just and reasonable" standards set forth in the Intercoastal Shipping Act of 1933 and the Shipping Act, 1916,¹⁶ and applying the general revenue regulatory standards promulgated by the FMC under the requirements of P.L. 95-475.¹⁷ The Government of Guam et al. v. Sea-Land Service, Inc. and American President Lines, Ltd., F.M.C. Docket No. 89-26, December 7, 1989.¹⁸ That case has involved the most massive litigation effort ever undertaken in the regulation of the noncontiguous domestic trades or in the history of the FMC. Following extensive discovery disputes and the protracted litigation of preliminary and collateral legal issues,¹⁹ the matter was finally heard before an FMC Administrative Law Judge (ALJ) in April - June of 1993. Post-hearing briefs were filed beginning in December of 1994 and continued through May of

¹⁶ Section 4 of the Intercoastal Shipping Act of 1933, 46 U.S.C. App. § 845a; Section 18(a) of the Shipping Act, 1916, 46 U.S.C. App. § 817(a).

¹⁷ 46 C.F.R. Part 552 - Financial Reports by Carriers in the Domestic Offshore Trades (FMC General Order No. 11).

¹⁸ At that time, most of the cargo in the Guam trade moved under FMC port-to-port tariffs and only a small portion moved under ICC intermodal tariffs.

¹⁹ Of course, this large litigation cost was merely the rational reflection of the massive annual excess revenues that the carriers were earning and that the Government of Guam was trying to eliminate. As noted above and in Appendix II, the excess revenues were approximately \$40 million per year. With such excess profits at stake, it is no surprise that APL and Sea-Land would utilize all available legal resources and spare no expense to delay a decision in Docket No. 89-26 as long as possible.

1995.²⁰ However, given the enormousness of the record, the ALJ requested and was granted a full year to issue his initial decision, a decision which is expected in late May or early June of 1996.²¹

In a move that can only be classified as a classic case of forum shopping and evasion of regulation, specifically referred to in the legislative history of the ICC Termination Act,²² in the period of 1989-90 both Sea-Land and APL canceled their port-to-port tariffs on file with the FMC and filed joint through motor-water intermodal tariffs with the ICC. By this device the carriers again attempted to undermine the efficacy of the regulatory system intended to maintain reasonable rates in the Guam trade and artificially bring the proceeding to an abortive conclusion. While much litigation ensued and is pending over the exact effective date of a true intermodal service by Sea-Land, the FMC has not permitted the carriers to withdraw from the proceeding.²³

GovGuam has expended enormous public resources in an attempt

²⁰ See, Docket No. 89-26 - Presiding ALJ Procedural Order, dated January 10, 1995.

²¹ Noting the apparent imminent demise of the FMC, by letter dated May 23, 1995 the presiding ALJ invited the parties to attempt to settle the complaint proceeding, an attempt that ultimately failed. However, the ALJ noted that his decision would not be forthcoming for a period of no less than an additional year from the date of the letter.

²² See, H.R. Rep. No. 104-311, 104th Cong. 1st Sess., at 113 (1995).

²³ See, e.g., FMC Docket No. 89-26 - Presiding ALJ Procedural Order (Denying Motion to Dismiss or, Alternatively, to Stay Proceedings Pending Resolution of Jurisdictional Issues), dated March 22, 1991.

to finally, after more than thirty years, have an independent, fair-minded adjudication of the rates charged shippers to Guam. The FMC proceeding is the only forum in which the carrier's own economics have been examined. Unfortunately, the record of that proceeding has been closed to public scrutiny by operation of an Umbrella Protective Order issued by the presiding FMC ALJ at the behest of the respondent ocean carriers.²⁴ The FMC has repeatedly refused to lift that Umbrella Protective Order for any public purpose beyond the adjudication of that complaint proceeding,²⁵ except, notably, when it became necessary to disclose some of that data to Matson at the time APL, one of the respondents in the proceeding, was negotiating a sale of its Guam service and vessels to Matson as well as a related transpacific vessel sharing agreement.²⁶

The Government of Guam recently made yet another request by appropriate Motion to the presiding Administrative Law Judge in FMC Docket No. 89-26 to allow disclosure of the record compiled in that proceeding in order to allow the Government of Guam to adequately respond to the request for comments, for DOT to adequately assess the Guam trade, and to ensure that the

²⁴ Government of Guam, et al. v. Sea-Land Service, Inc. And American President Lines, Ltd., FMC Docket No. 89-26, Protective Order of Confidentiality, April 20, 1990.

