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June 17, 2002

**Berliner
Candon
Jimison**

Washington, Los Angeles,
Berkeley and Sacramento
A Professional Corporation

BY COURIER

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



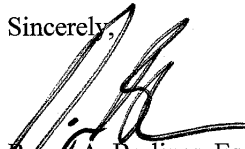
**Re: Government of the Territory of Guam v. Sea-Land Service, Inc.,
and Matson Navigation Company, Inc., STB Docket No. WCC - 101**

Dear Secretary Williams:

Enclosed are an original and 10 copies of "Reply 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,


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

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Enclosures

cc: All Parties of Record

1225 19th Street, NW, Suite 800
Washington, DC 20036-2489
Telephone 202.955.6067
Fax 202.822.0109

**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-187



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



Roger A. Berliner, Esq.
Mary Eva Candon, Esq.
Mark R. Gisler, Esq.
Megan M. Grant, Esq.
Berliner, Candon & Jimison
A Professional Corporation
1225 Nineteenth Street, NW
Washington, DC 20036
(202) 955-6067

**On Behalf of the
Government of Guam**

June 17, 2002

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**GOVERNMENT OF THE
TERRITORY OF GUAM,**

V.

Defendants.

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

-1-

- Defendants continue their quest to elevate a provision intended to provide carriers' limited flexibility in proposing rate adjustments (the Zone of Reasonableness or "ZOR") above the fundamental obligation of the Board to establish reasonable rates. This complaint proceeding will establish the maximum reasonable rates that Defendants can charge in the trade as of the date of GovGuam's complaint going forward until rates consistent with the Board's ruling are put in effect, and going back from the date of GovGuam's complaint for the two-year statute of limitations as determined in Phase I.
- Defendants have requested the Board to ignore its statutory duty to ensure reasonable rates on the alleged grounds that "there is no remedy that could be based on a determination of aggregate unreasonableness that would be both meaningful and reasonable for shippers." Defendants' Submission at 2, no. 3. Defendants' position in this regard is (a) nothing other than a recasting of a legal argument they lost in Phase I wherein this Board affirmed GovGuam's right to challenge the overall revenues earned by the Defendants; (b) directly contrary to the broad scope of the Board's authority to fashion a "just" remedy in a complaint case filed by a governmental entity; (c) wrong -- this Board has repeatedly found that an across-the board percentage rate reduction is a reasonable remedy; (d) premature insofar as reparations are within the scope of Phase III; and (e) unlawful since it would violate both the rule of the case and the fundamental obligation of the Board to enforce its statutory obligation to ensure reasonable rates.
- The competition issue, as raised by Defendants, misstates the law and is a complete red herring. Contrary to Defendants' misrepresentations, the Board has only required an examination of the effectiveness of competition as a predicate to a rate reasonableness review when there has been an "explicit directive" from Congress that it do so. Congress did not require such a showing in the context of the Board's obligation to ensure rate reasonableness in the domestic offshore trades, and the Board must not here.
- Defendants' insistence upon utilization of constrained market pricing ("CMP") principles and the application of the Stand Alone Cost Constraint ("SAC") in particular ignores their fatal flaws in this context. GovGuam submits the problems inherent in creation of a hypothetical model in a trade characterized by an artificial lack of competition and other constraints caused by the Jones Act, as well as the practical impossibility of obtaining cost and other financial data from foreign, third party carriers to feed into such a model, would result in a far less reliable analysis than would the application of G.O. 11 to real costs and revenues. If, contrary to GovGuam's view, the Board decides to limit GovGuam to application of the CMP methodology in this case, GovGuam, as the complainant, is entitled to select, after appropriate discovery, either revenue adequacy or stand-alone cost constraint methodologies.
- Defendants' arguments against application of the only methodology used to evaluate rate reasonableness for ocean carriers in the domestic offshore trades -- G.O. 11-- regurgitate previous legal arguments found by the Board to be unpersuasive. Their principle public

policy argument advanced here -- that application of G.O. 11 would have differing economic impacts on them -- is equally true of any methodology the Board could select.

**I. THIS PROCEEDING WILL DETERMINE
THE MAXIMUM REASONABLE RATE
DEFENDANTS MAY CHARGE IN THE TRADE
AS OF SEPTEMBER 1996 UNTIL SUCH DATE AS
THE LEGALLY PRESCRIBED RATES ARE PUT IN EFFECT**

Defendants assert that "GovGuam's complaint challenges all the defendants' rates in effect from September 10, 1996 to September 10, 1998." Defendants' Submission, p. 6. Defendants further assert that "in order to give some meaning and effect to the ZOR," it is "necessary at the outset to identify the 'base rates' that GovGuam is challenging." Id. Defendants request that the Board find that it is the rates in effect in September 1996 that are the base rates subject to GovGuam's challenge. Defendants' Submission, p. 7.

Defendants either misapprehend the nature of GovGuam's challenge or seek to mislead the Board regarding GovGuam's challenge. In either case, GovGuam submits that based on Defendants' submission, and their apparent effort to once again elevate the limited scope of the ZOR above rate reasonableness, additional clarity is required at this point regarding the fundamental nature of this proceeding.

The law requires Defendants' rates to be reasonable. ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 (ICCTA), 49 U.S.C. 13701(a)(1)(B). It grants GovGuam the right to file a complaint challenging the reasonableness of Defendants' rates. 49 U.S.C. 13701(c). And, as the Board noted, "a governmental authority is explicitly permitted to pursue a complaint on behalf of shippers affected by rates asserted to have been unreasonable, 49 U.S.C. 13701(d)(4)." Decision, pp. 2-3. Should the Board conclude, as the FMC did, that Defendants'

rates are unreasonable, the Board is required to “prescribe” the maximum lawful rate “to be applied for such transportation or service.” 49 U.S. C. 13701(b).

These provisions are separate and apart from the rights accorded defendants and shippers in connection with proposed rate changes as set forth in 49 U.S.C. 13701(d)(1), 13701(d)(2), and 13701(d)(3). GovGuam has not challenged a proposed rate change by Defendants under these provisions, provisions which this Board has determined is not controlling with respect to GovGuam’s complaint. Critically, the Board concluded, based on the legislative history of the ICCTA, that the distinct right of the defendants to propose rate changes, and to have those changes be deemed reasonable if they fall within certain statutorily prescribed bounds, does not immunize defendants from a broader complaint challenging the overall reasonableness of the underlying rates unrelated to proposed changes. Decision at 8.¹ As the Board concluded: “we cannot read a provision protecting “proposed” rates as immunizing existing rates that were found unreasonable when they were challenged before the FMC.” Id at 9.

The Board’s ruling in Phase I was consistent with its precedent regarding the relationship of the ZOR to complaint proceedings of the nature at issue here. As the Board held in Trailer Bridge, Inc. v. Sea Star Lines, LLC, STB Docket No. WCC-104 (October 27, 2000), slip op at 4.

¹ In its Decision, p. 8, the Board explained that the ZOR for non-contiguous domestic trade appears to have been modeled after the zone of rate freedom adopted for motor carriers in the Motor Carrier Act of 1980, Pub. L. No. 96-296, 94 Stat. 793 (1980) (“MCA”) rather than the ZOR contained the Staggers Rail Act of 1980, Pub. L. 96-448, 94 Stat. 1895 (“Staggers”). The Board (Decision, pp. 8-9) distinguished between the ZOR found in the MCA and Staggers Act indicating that the Staggers ZOR is more expansive than that found in the MCA in that the Staggers ZOR applied only to base rates that were found reasonable after a complaint, or that were deemed reasonable because they were not challenged within a 180-day window. The Board concluded that Staggers established a specific procedure for immunizing base rates which is in stark contrast to both the ZOR MCA and the ICCTA’s non-contiguous domestic trade ZOR. Decision, p. 9, n. 20.

[t]he ZOR is not dispositive of the determination to be made here. The ZOR is used to ascertain if specific rates are unreasonably high or low. . . . Trailer Bridge is not challenging any specific Sea Star rate here but, rather, is challenging defendant's overall rate structure as predatory.

Despite the effort to confuse this matter, the law is clear: Guam's challenge to the overall revenues of the carriers is unaffected by the ZOR.

GovGuam filed its complaint on September 10, 1998. The Board's responsibility is to assess the reasonableness of Defendants' rates as of that date through the pendency of this proceeding and to prescribe maximum lawful rates for the future. In addition, the Board concluded in Phase I of this proceeding that GovGuam's complaint is subject to a two-year statute of limitation. Decision, p. 7. Accordingly, the Board's obligation is to (1) determine the maximum lawful rates that Defendants were authorized to charge from September 1996, until such time as new tariffs are filed in conformance with a final, non-appealable order, (2) compare it with the rates that were charged, and (3) provide for "just" reparations for the difference. It is really that simple and straightforward.²

**II. THE ISSUE OF WHETHER GOVGUAM
HAS THE RIGHT TO CHALLENGE DEFENDANTS' RATES
ON THE BASIS OF TOTAL REVENUES IS SETTLED
AND DEFENDANTS' RELITIGATION OF THIS ISSUE
SHOULD BE SUMMARILY REJECTED**

Defendants make two related assertions, both of which are completely improper as a matter of law and utterly unfounded as matter of public policy: (1) "there is no reasonable methodology for assessing the reasonableness of the totality of the rates in effect ... because those rates ... varied widely" (Defendants' Submission, p. 9); and (2) "there is no way that such a

² See also Reply Verified Statement of Philip Burris, Section II.

determination could serve as the basis for a remedy to shippers that would be meaningful to shippers and, at the same time, reasonable and non-arbitrary” (Defendants’ Submission, p. 11). Defendants conclude: “[i]n sum, there is no methodology for assessing the reasonableness of rates in the aggregate that could provide remedies to shippers that would be both meaningful and reasonable.” Defendants’ Submission, p. 12.