²⁵ See, Id., Intervenor's Motion for Removal of the Hearing Transcript for June 18, 1993 from the Protective Order of Confidentiality Denied Without Prejudice, August 9, 1993; and, Ruling Concerning Whether Confidential Business Information and Data Should Be Declassified, August 31, 1994.

²⁶ See, Id., Ruling on Request of APL For Interpretation or Limited Amendment of the Protective Order, June 12, 1995.

Congressional objectives are not otherwise thwarted.²⁷

Unfortunately, the FMC has again refused to allow disclosure of the critical financial data contained in the record of Docket No. 89-26.²⁸ GovGuam believes that the Department of Transportation has an independent need for this information, and should take whatever steps are necessary to ensure that this material in this proceeding is available to the public as public policy is formulated. Importantly, this information would reveal critical and uncontested facts as to the level of rates in the U.S.-Guam trade, rates in other Pacific trades and the revenues, expenses, profits and rates of return earned by the "duopoly" carriers now serving the trade.²⁹

The regulatory history of Guam is a case study in the failure of the U.S. Government to ensure that the citizens of Guam are accorded the same basic status and protection of the law that citizens of the mainland, and, indeed, other domestic offshore jurisdictions enjoy. The history of the domestic offshore trade to Guam reveals that Guam has been subjected to a government sanctioned carrier duopoly for at least the last 30

²⁷ See, *Id.*, Motion For Declassification of Information Classified as Confidential Under the Protective Order, filed March 22, 1996 (attached as Appendix VIII).

²⁸ See, *Id.*, Renewed Motion For Declassification of Information Classified as Confidential Under the Protective Order Denied, April 10, 1996.

²⁹ As an example of the relevance of the testimony and exhibits in FMC Docket No. 89-26, a redacted public version of the June 18, 1993 cross-examination of APL's and Sea-Land's chief economic witness in the proceeding, Dr. A. Lawrence Kolbe, is attached to this submission as Appendix VII. As will be seen in the following discussion, this testimony is highly relevant to specific issues raised in this matter.

years, a product of the Jones Act. Furthermore, the pricing behavior of the duopoly has been noncompetitive, first by operation of a formal agreement exempted from the antitrust laws by the Shipping Act, 1916, and now by the practice of "parallel pricing" which, based upon the failure of responsible governmental agencies to take any concrete actions, also seems to be immune from antitrust scrutiny. Finally, no substantive rate regulation has been exercised by the FMC or the ICC in the Guam trade since 1964, contrary to the purported "protections" of Guam shippers included in the Intercoastal Shipping Act of 1933 and the Interstate Commerce Act. Although GovGuam has gone to great lengths to exert its supposed legal rights under the regulatory shipping laws of the United States against the duopoly serving its trade, no concrete actions have ensued from the Federal Government to date. Hopefully, Guam's experience with DOT will be more substantively equitable.

III. CARRIER COMPETITION IN BOTH THE REGULATED AND UNREGULATED PORTIONS OF THE GUAM TRADE

A. Summary

There is insufficient carrier competition in the domestic offshore trade to Guam to rely upon either market forces or light-handed regulation to protect the legitimate and statutory rights of shippers to just and reasonable rates. There are, and have been, only two U.S. carriers in the Guam trade, and represent a classic case of a "duopoly" extracting monopoly

rents. These carriers, unlike carriers in other portions of the domestic offshore trades, do not face competitive pressures from other U.S. carriers because only those U.S. carriers that can tie together Hawaii, Guam, the military cargo of the MSC, and the transpacific trade will participate in the Guam trade. They do not face competition from other bulk carriers, unlike other domestic offshore trades, because tug and barge operations are not feasible. They do not face competitive pressures from foreign carriers -- who, by law, are not permitted to carry U.S. goods. They do not face competitive pressures from other modes of transportation, including air cargo, which is prohibitively expensive for the nature of goods shipped to Guam. And, not only are the transportation services themselves insulated from competition, but Guam is captive to these carriers for all U.S. goods, and many of these goods, such as left-handed driven automobiles, are not substitutable. Moreover, Guam submits that it is inconceivable that the Department of Transportation would conclude that there is competition in the Guam trade on the basis of foreign carriers bringing goods to Guam in lieu of purchases from the United States. Thus, there is neither competition in the transportation services provided by the carriers, nor is there the ability of Guam to purchase these U.S. goods from other sources. Guam is, in every sense, a captive market, and it has been treated as one.

B. The Guam Trade Is Unique

GovGuam urges the DOT to recognize several unique circumstances surrounding the Guam trade that are critical to understanding the economics of this trade. One factor is Guam's location. Guam is the most distant trade served among the domestic offshore jurisdictions, 5,053 miles from the U.S. mainland. For comparison, the mileage to the second most distant domestic offshore jurisdiction, Hawaii, is only 2,091 miles from the U.S. mainland. Thus, for the domestic trades other than Guam, entry is far easier because voyage distances are much shorter. For these distances and conditions, inexpensive tug and barge service is possible and is extensively used in Alaska and Puerto Rico. Even Hawaii has had experience with successful utilization of tug and barge service from the mainland. This competitive option is not available to Guam, and therefore does not serve to cap ocean carrier rates.

Another major and unique facet of the Guam trade is that the two carriers serving Guam have always done so as an integral part of the two carriers' "pass by" service, a service whereby transpacific carriers stop at Guam on the westbound leg of their round trip voyages from the U.S. to the Far East using the same vessels that call at such countries as Taiwan, Korea and Japan. It must be remembered that even Hawaii is still served primarily on a "turn around" basis, a service whereby the carrier dedicates ships to a voyage restricted to the U.S. west coast and Hawaii. The effective allocable costs of each service are dramatically

different. Whereas, all of the costs of the service to Hawaii must be borne by Hawaii cargo, the service to Guam can share common system costs with Far East cargo. The long-haul services in the transpacific trades use large ships calling at a few ports to amass large cargo volumes to develop economic efficiencies, economies of scale and scope and very low operating costs per mile. As a result, rates in the transpacific trade show extremely low rates per mile. Theoretically, Guam rate levels should be comparable to Far East rate levels and below Hawaii rate levels. This cannot be farther from the harsh truth about Guam rate levels. They far exceed Far East rate levels and even exceed Hawaii rate levels. But then, while the transpacific trades are highly competitive, enjoying up to 20 competitors at any given time, the Guam trade is not. The cause and effect relationship between competition and prices is not lost on Guam shippers in light of these undeniable and obvious economic facts of life.

Thus, the uniqueness of Guam can and should create several beneficial circumstances in relevant transportation economic considerations. Guam contributes to, and should benefit from, economies of scale in the trade. Guam helps combine volumes from several trades, giving the carriers great economies of scale or scope. Most important, Guam's unique situation aids in easily determining how excessive the rates are, since comparisons can be made between the average Guam trade rate and the applicable rates in other Pacific trades, both domestic and foreign.

The two supplier scenario that we see in the Guam trade is the classic "duopoly", the most distilled form of market concentration short of an outright monopoly, and falling within the general class of noncompetitive market models known as "oligopoly". The effects of oligopoly market concentrations have been the subject of much analysis by classic economists like Samuelson. In an oligopoly, the forces of demand and supply are not in balance. The suppliers have a noncompetitive individual effect on total supply in the market, resulting in each of the oligopolists enjoying a portion of what would be considered monopoly profits if they were obtained in a true single supplier market. This fundamental pricing and profit result of an oligopoly holds true even when only legal collusive pricing practices, such as "parallel pricing", exist in the market.³⁰ Indeed, this economic theory is clearly reflected in the actual market place that shippers in the Guam trade must deal with every day. That is, they have available to them very limited transportation supply options and always at a very high price.

C. The Guam Trade Is Completely Dominated By A Duopoly

There are now, and practically speaking, there have only been, two carriers serving the regulated portions of the Guam trade at any one time. In 1996 Sea-Land and Matson will share the Guam trade. Although it has served the Guam trade for many years on an intermittent basis, most recently since 1987, in 1995 APL

³⁰ See, P. Samuelson and W. Nordhaus, *Economics*, (12th Ed. 1985) at 530-537; see also, *Id.* at pp. 503-510, 517-527, 542.

departed the trade when it sold its Guam service and the ships that provided that service to Matson. However, APL remains in the transpacific foreign trade service by means of a vessel sharing agreement with Matson.³¹

There is virtually no unregulated traffic moving in the trade with any other carriers. That is, while there is some amount of specific commodity cargo that is exempt from ICC and FMC tariff filing requirements, this cargo is still under nominal Federal regulatory authority. Even if we assume that "pure" bulk carriers are the intended "unregulated" traffic in the trade, they are generally chartered irregular service carriers, otherwise known as "tramps". These irregular operations are generally opportune lifts and do not constitute any significant form of competition to the liner operators that operate container ships. That is, container ship operators generally avoid the carriage of bulk commodities except for the occasional tank container and bulk ship operators rarely carry containerized cargo except for the occasional carriage of on-deck containers.

The only other carriers serving Guam are the occasional chartered vessels operated by or for the Military Sealift Command. While a few vessels under charter with MSC call at Guam as MSC's Sealift Program requires, these vessels are specifically prohibited from competing with commercial carriers by operation

³¹ See, Matson Navigation Company, Inc. and American President Lines, Ltd. Space Sharing Agreement, Agreement No. 224-010889-003, filed with the Federal Maritime Commission on July 20, 1995 (60 Fed. Reg. 37447, July 20, 1995).

of DOD Directive.³² Thus, ships under charter to the Navy also do not present any significant competition to the two container ship liner operators.