GovGuam submits that Defendants are blatantly and improperly seeking to re-litigate a legal issue conclusively resolved in GovGuam’s favor in Phase I of this proceeding: GovGuam has the legal right to challenge the totality of the rates charged by Defendants on the basis of their total aggregate revenues. Decision at pp. 3-5. The Board’s determination in this regard, like the FMC’s before it, is not only a proper interpretation of GovGuam’s statutory right, but is now the law of the case. Accordingly, all of Defendants’ arguments in Section II of its initial submission on pages 7-13, must be summarily disregarded in their entirety.

Defendants seize upon dicta in the Board’s Phase I ruling as the basis for their improper collateral attack, dicta wherein the Board stated that “[the STB] will determine, in Phase II of the proceeding, whether there is a reasonable methodology for assessing a rate structure complaint in this trade.” Decision, p. 5. GovGuam suggests that the Board’s choice of language here was unfortunate. “Whether” is not the issue in Phase II; “how” is the only issue. If whether was at issue it could imply that the Board, having found that GovGuam has the statutory right to challenge Defendants’ rates on the basis of their aggregate revenues, may have a legal right without a remedy. Such a conclusion would effectively negate GovGuam’s statutory right and the Board’s most fundamental obligation. There can be no dispute that Congress in the ICCTA has tasked the Board with performing the FMC’s former function: regulating the reasonableness

of rates for noncontiguous domestic trades. It is simply not possible that Congress intended to permit the STB to choose whether or not it wishes to enforce the statute. The Board does not have the option of throwing up its hands, as urged by the Defendants.

Nor will it be necessary, as Defendants allege, for the Board "to conduct a further proceeding to determine which of the hundreds of rates were reasonable and which were unreasonable." Defendants' Submission, p. 11. To paraphrase a former President: read our lips -- the reasonableness of any specific rate for an individual commodity is irrelevant to this proceeding. It is not within the Defendants' prerogative to reframe GovGuam's complaint. The Board has concluded that GovGuam has the right to assess the reasonableness of the rates in their totality. Should the Board conclude, as GovGuam is confident it will, that the Defendants are collecting revenues in excess of that which is reasonable, reparations will be in order.

In assessing reparations, a matter to be determined in Phase III, the Board will naturally be guided by 49 U.S.C. 13701(d)(4), which reads as follows:

(4) REPARATIONS.-- Upon a finding of violation of subsection (a), the Board shall award reparations to the complaining shipper or shippers in an amount equal to all sums assessed and collected that exceed the determined reasonable rate, division, rate structure, or tariff. Upon complaint from any governmental agency or authority, and upon a finding or violation of subsection (a), the Board shall make such orders as are just and shall require the carrier to return, to the extent practicable, to shippers all amounts plus interest, which the Board finds to have been assessed and collected in violation of subsection (a). (emphasis added)

Unlike the Defendants, the statute makes a clear distinction in three significant ways between reparations that may be awarded in the context of a complaint brought by a specific shipper and reparations that may be awarded in the context of a complaint filed by a governmental authority. Rather than require an exact accounting -- as is normally the case for complaints involving individual shippers -- the first obligation of the Board in the context of a

complaint filed by a governmental authority is to fashion a “just” award. This inherently equitable approach by definition encompasses many possibilities beyond those prescribed for specific shippers and recognizes the very different nature of a trade-wide complaint as opposed to a specific commodity rate challenge. The second directive to the Board is to compensate the shippers represented by the government “to the extent practicable.” This qualifier is conspicuously absent in the statutory instruction to the Board in the context of a complaint case filed by an individual shipper, and is itself an explicit recognition of the unique nature of a complaint case filed by a governmental entity. Again, by definition, the distinction made in the statute provides the Board with greater latitude in structuring a reparations award. And finally, the statute requires the Board to provide “interest” in the context of a complaint case filed by a governmental entity, a significant economic factor not included in the context of a complaint case filed by an individual shipper. In this manner, the statute recognizes the broader ramifications of a trade-wide complaint, brought by a governmental entity; ramifications that have broader economic consequences for the offending carrier.

Thus, the specific reparations provision of the governing statute pertaining specifically to a complaint filed by a government conclusively rebuts Defendants’ various arguments set forth throughout pages 7 - 13 that only reparations based on an analysis of each shipment to each shipper for each commodity are “meaningful” and “non-arbitrary.” A “just” award is not constrained to such a mechanical calculation. Accordingly, the Board should rule that GovGuam will be free to put forth “just” and equitable remedies as authorized by 49 U.S.C. 13701(d)(4).

Notwithstanding all of the above, it is also beyond dispute that reasonable methodologies already exist that satisfy the statute. This Board, using the precise methodology advocated by

Defendants, has found that across-the-board rate reductions are appropriate remedies. See, e.g., FMC Corp. v. Union Pacific Railroad Co., STB Docket No. 42022 (May 12, 2000); see also; Arizona Public Service Company and PacifiCorp. v. The Atchison, Topeka and Santa Fe Railway Company, 1997 WL 420253 (STB approved of a “percentage rate reduction method for calculating the maximum reasonable rates for the Arizona traffic.”); Coal Trading Corp., et al. v. the Baltimore and Ohio Railroad Co., et al., 6 I.C.C.2d 361, 1990 WL 287339. In addition, across-the-board percentage remedies are equally well settled under G.O. 11 as applied by the FMC.

In a classic example of the extent to which Defendants must stretch to justify their untenable rehash of lost legal issues, Defendants argue that because the Board stated that “a finding that rates in the aggregate are unreasonable would not necessarily require across-the-board rate reductions as a remedial measure,” (Decision at 4), “the Board seems to have agreed that a remedial order requiring across-the-board rate reductions would not be a rational remedy.” Defendants’ Submission at 12. That is one heck of a leap. GovGuam submits that a more reasoned interpretation of the Board’s statement is simply that there are any number of reparation options that can be explored, not just this one. There is no basis in either the statement made by the Board, or in its prior decisions, to suggest that an across-the-board reduction would not be “rational.”

While across-the-board reductions is one meaningful and reasonable approach to reparations, GovGuam does not rule out the possibility of advocating others in Phase III. Insofar as the gravamen of GovGuam’s complaint is excess revenues, the precise manner in which the carriers conform their tariffs to reflect reasonable revenues is of secondary significance.

GovGuam's primary interest is in ensuring that GovGuam no longer serves as the trade's "Golden Goose." Accordingly, GovGuam is prepared to explore flexible approaches to reparations as long as the totality of the rates do not exceed the maximum lawful revenues appropriate for the trade.

Moreover, there is an additional reason why creative options may be worth exploring in Phase III. This case is, on many levels, a case of first impression for the Board. As noted above, one of the most significant unique aspects of the case is that it is the first instance in which a government has filed an action on behalf of all shippers in the trade. Assuming, as GovGuam does, that the Board concludes that the Defendants have earned many millions in excess revenues since September, 1996, GovGuam does not rule out, *a priori*, advocating that a fund be established with the excessive revenues earned for the purpose of making needed improvements in Guam's port facilities, improvements that would benefit all shippers. Such a remedy, used in conjunction with an across-the-board reduction for future shipments, would actually benefit the Defendants as well and would satisfy the statutory requirement for a "just" outcome.

In sum, Defendants' arguments with respect to the inability of this Board to fashion a lawful and just remedy in this proceeding are contrary to law, the rule of the case, the scope of this phase of the proceeding, Commission precedent, and Complainant's rights in Phase III. They must be dismissed and disregarded in their entirety.

**III. DEFENDANTS HAVE FAILED TO DEMONSTRATE -- NOR CAN THEY --
THAT CONSTRAINED MARKET PRICING CONSTRAINTS
ARE A MORE EFFECTIVE REGULATORY TOOL THAN G.O. 11
IN THE CONTEXT OF ASSESSING RATE REASONABLENESS
IN THE DOMESTIC OFFSHORE TRADES**

Notwithstanding Defendants' submission, the only issue in this phase of the proceeding is

determining which methodology or methodologies are available to GovGuam to prove the unreasonableness of Defendants' rates *in toto*. GovGuam submits that unless this Board concludes that a particular methodology would produce unreasonable results, the Board should adhere to its general policy: "we generally agree that a complainant should be allowed to present the type of case it chooses." CF Industries, Inc. v. Koch Pipeline Company, L.P. 1997 WL 245340, *5 (I.C.C.) Here, nothing contained in Defendants' initial submission demonstrates why this Board should prevent GovGuam from using the only method ever used to assess rate reasonableness in the domestic offshore trades -- G.O. 11, and certainly provides no basis to conclude that constrained market pricing constraints are a more effective tool for doing so in this particular context.

A. Constrained Market Pricing Principles are Particularly Ill-Suited to the Guam Trade

Defendants assert that this Board should adopt "constrained market pricing" because "they are founded on economic concepts and considerations of regulatory policy of general applicability." Defendants' Submission at 14. GovGuam will certainly not dispute that CMP is founded on "economic concepts." However, GovGuam does dispute, as set forth in its initial submission and herein, that the economic concepts underlying CMP, including the directive to fashion a methodology that would make the targeted rail industry economically healthier, is the most appropriate tool in this specific context. GovGuam is supported in this conclusion by Mr. Philip Burris, who probably has more experience in the application of CMP by this Board than any other outside expert in the country.