D. The Existence Of Windfall Profits And The Absence Of New Entrants Are Not Inconsistent: There Are Substantial Barriers To Entry

Why, GovGuam is often asked, if the carriers are making so much money on the Guam trade, have not more carriers entered the trade? There are a number of compelling reasons why other carriers have not and can not enter the Guam trade, despite the windfall profits earned by the carriers now serving Guam.

1. The Guam Trade Is Profitable In The Context Of Larger, Transpacific Service, Not on a Stand-Alone Basis

The Guam trade is only 30,000 FEUs per year. By comparison, APL and Sea-Land each move approximately 400,000 FEU per year in the transpacific trade. The windfall profits that the carriers make on their Guam trade are in the context of a larger, transpacific service. While the windfall profits that have been made on the Guam trade are very substantial to Guam -- in the range of \$40-\$50 million a year, they are obviously not of a magnitude, in gross dollar terms, that would warrant the substantial investment required of a new entrant into the arena. For example, GovGuam understands that the combined revenue of APL and Sea-Land's transpacific trade exceeds \$4 billion a year. The

³² See, DOD Directive 4500.9.

windfall profits earned by the Guam trade thus only represent about 1% of their total revenues.

Moreover, applicable conditions in the Guam trade, primarily a westbound imbalance in the trade, have made it economically impossible for a carrier to serve Guam on a direct "turn around" service between the U.S. mainland and the island. Only carriers engaged in the transpacific trade generally can economically serve Guam on a westbound "pass by" basis. Traditionally, the only U.S. flag carriers that maintained a transpacific service were Sea-Land and APL and for many years these were the only carriers serving the Guam trade. However, the decision by APL increasingly to divest itself of ownership of U.S. flag vessels created an opportunity for APL to sell its very profitable Guam service to Matson, while still retaining the use of the vessels on the eastbound transpacific leg. It also created an appropriate market opportunity for Matson to expand into the Guam trade. Matson formerly served the Guam trade up to the late 1970's but departed that trade due to its inability to operate profitably in competition with the rates established by U.S. Lines with its pass-by service.³³ Now, rate levels are so high in the trade that when APL's market share became available,

³³ Under the Guam Rate Agreement, the carriers attempted to raise the Guam trade rates to levels keyed to Matson's "stand alone" service costs, an attempt that was abandoned when the FMC decided to investigate the financial justification for the rate action. Agreement No. 102-008454 - Guam Rate Agreement, 25 S.R.R. 385, 387 (1989).

Matson purchased the APL service and its vessels.³⁴

What has been evident by the service of Sea-Land and APL, and now Matson's proposed service, is that Guam can only be served profitably by a "pass by" service as part of a larger transpacific service, and that it can best be served in conjunction with a "pass by" service to Hawaii. That is, it is necessary to combine a Far East foreign commerce trade service with the Pacific domestic trades to construct a balanced trade with better vessel capacity utilization to allow more than a single U.S. flag carrier to operate profitably in this market. Fortunately, the historic eastbound imbalance in the transpacific foreign trades serves as an excellent complement to the experienced volumes moving westbound in the Guam trade. Admittedly, entry into the Guam trade would require any new entrant or entrants to make some inroads into the existing market shares of Sea-Land and Matson but it appears that more carriers competing for larger market shares and operating their vessel at a higher capacity utilization in a balanced east-west trade is the only realistic method by which increased competition and enhanced shipper transportation service options will ever be possible in the Pacific domestic trades.

³⁴ The decision of APL to sell the Guam service, even though highly profitable, is the result of its overall corporate decision to divest itself of U.S. flagged vessels on a worldwide basis in the next two to three years, and not a reflection of allegedly depressed net earnings in the Guam trade. To the contrary, in its 1995 Annual Report, Alexander & Baldwin, the parent company of Matson, in commenting on the effects of Matson's purchase of APL's service to Guam stated that "revenue will benefit...from the new cargo carried to Guam" and that "operating profit will improve moderately with the net contribution of that cargo...." Alexander & Baldwin 1995 Annual Report at 11.

Accordingly, under current law, in order for there to exist any meaningful competitive pressure on the existing carriers such that rates could be set by the market place, rather than through regulatory proxies, an operator would have to start a new U.S.-flag service and serve Asia as well. For the reasons set forth below, this is not, and has not been, a realistic option.