Defendants make two principal arguments in support of applying CMP here: (1) that the Board applied CMP in a pipeline case even though it was not required to do so; and (2) if the

Board were to apply instead a rate methodology that used “actual costs and rate bases of the two carriers, their rates would necessarily be found reasonable or unreasonable to different degrees.” Defendants’ Submission at 16-17. Neither of these arguments justify the Board deviating from its general policy of allowing GovGuam to put on its case as it chooses.

First, while Defendants make much of the application of CMP by the Board to a pipeline case, there is much less significance to the Board’s choice in that matter than Defendants present. First, as the Board observed, in that case both parties agreed “that the principles of CMP are appropriate for evaluating the reasonableness of Koch’s rates.” Koch Pipeline at *4. The issue before the Board in that proceeding was not whether to impose CMP on the complainant, as Defendants would have the Board do here, but rather, whether complainant would be required to use a particular form of CMP.

Moreover, it is hardly surprising that the parties concurred that CMP was appropriate in that context. As the Board observed, the statutory provision that governs rate reasonableness for pipelines specifically authorizes the use of a CMP approach: “[a]s noted, section 15503(a) provides that, in prescribing a rate, ‘the Board may utilize rate reasonableness procedures that provide an effective simulation of a market-based price for a stand alone pipeline.’” Id. Significantly, the same statute did not provide any such guidance to the Board in the context of rate reasonableness for ocean carriers in the domestic offshore trades.

Defendants also argue that the use of G.O. 11 will have the “perverse” result of penalizing the most cost-efficient carrier. This is nonsense. As Mr. Burris points out, the result of the application of any regulatory standard in this proceeding, in conjunction with market forces, will have differing consequences for each carrier. That is true whether the Board applies

G.O. 11 of CMP. It is the natural consequence of regulation: any determination of maximum reasonable rates will have differing effects on different carriers.

More broadly, and as set forth more fully in Mr. Burris verified statement, GovGuam contends that application of CMP is subject to serious limitations and problems if applied in the ocean carrier trades and the Guam trade in particular. In order for SAC to be a viable option in this proceeding, which GovGuam submits that the Board must find if it is to require GovGuam to use CMP, it must go far beyond what it has to date in rail proceedings.³ While the Coal Rate Guidelines provide a theoretical basis for a wide range of options in the construction of a hypothetical stand alone carrier, within the rail context in which it has been used, the range has been quite limited. For example, in considering what traffic will be moved by the hypothetical system, the rail cases have uniformly focused on the traffic actually moved by the Defendants. In this instance, GovGuam would have to be afforded the right to construct a hypothetical carrier that moves volumes other than those actually carried by Defendants in this proceeding and even combines the volumes of both carriers into one, more efficient carrier. This has never been done before.

GovGuam will also require the Board to fundamentally alter the determination of maximum reasonable rates for the issue traffic within the context of the SAC constraint. CMP strives to maintain differential pricing and, accordingly, seeks to maintain the existing relationship among the rates of the members of the shipper group. By reducing the issue rates by

³ In Section V of his Reply Verified Statement, Mr. Burris sets forth the breadth of latitude required for application of SAC in this specific context, should the Board mandate CMP here over Complainant's objections.

the percentage that aggregate revenues exceed aggregate costs, the theory is that the relationship among the rates has been maintained and thus, differential pricing has also been maintained.

In the Guam trade, the shipper group consists of only highly competitive transpacific traffic and the captive Guam traffic. Since the transpacific traffic is highly competitive, it may be priced at just above the carriers' marginal costs and because the Guam trade is a very small portion of the overall shipper group that would be included in any profitable stand-alone carrier, any surplus aggregate revenue over aggregate cost would be relatively small. Moreover, this surplus is attributable to the high rates paid by the captive Guam traffic rather than the low rates paid by the competitive transpacific trade. As a result, the STB's current practice under SAC of reducing the issue traffic by the percentage that aggregate revenues exceed aggregate costs would not provide sufficient relief to the Guam shippers. Finally, since the rates on competitive traffic are likely to be at or just above marginal costs, it is possible that an across-the-board reduction would result in rates for this traffic that are less than the carriers' marginal costs. If so, the Guam traffic at the higher rates would essentially be cross-subsidizing the competitive traffic in violation of the CMP Management Efficiency constraint that prohibits carriers from forcing captive traffic to cross-subsidize competitive traffic that moves at rates that are less than marginal costs. Such a result here would be a travesty, allowing Defendants to continue their exploitation of the Guam trade.

Finally, and significantly, one serious problem with the SAC constraint in this proceeding would be obtaining third-party discovery from foreign carriers. Unlike the case with domestic railways, neither the STB nor the courts has jurisdiction to compel foreign carriers to comply with discovery.

These are not minor matters. They go to the heart of the manner in which SAC has been applied by the Board. And they do not work here. GovGuam submits that only if the Board were to conclude that there is no other acceptable option, would it require the use of CMP under such circumstances. Given the availability of G.O. 11, that is a conclusion that GovGuam submits the Board can not reach.

B. There is no Basis for the Board to Require an Analysis of Competition in the Guam Trade as a Prerequisite for Determining the Reasonableness of Defendants' Rates

Defendants assert that "the Board [is required] to make a ... threshold determination that there was insufficient competition in the Guam trade in September 1996 ... before ... [determining] whether the aggregate rates of the carriers were unreasonable." Defendants' Submission, p. 19. To support this conclusion, Defendants rely heavily upon Koch Pipeline for the following astounding proposition: although "the statutory provisions pertaining to pipeline rates (like those applicable here) do not make a finding of market dominance a jurisdictional prerequisite to rate regulation, the Board held that sound regulatory policy requires a finding of ineffective competition before the Board may engage in rate regulation." Defendants Submission, p. 18.

GovGuam submits that Defendants have seriously misstated the law and this Board's conclusions in Koch. They know better. It is true that the Board did require a showing of market dominance as a prerequisite to a rate reasonableness determination in Koch. It is patently not true that the Board had any discretion in the matter: the Board specifically concluded that "[i]n light of the explicit directive of section 15503(b)(3), a market power inquiry is an essential consideration as we exercise our rate review authority." Koch at *7,8 fn.15. The Board could not have been clearer: "[o]ur understanding of the (b)(3) provision is that Congress intended that

we exercise our rate prescription powers only where a shipper lacks effective competitive alternatives.” Id at *4.

The extent to which Defendants have misstated the Board’s conclusions in Koch demonstrates many things, but for purposes of this pleading, GovGuam will limit its observations to the effect on their otherwise unfounded argument. The difference between the “explicit” Congressional directive as it relates to pipelines as set forth in Section 15503(b)(3) and the complete absence of any similar provision as it pertains to the Board’s jurisdiction over ocean carriers in the domestic offshore trades could not be more revealing. Congress made a critical distinction between the two transportation modalities, and with good reason. Competition is not a predicate to reaching the issue of ocean carrier rate reasonableness and the Board should summarily reject Defendants’ unbecoming and inappropriate argument.⁴

Moreover, contrary to Defendants’ extended argument and attached employee statements on the competition issue, and as discussed in great detail by the Reply Verified Statement of Dr. Nadel, the Guam trade clearly is not competitive by any measure. “The only prima facie case that the facts and economic analysis support is that competition is sorely lacking, and that the trade is a very non-competitive duopoly with rates being greatly in excess of costs.” Nadel Reply Verified Statement at 1. Dr. Nadel is supported in his conclusions in this regard by Mr. Burris: “Defendants’ argument that the Guam trade is competitive runs contrary to a significant body of evidence that suggests that they price the Guam Trade as duopolists.” Burris, Reply Verified

⁴ Finally, as is true with most of Defendants’ arguments in this Phase, this “threshold issue” should have been raised in Phase I wherein the parties were to address such legal issues. On this basis alone, it would be proper for the Board to conclude that Defendants are now barred from raising this matter at this late hour.

Statement at 11. Accordingly, insofar as a matter of law, there is no basis to assess the effectiveness of competition as a prerequisite to determining rate reasonableness, and since the overwhelming factual evidence that does exist supports GovGuam's view that the Jones Act and other factors effectively preclude competition, the Board must affirm GovGuam's unconditional right to a rate reasonableness determination.

C. The Board, Consistent with Its Policy, Should Reject Defendants' Effort to Select for Complainant Any Specific Methodology

If, contrary to GovGuam's position, the Board precludes GovGuam from employing G.O. 11, it should nonetheless completely reject Defendants' effort to prescribe which of the CMP constraints GovGuam may invoke in Phase III. It is well established in STB proceedings that the Complainant is entitled to choose among the various CMP methodologies. See, CF Industries, Inc. v. Koch Pipeline, 1997 WL 245240. Moreover, as discussed by Mr. Burris, Defendants' arguments regarding the alleged superiority of SAC over revenue adequacy are totally without merit. It is, and must remain complainant's right to select the methodology of its choice, particularly if that choice is limited to CMP.

**IV. THERE IS NO BASIS IN LAW OR PUBLIC POLICY
TO DENY GOVGUAM THE RIGHT TO EMPLOY
THE ONLY METHODOLOGY EVER EMPLOYED
TO ASSESS RATE REASONABLENESS
IN THE DOMESTIC OFFSHORE TRADES**

Defendants seek to convince this Board that it should preclude GovGuam from utilizing G.O.11, even though G.O.11 is the only methodology used to assess rate reasonableness in the trade and, more to the point, it is the precise methodology that the FMC used recently in concluding that the ocean carriers serving Guam extracted unreasonable revenues from the trade. Defendants' argument here, like many of those that precede it, is fundamentally a rehash of the

legal arguments they lost in Phase I and legal arguments they lost before the FMC. They are now trying for their third bite of the apple.

This Board has already ruled that GovGuam is not precluded as a matter of law from invoking G.O. 11, after fully taking into account the statutory context and legislative history surrounding ICCTA. Decision, p. 4. The Board concluded, and the law of the case for purposes of Phase II and III is that “Congress did not clearly articulate a preference for the regulatory approach of the ICC or the FMC. In fact, it is reasonable to infer that Congress knew that a major GovGuam case was pending at the FMC, and that it left it to the Board to decide whether or not to follow whatever approach the FMC might finally adopt.” Decision at 4. Accordingly, GovGuam urges the Board to reject all of the arguments advanced by Defendants on pgs. 27-34 of their initial submission wherein they reargue statutory construction and legislative history⁵

Tellingly, when Defendants do finally specify alleged “glaring shortcomings” of G.O. 11, the very first lament is that “the FMC’s methodology provided no specific information about the lawfulness of particular rates.” Defendants’ Submission at 35. GovGuam suggests that this is akin to beating a dead horse: insofar as GovGuam is not challenging the lawfulness of any particular rate, the fact that G.O. 11 does not provide any information relevant to the lawfulness of particular rates is itself irrelevant. It does provide useful information, as demonstrated by the FMC, about the lawfulness of the totality of Defendants’ rates. That is what G.O. 11 does well,

⁵ See e.g. “[a]s part of the transfer of regulatory authority over water carriers in the non-contiguous domestic ocean trades effected by the Interstate Commerce Commission Termination Act (“ICCTA”), Pub.L. No. 104-88, 109 Stat. 803 (1995), Congress repealed the underlying statutory bases for G.O. 11, and the FMC regulations were rescinded”, Defendants’ Submission, p. 27; “FMC financial reporting and rate regulation procedures arose in a particular statutory context that no longer exists . . . [and] the statutory regime administered by the Board differs substantially from that formerly administered by the FMC.” Defendants’ Submission, p. 29.

and that is what GovGuam seeks here.

Defendants also criticize G.O. 11's reliance upon the Fully Distributed Cost (FDC) methodology for "allocating costs between the various components of a mixed regulated/unregulated service of which Guam is a relatively small," claiming that it has "anomalous applications" in the Guam trade. Defendants' Submission at 35-36. GovGuam does not contest that G.O. 11 performs the important task of allocating costs as between the regulated and unregulated trades. However, it is a task that G.O. 11 has performed admirably well. Moreover, to the extent there is any concern regarding "anomalous applications", GovGuam submits that the odds of such a result are far greater in the context of constructing a completely hypothetical carrier than relying upon a time-tested methodology designed for this purpose.

GovGuam confesses that it does not understand the Defendants' unintelligible concerns regarding the application of historic G.O. 11 data to future rates and capital investments, as set forth in Defendants' Submission on p. 36. Nonetheless, GovGuam is confident that this agency, like the FMC, will have no difficulty in accurately obtaining and applying past period data for the periods at issue. To the extent that Defendants are expressing concern that potential reparations and lower rates could have an adverse impact on their current corporate plans, that is a reality faced by every regulated entity.

As to the Defendants' observation that the Board could not perform a G.O 11 analysis insofar as it does not have the financial data from the carriers in the form used by the FMC for that purpose, GovGuam simply replies that this is not a problem. GovGuam respectfully suggests that the carriers have all the information required to make this analysis accurate, and that the Board has all the authority it requires to obtain it.

These are the four "glaring shortcomings" upon which Defendants base their contention that the Board should reject G.O. 11. With all due respect, these are not even issues of any moment, let alone dispositive considerations. Indeed, the very weakness of the presentation underscores the reasonableness of G.O. 11.

CONCLUSION

For the reasons set forth above, and in the accompanying verified statements of Mr. Burris and Dr. Nadel, GovGuam respectfully requests that the Board find that in the context of this specific proceeding, G.O. 11 is superior to CMP to determine the maximum reasonable rates of Defendants from September, 1996 going forward.

Respectfully submitted,



Roger A. Berliner
Mary Eva Candon
Mark R. Gisler
Megan M. Grant
Berliner, Candon & Jimison
1225 Nineteenth Street, N.W., Suite 800
Washington, D.C. 20036
(202) 955-6067

Attorneys for the Government
Of the Territory of Guam

June 17, 2002

CERTIFICATE OF SERVICE

I hereby certify that I have, this 17th day of June, 2002, caused a copy of the foregoing **“Reply 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:

C. Jonathan Benner
Leonard L. Fleisig
Troutman Sanders
401 Ninth Street, N.W.
Suite 1000
Washington, D.C. 20004

By Courier

Robert T. Basseches
David B. Cook
Eric C. Jeffrey
Shea & Gardner
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036-1806

By Courier

Richard A. Allen
Andrew R. Plump
Zuckert, Scoutt & Rasenberger, L.L.P.
888 - 17th Street, N.W.
Suite 600
Washington, D.C. 20006-3939

By Courier

Maryellen B. Cantanni
APL Limited
1111 Broadway
Oakland, CA 94607-4036

By First Class Mail

Kevin C. O'Rourke
Matson Navigation Company
333 Market Street
San Francisco, CA 94105-2102

By First Class Mail

Alan A. Rudnick
CSX Corporation
P.O. Box C-32222
Richmond, VA 23261-2222

By First Class Mail

Peter J. Shudtz
CSX Corporation
One James Center
901 E. Cary Street
Richmond, VA 23119-4057

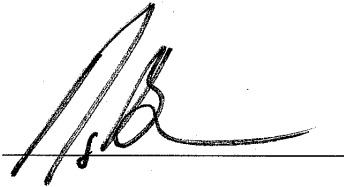
By First Class Mail

Rick A. Rude
Law Office of Rick A. Rude
207 Park Avenue
Suite 103
Falls Church, VA 22046

By Courier

Bjarne R. Henderson, Lt. C.
Assistant Staff Judge Advocate
HQMTMC
Attention: MTJA
Hoffman Building #2
Room 12N67
200 Stovall Street
Alexandria, VA 22332-5000

By Courier

A handwritten signature in dark ink, appearing to be 'R. Berliner', written over a horizontal line.

Roger A. Berliner, Esq.
Mary Eva Candon, Esq.
Mark R. Gisler, Esq.
Megan M. Grant, Esq.
Berliner, Candon & Jimison
A Professional Corporation
1225 Nineteenth Street, NW
Suite 800
Washington, D.C. 20036
(202) 955-6067
Fax: 202-822-0109

Counsels for Complainant
Government of the Territory
of Guam

A

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

**GOVERNMENT OF THE
TERRITORY OF GUAM
Complaint**

V.

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

)
)
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)
) **Docket No. WCC-101**
)
)
)
)
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Reply
Verified Statement
of

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

On Behalf of
Government of the Territory of Guam

Due Date: June 17, 2002

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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. I am the same Philip H. Burris that submitted an Initial Verified Statement ("IVS") on behalf of the Government of the Territory of Guam ("GovGuam") on April 23, 2002. My qualifications are attached as Exhibit __ (PHB-1) to my IVS.

Because of my extensive familiarity with Constrained Market Pricing ("CMP") principles for determining maximum reasonable rail rates before the Surface Transportation Board ("STB or Board"), and its predecessor agency the Interstate Commerce Commission ("ICC").¹ GovGuam requested that I comment on the use of CMP principles as a regulatory standard to determine maximum reasonable rates in this proceeding.² My comments regarding the use of CMP principles in this proceeding are included in my IVS.

GovGuam has now requested that I reply to Defendants' Initial Submission in Phase II – Appropriate Standards of Rate Reasonableness ("Initial Submission"),³ as it relates to the use of CMP principles as a regulatory standard in this proceeding. In addition, GovGuam has requested that I address the proper application of the CMP principles, were the Board to determine to use CMP principles as the regulatory standard in this proceeding.

In their Initial Submission, Defendants make numerous erroneous arguments regarding application of regulatory standards in general and various CMP constraints specifically.

¹L. E. Peabody & Associates, Inc. has participated in every proceeding before the ICC and the STB where CMP principles were developed and subsequently used to determine maximum reasonable rate levels.

²CMP was adopted by the ICC in its decision in Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines, Nationwide 1 I.C.C. 2d 520 (1985) ("Rate Guidelines").

³Defendants' Initial Submission was also filed on April 23, 2002.

Defendants' arguments related to CMP principles are frequently contradictory and demonstrate Defendants' lack of understanding of CMP principles, their development, and the historic application by both the Board and the ICC. Each of Defendants' erroneous arguments related to CMP principles is addressed in the balance of this verified statement. In addition, I address the proper application of CMP principles in this proceeding. This Reply Statement is organized under the following headings:

- II. Effective Date of Rate Reasonableness Determination in This Proceeding
- III. Across-the-Board Rate Reduction of Guam Rates is an Appropriate Remedy
- IV. CMP Principles as a Regulatory Standard in this Proceeding
- V. Proper Application of CMP Principles in this Proceeding
- VI. Conclusions

II. EFFECTIVE DATE OF A RATE REASONABLENESS DETERMINATION IN THIS PROCEEDING

In their Motion to Dismiss, Defendants argued that GovGuam is barred from challenging the Guam rates because these rates have not been increased by the amounts allowed by the "Zone of Reasonableness" ("ZOR") increases pursuant to Section 13701(d)(1) of the ICCTA. In its decision disposing of Defendants' Motion to Dismiss, served November 15, 2001 ("Decision"), the Board rejected Defendants' claim that GovGuam is barred from challenging Defendants' rates because the rates are within the levels permitted by ZOR. The Board indicated that the ZOR is not a safe harbor for base rates and applies only to *proposed* rates and the new rate would be deemed reasonable if the amount by which it increases the prior rate is within the ZOR. See Decision at page 8. Further, the Board concluded based on the legislative history of the ICCTA, that base rates are not immune from challenge.