2. High Capital Costs Represents A Substantial Barrier To Entry: A New Entrant Into The Transpacific Trade Would Require A Commitment Of Approximately \$700 Million

To compete in the transpacific trade, a carrier needs to be able to compete with the economies of scale and scope offered by APL and Sea-Land, which, as noted above, move approximately 400,000 FEU per year. To compete on this level requires an enormous commitment of resources, resources that would be at significant risk. According to Mr. Ron Gottshall, former Managing Director of the TWRA (the Transpacific Westbound Rate Agreement), the entry cost into the transpacific trade by a new carrier would require a commitment of ".... somewhere between \$600 and \$700 million to operate a weekly service".³⁵ This is obviously a substantial amount of risk capital, an amount that exceeds that which is justified on the basis of even \$40-\$50 million in unjustified profits.

Thus, the extremely high capital costs necessary to enter the Guam trade creates an inherent "first entry" advantage to the

³⁵ Testimony before the Subcommittee on Information, Justice and Agriculture of the Committee on Government Relations of the United States House of Representatives, September 30, 1993.

entrenched carriers in the trade, and giving rise to the oligopolistic, quasi-monopoly conditions experienced in the trade for decades. Moreover, a new entrant would hardly have any assurance that it would be able to capture the entire Guam trade, or even a majority of it. This is particularly true given the ability of the existing, entrenched carriers to simply reduce their rate levels to levels approximating just and reasonable levels in the face of a competitive threat, and thereby drive out the new entrant.

Indeed, insofar as a new entrant into the market today would be doing so on the basis of distorted economics -- the excessive rates charged by the current carriers -- the new entrant would have to have sufficient assurances that those distortions would not be in fact be ameliorated in a time frame that would undermine their substantial investment. In other contexts, this would be considered "uneconomic bypass" -- where an entrant is entering the trade not on the basis of sound economics and growth, but on the basis of distorted economics caused by regulatory failures.³⁶

Far from demonstrating that the relative inability of a new entrant to enter the field shows the reasonableness of the existing carrier charges, the substantial barriers to entry underscore the absolute imperative for regulatory solutions that

³⁶ GovGuam would note that this is precisely what happened in an analogous industry, the natural gas pipeline industry, in California, where substantial investments were made on the basis of regulatory failures, not market requirements.

assure captive shippers of just and reasonable rates. The need to protect "captive shippers" was long recognized by the STB's predecessor, the ICC, in the context of captive coal shippers. Rail shippers of coal even had alternatives, river barges and trucks, alternatives that Guam does not have. However, those alternatives were very expensive. The ICC determined it would be inappropriate to allow railroads to charge coal rates equal to the rates that the captive shippers would have been forced to pay for inefficient and higher cost alternative transportation, and thereby established rate ceilings for rail shipments that permitted rail carriers to attain only "revenue adequacy".³⁷

Thus, we see that capitalization costs in the Guam trade are a substantial contributory factor in creating the duopolistic market pattern that has existed for so long. The significant initial entry costs create a huge advantage for existing carriers and shield them from new entrants, notwithstanding the high rates and profitability of the trade.

³⁷ Under ICC case law, a captive coal shipper cannot be charged more than an efficient "stand alone" railroad service would cost. Coal Rate Guidelines - Nationwide, 1 I.C.C. 2d 520 (1985) aff'd, Consolidated Rail Co. v. U.S., 812 F.2d 1444 (3rd Cir. 1987). In the context of ocean transportation to Guam, Guam captive shippers could not be charged more than the costs of providing an efficient ocean transportation transpacific "pass-by" service to the island. Similarly, market dominant carriers cannot obtain revenues that are more than "adequate", i.e., a fair market rate of return. *Id.* That the carriers serving Guam are only entitled to a fair market rate of return is, and always has been, the fundamental premise upon which all of GovGuam's arguments before the FMC, the ICC and now DOT are based.

3. The Jones Act Represents A Substantial Barrier To Entry

The Jones Act prohibits foreign flag carriers from serving the trade between Guam and any other U.S. port, including both Hawaii and the U.S. West Coast.³⁸ While a number of non-protectionist governmental intervention actions in the noncontiguous domestic trades can be readily identified, including adverse tax policy,³⁹ unduly stringent vessel manning requirements relating to number, classification and citizenship,⁴⁰ unduly restrictive citizenship requirements for the ownership of U.S. flag vessels⁴¹ and duplicative and unnecessarily burdensome vessel inspection procedures,⁴² it is the governmental actions associated with the Jones Act that are most easily identified as having the most significant limiting effects on the entry of ocean carrier competitors into the noncontiguous domestic trades.

This intervention is the dual limitation of mandatory U.S. flagging of vessels serving those trades and the requirement that

³⁸ Section 27 of the Merchant Marine Act, 1920, 46 U.S.C. App. § 883.

³⁹ See, e.g., Focus on Treasury: Incoming Treasury Letters (COR), *Shipper Asks for Broader Exemption From Proposed BTU Tax* (Legislative Proposals) (Doc 93-5022), Grill, Philip M., Matson Navigation Company, 59 Tax Notes 617 (May 3, 1993).

⁴⁰ See, e.g., 46 C.F.R. Parts 15.100, 15.300, 15.400, 15.500, 15.600, 15.700, 15.800, 15.900, 15.1000; see also, 46 C.F.R. § 15.525 (reference to additional manning requirements).

⁴¹ Section 9 of the Shipping Act, 1916, 46 U.S.C. § 808, 19 C.F.R. § 67.47; see also generally, 46 U.S.C. §§ 801-835; 46 C.F.R. Part 221.

⁴² See, e.g., 46 C.F.R. Parts 2.01, 2.10, 2.20, 2.50, 2.75, 2.85, 2.90, 2.95.

those U.S. flagged vessels be built in domestic U.S. shipyards.⁴³ Of course, these limitations carry with them most of what is here defined as the non-protectionist interventions that also serve to restrict entry into the noncontiguous domestic trades. However, it is the U.S. flag vessel documentation requirements, and in particular those applicable to the coastwise trades, that carry with them the U.S. citizen ownership restrictions and, thereby, largely preclude foreign investment in the domestic trades. This restriction on foreign investment in the domestic Jones Act fleet coupled with the Jones Act's requirement that vessels in the coastwise trades be built in U.S. shipyards results in the most significant cost impact on vessel operators contemplating entry into the noncontiguous domestic trades. These statutory restrictions on operators in the domestic trades in combination create the greatest part of the Jones Act's barrier to entry into the domestic shipping market.

The importance of reducing or eliminating such interventions and thereby increasing the number of potential entrants into the noncontiguous domestic trades and the pivotal role that the Jones Act requirements play in limiting entry into those trades has been universally recognized by affected shipper interests and the offshore governments whose jurisdictions' economies are linked to those shipper interests. Thus, almost without exception those interests have consistently sought to have the protectionist

⁴³ Section 27 of the Merchant Marine Act, 1920, 46 U.S.C. App. § 883.

governmental intervention inherent in the Jones Act eliminated through either specific trade or commodity exemptions.⁴⁴ These efforts have been strenuously resisted by those interests that are either directly or indirectly protected by the Jones Act, including obviously the U.S. flag vessel operators in the trades, the domestic U.S. shipbuilding industry and the maritime labor unions. It is important to remember, however, that the resistance of these latter interests is not based upon arguments that the overall economic welfare of the United States is best served by a continuation of the Jones Act protectionist market interventions. Rather, those interests have always chiefly relied upon tenuous arguments that the Jones Act operates as an essential element in maintaining a viable national defense.⁴⁵

Suffice it to say, however, that there is really no question that the elimination of the barriers to entry created by the Jones Act would result in more carrier competitors entering those trades and thus largely precluding the ability of carriers to engage in any of the practices of concern to Congress that result in unjust and unreasonable rates.

Setting aside for a moment the issue of elimination of the Jones Act restrictions, there is the possibility of a more fine tuned method of reducing barriers to entry into the noncontiguous domestic trades and thereby creating more meaningful competition

⁴⁴ See, East-West Protest Grows to Jones Act, Journal of Commerce, March 7, 1996, at p. 1, col. 2.

⁴⁵ See, e.g., National Security Importance of U.S. Maritime Cabotage, Maritime Cabotage Task Force (March 6, 1996).

in those trades and eliminating the "effects" of parallel pricing. Consideration should be given to the possibility of ameliorating the adverse effects of the Jones Act by eliminating that aspect of the legislation which arguably creates the greatest part of the entry barrier caused by that Act with respect to those components of the trade that do not qualify as competitive markets. Above all else, it is the requirement that Jones Act vessels be U.S. built which creates the most significant cost barrier to entry in the noncontiguous domestic trades. If this restriction were eliminated for the noncompetitive trades, foreign built vessels could be reflagged to U.S. registry with relatively minimal capital investment and significant opportunities for new entrants into the domestic trades would be created. While this modest action will undoubtedly be heard to adversely effect the U.S. shipbuilding industry, a matter that is also discussed further in the section of these comments concerning the need for additional shipper protections, it would certainly serve to increase the number of vessels in the U.S. flag fleet and thereby fulfill the more critical aspects of the alleged national security interests underlying the continued existence of the Jones Act.