The Defendants now attempt to give the ZOR new meaning by arguing that the base rates are those in effect on September 10, 1996 and that any reparations awarded after that date would be limited by the maximum allowable amount of the ZOR increases. Defendants arrive at the date of the base rates on the basis that reparations would be limited to two years prior to the date the complaint was filed, i.e. September 10, 1998. Defendants' position is without merit.

In its November 15, 2001 Decision in this proceeding, the Board indicated that the ZOR only applies to proposed rates. The Board stated: "...we cannot read a provision protecting "proposed" rates as immunizing existing rates that were found unreasonable when they were challenged before the FMC." This statement combined with Board precedent in railroad proceedings leads one to the following conclusions regarding the reasonableness of ZOR rate increases and prescribed rates.

First, GovGuam has filed a complaint related to the reasonableness of Defendants' published tariff rates under Sections 13701(a) and 13701(c) of the Interstate Commerce Termination Act of 1995 ("ICCTA"). Further, Section 13701(b) states that when the Board finds it necessary to stop or prevent the violation of Section 13701(a) the Board shall prescribe a rate which is reasonable.

GovGuam's complaint was filed on September 10, 1998 and the STB has an obligation to determine the reasonableness of the rates charged beginning on that date and through the pendency of this proceeding. The Board must also consider the reasonableness of the rates charged by Defendants during the two years previous to September 10, 1998.

One would expect that the Board will determine the reasonableness of all the rates, or the aggregate of all rates, charged by Defendants from September 10, 1996 through a final decision in the proceeding. Any increase or decrease in rates that the carriers have taken or will take during this

period is irrelevant to the Board's findings and will balance out in the reparations calculations.⁴ The Board will determine reasonable rate levels for each period during the pendency of the complaint and award reparations to the extent that the actual rates charged exceed maximum reasonable rate levels.

As GovGuam has filed a complaint as to the level of the published tariff rates the Board, if it determines the current and are unreasonable, will prescribe the maximum reasonable rates that Defendants may charge. In rail rate proceedings, the prescribed rate is the maximum reasonable rate and is the maximum amount that the railroad is allowed to charge. Stated differently, in rail proceedings, the prescribed maximum reasonable rate is *not* subject to ZOR increases. After all the prescribed rate is the *maximum reasonable rate*.

A rail carrier is not allowed to increase their rates above prescribed maximum reasonable levels, unless it demonstrates that circumstances have changed and the prescribed rate no longer represents a maximum reasonable level. (See STB Docket No. 41185, Arizona Public Service Company and PacifiCorp v. Atchison, Topeka and Santa Fe Railway Company, served July 29, 1997.)

More recently, in proceedings where stand-alone costs have been used, the Board has used the DCF model to prescribe maximum reasonable rates for the issue traffic for each quarter throughout the period of examination of the hypothetical carrier, most frequently 20 years. See FMC.⁵ The period of examination would include the entire reparation period. In this instance a 20

⁴See for example, STB Docket No. 42022, FMC Wyoming Corporation and FMC Corporation v Union Pacific Railroad Company, served May 12, 2000 ("FMC"), where the Board found UP's rates to be exceed maximum reasonable levels and ordered reparations based on its prescribed rates without regard to the fact that UP had taken two rate increases on the issue traffic during the pendency of that proceeding.

⁵In rail proceedings, the Board determines the maximum rate after considering a jurisdictional threshold calculation. In this proceeding such a calculation is not required.

year examination would extend from September 1996 through August 2016. See FMC.

To allow the Defendants to apply cumulative ZOR increases to maximum reasonable *prescribed rates* would render the term of *maximum reasonable rates* meaningless. ZOR increases are meant to provide Defendants flexibility to raise or lower rates that *have not been* prescribed by a maximum of 7.5 percent and 10.0 percent, respectively, without challenge. The ZOR is not intended to apply to rates that have been prescribed as a result of the filing of a complaint proceeding. This is supported by both the STB's application of maximum reasonable rates in rail proceedings and its statement in its November 15, 2001 Decision in this proceeding indicating "we cannot read a provision protecting "proposed" rates as immunizing existing rates that were found unreasonable when they were challenged before the FMC.

III. ACROSS-THE-BOARD RATE REDUCTION OF GUAM RATES IS AN APPROPRIATE REMEDY

The Defendants claim that determining the reasonableness of Guam rates in the aggregate is infeasible given the variation in rates and shipping conditions. The Defendants contend that an aggregate rate reduction would be inappropriate because "...any remedial order based on a determination regarding rates in the aggregate that required the payment of reparations to all shippers (or some subset of them), or any order requiring carriers prospectively to roll back or hold down their rates (or some subset of them) would necessarily be arbitrary and unreasonable." See Defendants' Initial Submission, page 11. Defendants' position is without merit and ignores the manner in which the Stand-Alone Cost Constraint is applied, which Defendants advocate for use in this proceeding.

Despite identifying the Stand-Alone Cost Constraint as the most appropriate regulatory scheme, the Defendants overlook the fact that the Board has historically applied rate reductions

resulting from application of the Stand-Alone Cost Constraint in precisely the manner which Defendants claim to be impractical, arbitrary and unreasonable. In Docket No. 37809, Coal Trading Corporation, et al. versus The Baltimore and Ohio Railroad Company, et al., served January 17, 1990. ("Coal Trading") the ICC stated:

"The Appendix A (ICC decision) approach recognizes the need for differential pricing by setting the maximum rate for each movement as a percentage reduction in the actual rate charged. It preserves the rate structure for the traffic group by maintaining existing rate relationships, albeit at reduced levels, and thereby implicitly recognizing varying demand elasticities." See Coal Trading, 6 I.C.C. 2nd, p. 380.

In other words, the Board applies the same across-the-board percentage reduction to all of the traffic moved on the hypothetical carrier's system. This same across-the-board percent reduction methodology has been used in every rail proceeding subsequent to Coal Trading where the STB found aggregate stand-alone revenues to exceed aggregate stand-alone costs. Given this approach, the application of aggregate rate reductions *is* feasible contrary to Defendants' claim.

As fully discussed in Section V of this statement, and due to the specific circumstances of the Guam trade, I believe that an aggregate percentage reduction for *all* traffic handled by a hypothetical stand-alone carrier is an inappropriate application of the stand alone cost constraint in this proceeding because the differential in rates between the Guam traffic and the other traffic is high and results from years of monopoly pricing tactics by Defendants. Defendants should not be rewarded because they have continuously charged the Guam traffic monopoly rate levels. As an economic alternative, the STB should reduce all rates in the Guam Trade by an across-the-board percent reduction that would attribute the entire amount that the hypothetical carrier's aggregate revenues exceed its aggregate costs to any traffic moved by the hypothetical carrier whose rates exceed the stand-alone cost per FEU-mile.⁶ By following this modified differential pricing

⁶FEU is a forty-foot equivalent unit.

procedure, the STB would maintain the relationships among the individual rates charged in the Guam Trade and would protect the Guam Trade from the monopoly pricing practices currently imposed by Defendants.

IV. CMP PRINCIPLES AS A REGULATORY STANDARD IN THIS PROCEEDING

In their Initial Submission, Defendants conclude that if the Board were to determine that a methodology exists for determining maximum reasonable rates for Guam trade, then the Board should apply CMP principles as developed in railroad and pipeline proceedings. See Initial Submission, page 14. Defendants then indicate:

“These [CMP] principles are most appropriate for a case like this because they are founded on economic concepts and considerations of regulatory policy of general applicability and because other methods the Board and the ICC have used to assess the reasonableness of rates are not feasible in a case challenging the totality of the carriers’ rates in a particular trade”. Id.

In spite of Defendants’ support for the use of CMP principles because they are founded on “economic concepts of regulatory policy and general applicability”, Defendants apparently have little knowledge of the basic CMP principles, development of these principles, or how they are currently applied by the Board. For example, and as discussed in the previous section of my Reply Verified Statement, Defendants strongly oppose an overall rate reduction for all rates, yet they fail to recognize that the Board’s current application of the Stand-Alone Cost Constraint is to apply an overall rate reduction for all traffic handled by the hypothetical carrier.

Further, Defendants argue that the “major impetus for the development of CMP” is the substantial variations in elasticities of demand for the traffic handled by the railroad industry. See, Initial Submission, page 16. As discussed in my IVS, the overriding impetus for development of

CMP principles was the statutory mandate of Staggers for the ICC to improve the financial viability of the railroad industry. Allowing the railroads to price their traffic based on a recognition of the varying demand elasticities of the traffic handled by the industry became a vehicle to assist the railroads in achieving financial viability. In the regulation of rates charged in the non-contiguous domestic trade, the Board faces no mandate to improve the financial health of the Maritime Industry. Other areas where Defendants have misconstrued CMP principles and their application are discussed below.

**A. The Board Need Not Determine
If Defendants Have Market Dominance**

The Defendants argue that the Board must first determine if the Defendants have market dominance before rate reasonableness can be examined. Defendants support this argument based on two erroneous assertions. First, Defendants state: "The threshold inquiry under constrained market pricing standards, which the Board should undertake in this case, is whether there is effective competition in that market...." See Initial Submission, page 3. Defendants' statement implies that, if the Board chooses to apply CMP in this proceeding, then it must also consider market dominance. Defendants' assertion is erroneous.

CMP per se does *not* require a market dominance examination. The Staggers Act and the ICCTA, not CMP, require a finding of both qualitative and quantitative market dominance before the Board has jurisdiction over the maximum reasonable levels of railroad rates. CMP is merely a theoretical construct for determining the maximum reasonable rates once the Board has determined that the carriers have market dominance over the traffic at issue in a complaint.

Second, CF Industries, Inc. v. Koch Pipeline Company, L.P., served May 14, 1997 ("Koch"), does not support Defendants' assertion that the Board must consider market dominance in this proceeding. Contrary to Defendants' argument, the Board is required by statute to consider

effective competition in its regulation of pipeline rates . The ICC Termination Act of 1995 (ICCTA) requires that the Board consider competition in pipeline cases, section 15503, states:

“When prescribing a rate, classification, rule, or practice for transportation or service by a pipeline carrier, the Board shall consider, among other factors.....the availability of other economic transportation alternatives.”

The Board has no such mandate for noncontiguous domestic trades, and the Board’s decision in the Koch case should not be misconstrued as a precedent for noncontiguous domestic trades.

Third, Defendants argue that they face competition through a faulty parallel with the railroad industry, claiming that, “The Board, however, has not merely found but presumed that two carriers serving markets would be sufficient to provide effective competition, and has done so in circumstances where there were far greater barriers to entry than in the Guam trade.” See Initial Submission, page 20. Several factors keep competition in the North American railroad industry from being analogous to the Guam trade. In the long-run, rail shippers sometimes can seek market place relief by (1) shifting locations or the amount of traffic between locations, (2) “build-outs” to competing carriers, and/or (3) using other modes of transportation. None of these options is feasible for most of Guam traffic because Guam shippers are stuck in one location and because Guam shippers are limited in their access to competitive carriers due to the Jones Act.

Third, Defendants also cite a precedent that does not exist. The Board might consider two-carrier competition as evidence of effective competition in the railroad industry, but it has done so on an empirical body of evidence specific to that particular industry. In its decision in the Finance Docket 32760, Union Pacific Corp. et al. – Control – /Southern Pacific Rail Corp. et al., 1 S.T.B. 233, (1996) the Board stated: “As DOT has pointed out, the outcome where just two companies offer the only significant competitive alternatives in a market may range all the way from intense rivalry to collusion, depending upon the industry.” (1 S.T.B. 385) The Board’s finding that two rail carriers

serving one location is evidence that market dominance does not exist is not a definitive indication that two water carriers serving the Guam trade provide effective competition.

Finally, Defendants argument that the Guam trade is competitive runs contrary to a significant body of evidence that suggests that Defendants price the Guam Trade as duopolists. The Defendants' duopoly pricing is evident from the contrast between the rates 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 highly competitive. Lines 1 and 2 of Table No. 1 below compares the current average rates charged by CSX Lines and Matson for commodities not requiring specialized equipment with those charged in the transpacific trade. Lines 3 and 4 of Table No. 1 provides a comparison of rates charged by Sea-Land (formerly owned by CSX, Inc.) in 1995 for movements in the Guam trade and movements in the transpacific trade.

Table No. 1⁷
Comparison of Rates per FEU
in the Transpacific Trade

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

N/A = not available

⁷I also included this table in my IVS at page 16.

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,⁸ which reflects the difference between a captive market environment and 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 serve Guam are en route from the United States to Asia and these vessels are carrying the transpacific traffic at the far lower rates than 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 result of the Jones Act and other Federal and local regulations.

**B. Limiting the Regulatory Standard to
CMP SAC Constraint Is Inappropriate**

Defendants argue that if the Board determines to require the use of CMP principles that the Stand-Alone Cost Constraint is the appropriate CMP constraint to be used in this proceeding. Defendants base this argument on the alleged superiority of the Stand-Alone Cost Constraint and certain deficiencies in the Revenue Adequacy Constraint. Before addressing each of Defendants' reasons for seeking prescription of the use of the Stand-Alone Cost Constraint, it must be pointed out that under CMP principles it is the prerogative of the Complainant to determine which CMP constraint(s) to use to prove its case.⁹

⁸This 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.

⁹CMP actually includes four constraints. In addition to the Revenue Adequacy and Stand-alone Cost Constraints discussed by Defendants, CMP includes a Management Efficiency Constraint and a Phase-In Constraint.

The Board confirmed this flexibility in regards to CMP approaches in Koch, stating:

"As we have recognized, there is 'no single formula' that can perfectly test the reasonableness of rates. Rate Guidelines, 1 I.C.C. 2d at 524. Thus, CMP purposely affords *complaining* parties flexibility to approach a rate analysis from alternative perspectives, examining either the pricing needs of a hypothetical carrier or the defendant carrier's pricing needs." [emphasis supplied]

Should the Board decide that CMP is appropriate for Phase III of these proceedings, GovGuam must have flexibility in selecting the most appropriate CMP constraint(s). The appropriate constraint cannot be determined until after discovery is complete and the carriers have provided GovGuam with the information solely in their possession that is needed to apply the CMP principles.

1. Alleged Superiority of the SAC Constraint – Defendants claim that because the Stand-Alone Cost Constraint uses the costs and revenues of a least cost hypothetical carrier rather than the Defendants' actual costs and revenues, that both Defendants will be affected equally by the result. See Initial Submission, page 25-26. Defendants' claim that because both the GO-11 and Revenue Adequacy Constraint rely on Defendants actual individual cost structures and revenues that using either of these methodologies would necessarily result in their rates being found reasonable or unreasonable to differing degrees, even though the competition between them has required their rates to be similar if not identical. Defendants also assert that any rate reduction required of the more efficient carrier would have to be matched by the less efficient carrier, which could result in the less efficient carrier earning less than adequate revenues and perhaps causing the less efficient carrier to leave the market. See Initial Submission, pages 16-17 and 25-26.

Defendants are correct in stating that a properly functioning market will cause the carriers to match each others rates. In turn, the less efficient carrier will earn lower profits. Use of the Stand-Alone Cost Constraint, will not alter this situation. These market dynamics do not justify

rejection of GO-11 or the Revenue Adequacy Constraint, nor do they favor the Stand-Alone Cost Constraint. Any reduction in rates, regardless of the methodology used to determine the magnitude of the reduction will cause the less efficient carrier to earn less profits than the more efficient carrier.

In those instances where one carrier's rates are farther from those of an efficient hypothetical competitor, those rates will have to change to a greater degree in order to remove the impact of inefficiencies. Where both carriers have identical rates, which they do in many instances, and their rates are reduced by the same percentage, the carrier with the less efficient cost structure will experience a greater reduction in its net profit which is the same result described by Defendants under GO-11 and the Revenue Adequacy Constraint. The Defendants' objections do not represent valid economic reasons for favoring a Stand-Alone approach over Revenue Adequacy or GO-11. Moreover, as stated previously, CMP requires that the Complaint have the flexibility to choose the CMP constraint(s) that best supports the facts of its case.

2. Alleged Deficiencies of the Revenue Adequacy Constraint – The Defendants contend that the Board should reject the use of the Revenue Adequacy Constraint for testing rate reasonableness for three reasons. First, Defendants claim that the Revenue Adequacy Constraint is only properly applied to rate increases, not existing rates. The Defendants provide no evidence for this assertion, and nothing in Rate Guidelines indicates that the Revenue Adequacy Constraint should not be applied to existing rates. In fact, in Rate Guidelines the I.C.C. viewed the various CMP constraints as different approaches to solving the basic problem, stating that

"Although we have described the constraints in CMP separately, they are necessarily interrelated. They represent different means of approaching the same basic issue, i.e., the extent of unattributable costs to be covered through differential pricing and the portion that can be charged to the shipper involved."¹⁰

¹⁰1 I.C.C. 2d at 547.

Second, Defendants allege that because the Revenue Adequacy Constraint examines rates for the carrier's entire system, it has no relevance to the reasonableness of existing rates on a single segment of the system. See Initial Submission, page 26. Again, Defendants demonstrate their unfamiliarity with CMP. In contending that the revenue adequacy of the entire system is irrelevant to and of its segments, the Defendants contradict CMP principles. Rate Guidelines state:

"Captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current or future service needs." 1 I.C.C. 2d at 535-536.

Contrary to what Defendants suggest, the Revenue Adequacy Constraint was never intended to analyze only a portion of a carrier's system but rather the system as a whole. Applied to the Guam trade, CSX Lines and Matson should not be able to use their market power to charge Guam shippers differentially higher rates if these rates are unnecessary for the carriers to maintain financial solvency and still serve the Guam trade.

Finally, Defendants assert that revenue adequacy is a long-term concept that calls for a company to earn an investment over time, but as Matson only entered the Guam trade in 1996 a long term view is not possible. Defendants appear to be unaware that CMP is a long-term concept. Not only does the Board require evidence as to the long-term return on capital in the Revenue Adequacy test, it has the same requirement when applying the Stand Alone Cost Constraint. As stated previously, when the Board determines maximum reasonable rates using the Stand Alone Cost Constraint it examines the hypothetical carrier's cash flows using a discounted cash flow ("DCF") model. These cash flows determine the hypothetical carrier's revenue requirements related to both operating costs and capital recovery requirements for the entire period examined. This examination of cash flows has typically been for a twenty-year period. Like the Revenue Adequacy Constraint, Stand-Alone Cost Constraint is a long-term concept which analyzes a hypothetical carrier's return

on investment over time.

V. PROPER APPLICATION OF CMP PRINCIPLES IN THIS PROCEEDING

If the Board decides that CMP principles are appropriate for Phase III of this proceeding, the Board should continue to allow the shipper, not the carrier, to choose which CMP constraint that is most suitable. As was stated in Rate Guidelines, CMP was designed to “offer the flexibility to approach the rate analysis from various perspectives.” Since the shipper has the burden of proving that a rate is unreasonable, the shipper also has the ability to choose which CMP approach that is most consistent with the facts uncovered during discovery.