It must also be noted that under current law, the Guam trade enjoys an exemption from the otherwise applicable Jones Act requirement that U.S. flag vessels serving the trade be built in

U.S. shipyards.⁴⁶ Theoretically, this exemption would allow more entrants into the Guam trade and increase competition, eliminating the concern over parallel pricing. However, as noted above, in the absence of extending this exemption to Hawaii, Guam will remain captive to the existing carriers who have combined Hawaii, Guam, and the transpacific trades in the manner necessary to efficiently operate in this trade.

E. Guam Shippers Are Captive: There Are No Meaningful Substitutes For Either The Transportation Services Or The Goods Transported

Unlike other shippers that have been deemed "captive" by U.S. regulatory agencies, Guam does not have any alternative form of transportation available to it that is remotely suitable or economical for the purpose of transporting the goods shipped on ocean going container vessels. Unlike other components of the domestic offshore trades, such as Alaska, Hawaii, or Puerto Rico, Guam does not have the ability to utilize tug and barge operations to effectively cap the rates charged by the two carriers. Nor can air cargo be considered a realistic option, unless the universe of options that is considered suitable for substitutability is any vessel that moves by air or water and has

⁴⁶ This *de facto* exemption from the U.S. built requirement of section 27 of the Merchant Marine Act, 1920, is based upon the ability of U.S. flag vessel operators to utilize vessels under foreign commerce registry to serve, *inter alia*, the Guam trade. See, 46 U.S.C. § 12105. Foreign commerce registry statutes and regulations do not impose a U.S. built documentation requirement as do the other Jones Act trades, which require a coastwise endorsement on documentation that includes the Jones Act U.S. built requirement.

potential cargo carrying capabilities -- regardless of price.⁴⁷

It has also been suggested from time to time that because Guam is served by foreign carriers, the rates charged by U.S. carriers are effectively capped by the rates charged for comparable goods from foreign sources.⁴⁸ This concept, the theory of substitutability of goods and services, essentially holds that at some point the costs of goods and services in the domestic offshore commerce of the United States becomes so high due to the favorable intervention of the Federal Government in favor of the carriers that unavoidable economic forces result in driving consumers of those goods and services into foreign markets.

However, for many "captive" Guam shippers, including the Department of Defense, such substitution of sources of supply is simply not an option. For example, a major component of the Guam trade is automobiles. Guam's DOT requires that only U.S. specification vehicles, left-hand drive cars, be used on the island. Japan doesn't generally produce left-hand drive cars. Thus, even assuming that U.S. public policy would somehow be

⁴⁷ Of the 22 major shippers of the top 15 imported commodities to Guam surveyed by GovGuam in this matter, only one shipper utilized air cargo service for any portion of its merchandise, i.e. watches from Europe.

⁴⁸ The Port Authority of Guam reports that of the 1,104,153 revenue tons of cargo imported to Guam, 87% (958,239 revenue tons) came from domestic imports while only 13% (145,914 revenue tons) came from foreign imports. Foreign flag capacity to Guam from Asian ports (90% of the foreign cargo) comes primarily from two foreign flag carriers (Kyowa and Palau/Kambara) each on a two week call schedule using 250 FEU vessels, or about 19% of the combined capacity of APL and Sea-Land. In 1996, PM&O started calling at Guam on a 21-day service carrying on average 20 FEU's per call. Zim (Australia) also calls at the island, but on an infrequent basis, also with small ships.

served by promoting Japanese cars on Guam, they are not a substitutable good. The Guam shippers of automobiles are captive to the U.S. carriers. They are not alone.⁴⁹ Thus, no external price constraint resulting from foreign market substitution opportunities exists in those cases, leading to unreasonably high prices in the absence of either another form of competitive or regulatory price constraint.

However, in those situations where substitution is possible in the long term, unless some form of domestic competitive or regulatory constraint is imposed on carrier pricing, substitution will occur causing a loss of economic activity to the domestic U.S. economy.⁵⁰ This phenomenon has, in fact, already occurred in the Guam economy to a discernable degree. Economic studies of the Guam economy have revealed that a dramatic increase in the flow of goods between Guam and the Far East has taken place beginning in the 1980's and continuing to this day. This has coincided with a significant increase in the GNP of Guam and it is widely regarded that the increase trade with the Far East has been a major catalyst for economic growth on the island.

⁴⁹ Other examples of "captive shippers" among the 15 top moving commodities in the Guam trade are: Tires (manufacturers recommendations require U.S. source for U.S. vehicles); Auto Parts (U.S. vehicle manufacturers source parts from U.S.); Fresh Fruits & Vegetables, Meat, Poultry and Eggs (Customs entry restrictions); Air Conditioners and other Manufactured Goods for Federal contracts (must comply with Buy American Act, 41 U.S.C. §§ 10a-10d).