If SAC is used in Phase III of this case, the Board’s current application of SAC needs to be revised to eliminate the use of an across-the-board percent rate reduction. 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 such that the reduced rates in aggregate produce the stand-alone costs. As I mentioned in my IVS statement, the Board’s current method of allocating stand-alone costs will not protect the Guam trade from the Defendant’s monopoly pricing practices.

Because of the great distance between Guam and the U.S. west coast and the requirements for weekly service, any hypothetical stand-alone carrier must handle more than the issue traffic in order to efficiently use its vessels’ capacity. All the volumes moving in the transpacific trade, other than 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 small portion of the overall transpacific trade.

Because of this situation, the economics of the Guam trade are very different from that of the North American rail markets where SAC has recently been applied. While North American rail markets consist of a multitude of shippers with different demand elasticities and different revenue to variable cost ratios, the Guam trade essentially consists of two markets. One market is comprised of shippers in Guam who are subject to monopoly pricing due to artificial entry barriers created by the Jones Act. The other market consists of transpacific cargo shippers that participate in a highly competitive market that pay vastly lower rates than those of the Guam shippers. In the competitive transpacific market, individual carriers have little ability to set prevailing prices, while CSX Lines and Matson maintain almost complete control over prices in the Guam market. Further, because the Guam trade is only a small portion of the overall shipper group that would be included in any profitable stand-alone carrier, then any surplus aggregate revenue over aggregate cost will be relatively small. Further, this surplus is attributable to the high rates paid by the captive Guam traffic rather than the low rates paid by the competitive transpacific trade.

The STB's current practice of reducing the issue traffic revenue by the percentage that aggregate revenues exceed aggregate cost that, by definition, maintains the relationship between the existing individual rates of the shipper group, would therefore, not provide adequate relief to the Guam shipper. An alternative that would preserve Ramsey pricing principles would consist of the following allocation of the difference between aggregate SAC revenues and aggregate SAC costs. The STB should reduce all rates in the Guam Trade by an across-the-board percent reduction that would attribute the entire amount that the hypothetical carrier's aggregate revenues exceed its aggregate costs to any traffic moved by the hypothetical carrier whose rates exceed the stand-alone cost per FEU-mile. Through this application, the STB would maintain the relationships among the individual rates charged in the Guam Trade. The STB would also protect the Guam Trade from the

monopoly pricing practices currently imposed by Defendants and would guard against any cross subsidy arising from reducing the already low competitive rates below the cost of providing the service.

If an across-the-board reduction caused the highly competitive rates to fall below the carriers' cost of providing service, a cross-subsidy would exist which is in violation of CMP's Management Efficiency Constraint. This Management Efficiency Constraint states that the carrier cannot force captive traffic to cross-subsidize competitive traffic that moves at rates that are less than marginal costs. 1 I.C.C. 2d 537-542.

If one assumes that the CMP principles (and specifically the Stand-Alone Cost Constraint) are to be used to determine a simulated competitive price in this proceeding, then certain additional principles must be strictly adhered to. Each of these principles is discussed below.

A. Contestable Markets

As fully addressed in my IVS, the Jones Act restricts companies that can participate in the domestic offshore trades to U.S. Flag carriers and in doing so creates a barrier to entry. This is particularly true with the Guam trade because of the significant distance (approximately 5,000 miles) between the US and Guam which is served by only two carriers at the same or similar rate levels. Other domestic offshore trades, such as those between the contiguous 48 states and Alaska or Puerto Rico, are served by more than two carriers as the distance between the contiguous states and these locations are substantially less than the distance from the U.S. Mainland to Guam.

The theory of contestable markets requires that no barriers to entry or exit exist and by removing any such barriers competitive prices can be determined even in monopoly or oligopoly markets. The Stand-Alone Cost Constraint provides a methodology to approximate the full economic cost, including an adequate return on investment, that is required for an efficient producer

to provide the service required by the shipper or group of shippers. The resulting stand-alone cost is a simulated competitive price to which the actual rates can be compared.

Stated differently, if the Stand-Alone Cost Constraint is to be applied to the Guam Trade to determine the maximum reasonable rate levels, all barriers to enter and exit the relevant market place must be removed, including the impact of the Jones Act.

B. Shipper Group

A least cost, most efficient carrier must size and fully utilize its physical plant in order to minimize its average cost of production. To accomplish this maximum utilization, the designer of the stand-alone carrier must have complete freedom to select its traffic or shipper group. As stated in Rate Guidelines, "The ability to group traffic of different shippers is essential to the theory of contestability....We see no need for any restrictions on the traffic that may potentially be included in the stand-alone group." 1 I.C.C. 2d 544

For the service that is at issue in this proceeding, the least cost, most efficient competitor would seek to transport high rated commodities moving between low cost, highly efficient ports and the United States and that are in relatively close proximity to the route between the west coast of the United States and Guam. The shipper group would potentially include all traffic currently carried by the Defendants in this proceeding to and from Guam, Saipan, Tinian and Rota. The shipper group may also include, for example, all traffic between the 48 contiguous states and Hawaii, all Military cargo between the United States and locations such as Okinawa, Japan and Korea and traffic moving between the United States and Asia ports. The complainant would have the ability to include in its group the volumes and revenues that are currently handled not only by the Defendants, but other carriers as well.

C. Revenues

The revenues available to a stand-alone carrier in this proceeding would be the same as those available to the Defendants and other carriers that are carrying the volumes of traffic identified to be included in the stand-alone shipper group. These revenues would include the following:

1. Movement Related Revenues – Movement related revenues include the port-to-port rates charged by the incumbents and the water portion of the joint water/inland transportation rates¹¹ charged by the incumbents and other carriers. In addition, if the incumbent receives additional revenues associated with ancillary activities then the stand-alone carrier is entitled to those revenues. For example, the CSX Lines and Matson tariffs contain separate charges for wharfage charges at west coast ports and for terminal charges at the Port of Guam. The stand-alone carrier is entitled to include the revenues associated with these charges in its stand-alone system.

2. Subsidy payments – U.S. Flag carriers receive several forms of subsidies from the Federal Government, including items such as subsidies for carrying military cargo, subsidies for placing ships in the U.S. Merchant Marine reserve fleet¹² and subsidies related to performing services to the Federal Government as an Operating Differential Subsidy (“ODS”) contractor.¹³ To the extent the stand-alone carrier participates in any of these programs, it faces the same obligations and is entitled to the same subsidies and benefits as received by the incumbent carriers.

¹¹Rate Guidelines do not preclude the inclusion of the inland portion of the joint water/inland transportation rates as long as the associated operations and costs are accounted for.

¹²The Maritime Security Act of 1996 provides a subsidy program for certain U.S. flag vessels. Under this program each participating vessel is eligible to receive an annual subsidy payment of \$2.1 million subject to annual appropriation.

¹³An ODS contractor obligates itself to provide services to the Federal Government such as providing a defined level of service on certain trade routes, exclusively employing U.S. citizen officers and crews whose wages and benefits exceed those paid by foreign operators by a factor of three.

3. Charter Revenues – Matson and CSX Lines have entered into agreements with APL and Maresk Sea-Land, respectively, for the movement of volumes between the United States and various Asian locations which actually move on the same vessels that Matson and CSX Lines use to serve Guam. A stand-alone carrier is entitled to the same revenues as are received by the incumbent carriers.

D. Capital Investment

The stand-alone carrier is entitled to complete freedom of entry and exit the market place which translates to instantaneous access to the capital required to purchase the needed assets and the calculation of the residual value of assets using economic depreciation. Stated differently, the stand-alone carrier is free to size the capacity of its vessels, fleet and shore facilities to maximize their utilization based on the volume to be handled at different time periods over the model. For example, were the stand-alone carrier to determine that the vessels used in the initial year of service were of insufficient size to move traffic available in a subsequent year, it is free to replace the vessel it is currently using with vessels of the appropriate size.¹⁴

Further, if the stand-alone carrier determines that it was economically justified in spending the capital required to expand the facilities at the Port of Guam in order to be able to increase the size of the vessels that can be accommodated at that facility, then the stand-alone carrier will face no barrier to making such an investment.

E. Service to be Provided

1. Frequency of service – Currently both Matson and CSX Lines provide weekly service to Guam and according to their published schedules their vessels arrive on Monday and Tuesday of

¹⁴The stand-alone carrier is free to acquire assets through any method that is available to the Defendants, such as purchase, capital lease or operating lease.

each week, respectively. A least cost, most efficient carrier that handles all of the volume moving in the noncontiguous domestic Guam trade would possibly provide weekly service that stops at Guam at the beginning of the week, however, it would not be required to have separate vessels stop at Guam on both Monday and Tuesday each week when a single vessel would provide this same level of service.

2. Routing – In developing a routing schedule, the stand-alone carrier must be free to call on whatever ports it deems necessary to provide the most efficient combination of operating costs (such as port fees, cargo handling charges and vessel operating expenses) that are matched to the handling of the most profitable traffic available. The stand-alone carrier must be able to select a routing plan that is different than that provided by the incumbents if a different routing plan is required to optimize these and other profit maximizing factors, as long as that route is feasible and the operations verifiable.

F. Operating Costs

As a least cost, most efficient carrier, the stand-alone cost carrier will utilize the most current technologies and productivity methods appropriate to provide the required level of service for its shipper group. For example, as discussed in the Drewry Report,¹⁵ the container shipping industry made significant strides in reducing administration and overhead costs throughout the early and mid 1990's primarily through reductions in the workforce resulting from improvements in automation. A least cost, most efficient carrier would take advantage of these productivity improvements and incorporate them into its business plan.