⁵⁰ It is clear that to some extent basic commodities are being shipped to the Guam market from foreign sources, specifically, Frozen Meat and Toiletries from Sydney, Sugar from Brisbane, Men's Sweater Parts from Korea, and Canned Fish from Yokohama. Additionally, a cognizable volume of General Merchandise is imported from Yokohama through the Port of Agana. See, Appendix IV, *passim*. Some Watches and Jewelry are air lifted from Europe.

However, it must be noted that even the fortunate shippers with the ability to avail themselves of a substitute supply source in a foreign market will still have an excess cost imposed on them by the high transportation rates charged by a protected carrier. Shippers that can substitute supply sources should be enjoying even lower costs from a domestic market if the shipping rates were reasonable. One can only conclude from this situation that exploitative carrier pricing of transportation services has caused the Guam economy to be injured and increasingly alienated from the domestic U.S. economy and driven, albeit only incrementally, into the Far East (Japan) economic sphere.

A parallel situation has occurred with regard to the presence of the Department of Defense on the island of Guam. Up until recent years, the Navy maintained a very large presence on the island. At the time that the large bases in the Philippine Islands were closed it was widely assumed that these forces would be shifted to Guam, resulting in Guam becoming one of largest and most critical strategic base locations for the U.S. military in the world.⁵¹ However, in an environment where cost considerations have attained a paramount status of importance with DOD, a careful analysis of the costs of increasing the Navy's presence in Guam was undertaken in the context of the BRAC Commission inquiry.⁵² It was soon ascertained that the costs of

⁵¹ New Philippine Government Eyes U.S. Accord, *Jane's Defence Weekly*, July 1, 1992, Vol. 25, No. 7, at 638.

⁵² See, 10 U.S.C. § 2687 (1995); P.L. 103-421, Oct. 25, 1994, 108 Stat. 4354.

maintaining a large presence in Guam was prohibitive,⁵³ due largely to the costs of transporting personnel and supplies to and from that location.⁵⁴ The alternative strategic base site originally chosen was in Japan which although still expensive, enjoys a relative advantage in transportation costs due to the ability of DOD to conduct competitive procurements of ocean transportation services in the transpacific trades. While political considerations may have ultimately overridden the cost based considerations of relocating major DOD facilities to Japan in favor of Hawaii, an issue the Government of Guam is working to have DOD reopen and reexamine, the fundamental effects of transportation costs on DOD's sustainment and supply budgets cannot be denied.⁵⁵

Accordingly, unless it is the official policy of the Department of Transportation to encourage Guam to reduce its \$1.6 billion a year trade with the mainland and to push Guam into the economic sphere of our Asian allies, which GovGuam asserts is simply not conceivable, then it must be assumed that Guam shippers are indeed generally captive to the existing carriers.

⁵³ Navy Takes Major Hits in Latest BRAC Round, Navy News & Undersea Tech., March 6, 1995, Vol. 12, No. 9, ISSN 8756-1700.

⁵⁴ In a recent letter to Senator Pressler, among others, objecting to certain provisions of the ICC Termination Act, V.ADM. W.A. Earner, Deputy Chief of Naval Operations (Logistics) specifically noted that "[b]ecause of the high cost of transportation to Guam the Navy is considering shifting many personnel and operations to Japan." A copy of Admiral Earner's letter is attached to this report as Appendix IX.

⁵⁵ See, BSEC deliberations at 11.23.94 RP-0455-F8 and, at 12.19.94 RP-0514-F10.

As captive shippers, they are entitled to no less protection from the abuse of market power than captive shippers in other transportation markets overseen by regulatory agencies. GovGuam seeks nothing more and demands nothing less.

IV. THE RATE STRUCTURE IN THE GUAM TRADE

A. Summary

Guam asserts that the record of proceedings before the FMC reveals that the overall rate structure in Guam is of very secondary importance to the shippers in Guam due to the fact that each and every commodity rate charged by the carriers serving the trade exceeds a reasonable maximum. The most egregious example of the unjust rate levels imposed on shippers in the trade is the rate on the movement of household goods, which is undeniably the highest rate observed in the Pacific trades and cannot be justified on the basis of any calculation of carrier costs.

Nevertheless, the rate structure of the trade to Guam is of some concern to shippers in the trade due to the practice of carriers imposing general rate increases as a percentage of underlying rates. Over time this distorts the relationship between high rated and low rated commodities. The correction of the rate structure by carriers should be subject to regulatory review with shipper input to ensure that commodity rates are generally based on costs.