Further, the stand alone carrier would not include any operating costs associated with

¹⁵*Global Container Markets, Prospects and Profitability in a High Growth Era*, Drewry Shipping Consultants, July 1996, p. 122.

services that are not covered by the rates governing the traffic that is included in the group. For example, the Matson and CSX Lines tariffs for shipments in the noncontiguous domestic trade to Guam show a "base rate" and an add-on rate for a "zone arbitrary". The zone arbitrary covers the movement between the actual origin or destination and the container yard. The costs associated with this land move would not be borne by a stand-alone carrier if that rate were not used to develop the stand-alone revenues. The complaining shipper has the right to choose what services, costs and revenues to include in its group under the Stand-Alone Cost Constraint.

Moreover, if as shown in the Matson and CSX Lines tariffs, separate charges are levied for wharfage charges at west coast ports and terminal charges at Guam, the costs associated with these charges are not borne by the stand-alone carrier unless that carrier also receives the revenues related to the services for those charges, a factor that is solely determined by the creator of the group.

It is well established in the stand-alone analyses presented in railroad related proceedings that a least cost, most efficient carrier is not required to be bound by labor union work rules and wage rates. The same would hold for a least cost most efficient water carrier.

G. Discounted Cash Flow Model

Rate Guidelines indicate that stand-alone cost should reflect a multiple-period analysis. I.C.C. 2d 545. In railroad proceedings, the Board has accepted the use of a Discounted Cash Flow ("DCF") model that projects the stream of earnings which can be expected, then discounts the earnings stream using the current cost of capital to derive the present value of the stand-alone system. The resulting stand-alone costs for each period are compared to the current and forecast revenues produced by the shipper group to determine if current revenues exceed stand-alone costs.

1. Useful asset life – The forecast stream of earnings is dependent on the life of each of the assets acquired by the stand-alone carrier. For example, the average container vessel life is 25

years.¹⁶ However, the noncontiguous domestic trades generally require not only U.S. Flag vessels but also U.S. built vessels. Because of the high cost of construction of U.S. built vessels, the actual useful life of these vessels are typically extended well beyond the normal service life of 25 years. Assuming the stand-alone carrier determines to acquire U.S. built vessels, then the longer than average vessel life experienced by U.S. built vessels must be recognized when determining the stream of earnings for the stand-alone carrier.

2. Discount rate – The discount rate accepted by the Board for use in the DCF model in rail rate proceedings has historically been based on the Board’s determination of the railroad industry current cost debt and equity and the Board’s weighting of these components for the industry. In this proceeding and assuming the Stand-Alone Cost Constraint is used, the cost of capital will reflect the capital structure relative to the maritime industry.

3. Capital Construction Fund – The Merchant Marine Act of 1936 established a Capital Construction Fund (“CCF”) which permits U.S. Flag carriers to enter into an agreement with the Federal Government to assist in the acquisition, construction or reconstruction of vessels and for repayment of existing vessel indebtedness. Deposits into a qualified CCF plan are tax deductible in the year they are made and may be withdrawn for investment in vessels and certain related equipment. Qualified withdrawals do not give rise to a current tax liability, but reduce the depreciable bases of the vessels or other assets for income tax purposes. To the extent the stand-alone carrier participates in the CCF program, the DCF model must properly recognize all of the accounting and tax laws associated with the CCF program.

H. Resulting Rate Structure

The Stand-Alone Cost Constraint produces the aggregate revenues that must be charged for

¹⁶To be provided.

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. Rate Guidelines indicates that this is best accomplished on the basis of Ramsey Pricing principles. 1 I.C.C. 2d 546.

In rail maximum rate proceedings and as a surrogate for using Ramsey Pricing principles, the Board has determined that when the aggregate revenues produced by the stand-alone carrier's group of traffic exceed stand-alone costs, all rates in the stand-alone shipper group are reduced by the same percentage reduction such that the reduced rates in aggregate are equal to the stand-alone cost.

The rates currently charged the Guam Trade by the incumbents, reflect an extreme application of monopoly/duopoly power. This exercise of monopoly power can best seen by comparing the rates to Guam to the rates of other shippers that are available for inclusion in the stand-alone group. Instead they simply reflect the artificial duopoly price structure created by the Jones Act barriers to entry. As previously discussed, the Board's recent practice of simply reducing the rates charged to all shippers in the stand-alone shipper group is not appropriate in this proceeding and the Board should adopt the procedures as outlined above which would protect the Guam shippers and not reward the Defendants' monopoly/duopoly market power.

I. Future Rates

The DCF model determines the maximum reasonable rates that the carriers may charge in each calendar quarter for the entire period examined. This examination of cash flows has typically been for a twenty-year period and the rates have been adjusted to reflect changes in demand and changes in the carriers' costs. If CMP and the Stand-Alone Cost Constraint are applied in Phase III, then the ZOR would be irrelevant, since the DCF model, by definition, would determine maximum

reasonable rates for the multi-year period.¹⁷

J. Third Party Discovery

As discussed previously, Matson and CSX Lines have entered into agreements with APL and Maresk Sea-Land, respectively, for the movement of traffic between the United States and various Asian locations. These traffic volumes actually move on the same vessels that Matson and CSX Lines use to serve Guam. As a result, GovGuam will need to seek third party discovery from APL and Maersk Sea-Land related to the traffic, revenues, costs and the specifics of the agreements between the Defendants in this proceeding and APL and Maresk Sea-Land for the traffic that may be included in the stand-alone system.

VI. CONCLUSIONS

CMP principles are theoretically sound, but should not be applied in this proceeding for two primary reasons. First, the Stand-Alone Cost Constraint, as currently applied by the Board is not appropriate for this proceeding because it will reward the monopoly/duopoly position enjoyed by Defendants. Second, application of the Stand-Alone Cost Constraint in this proceeding is problematic, primarily because the information required to develop a robust stand-alone hypothetical competitor is potentially available only through discovery from third party foreign companies.

Were the Board to determine to use CMP principles in this proceeding, then GovGuam must have the ability to pursue all needed discovery and must be provided with the ability to select which CMP constraint(s) best represent its position. Further, if GovGuam selects the Stand-Alone Cost

¹⁷As discussed previously, ZOR increases do not apply to maximum reasonable rates prescribed by the Board regardless of the methodology used to determine those rates.

Constraint, the Board's current application of an across-the-board rate reduction to all shipments on the hypothetical carrier's system must be altered in order to provide adequate protection to the Guam Trade.

A better maximum rate tool is the GO-11 standard. The GO-11 standard was developed by the Federal Maritime Commission precisely for the determination of the reasonableness of rates charged in the non-contiguous domestic trades. Defendants' have not raised any objections to the use of GO-11 that do not equally apply to the use of the Revenue Adequacy and Stand-Alone Cost Constraints. In light of these factors, use of GO-11 is appropriate for use in this proceeding.

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.


Philip H. Burris

Sworn to and subscribed
before me this 17 day
of June, 2002.

Witness my hand and official seal.

Anthony V. Evanshaw III

My Commission expires: September 30, 2003

B

GOVERNMENT OF THE
TERRITORY OF GUAM,

V.

SEA-LAND SERVICE, INC.)
and)
MATSON NAVIGATION COMPANY,)
INC.,)

Docket No. WCC-101

Ernest Nadel, PhD
Principal
LECG, LLC

June 17, 2002

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I. INTRODUCTION

My name is Ernest Nadel, PhD. I am a principal with LEGC, LLC. The firm's main office is at 2000 Powell Street, Emeryville, CA 94608. I submitted an Initial Verified Statement (IVS) on behalf of the Government of the Territory of Guam (GovGuam) on April 23, 2002.

I have an extensive familiarity with containership economics, GO-11, the transpacific trade, and the Guam trade in particular. GovGuam has requested that I evaluate the use of GO-11 as a regulatory standard to determine maximum reasonable rates in this proceeding. My comments regarding the use of GO-11 in this proceeding are included in my IVS.

GovGuam has now requested that I reply to Defendants' Initial Submission in Phase II - Appropriate Standards of Rate Reasonableness (Defendants' Initial Submission). Specifically, I have been asked to reply to (a) Defendants' allegations that there is effective competition in the Guam trade, and (b) Defendants' arguments against the use of GO-11 as a regulatory standard in this proceeding. In this statement I detail how, in their Initial Submission, Defendants made numerous errors, omissions and misinterpretations regarding the above-mentioned issues.

II. COMPETITION IN THE GUAM TRADE

Defendants allege that they have presented a "prima facie case" that there is "effective competition" in the Guam trade. Defendants' Initial Submission, p. 4. Defendants are wrong. The only prima facie case that the facts and economic analysis support is that competition is sorely lacking, and that the trade is a very non-competitive duopoly with rates being greatly in excess of costs.

In support of their claim that there is effective competition in the Guam trade, Defendants rely on the United States Department of Transportation, A Report to Congress: Competition in

the Noncontiguous Domestic Maritime Trades (1997) (DOT Report), and the verified statements of Peter P. Wilson, Mark D. Miller, and Daniel Downes. Defendants summarize what they refer to as the “strong prima facie case” by citing the following facts as support for their conclusion:

- The US-Guam trade has always been serviced by “at least two U.S. Flag carriers,” and that “[s]ince 1972, seven companies have provided such services, and five of those have left the trade.” Defendants’ Initial Submission, p. 19.
- There is “indirect competition” to the U.S. Flag carriers from 2 foreign flag carriers, one each “based in Asia and Europe.” Id.
- “Aggregate revenue per container for the U.S. Mainland to Guam trade showed a 1995 level of less than 80 percent of the 1990 level, after adjusting for inflation.” Defendants’ Initial Submission, p. 20
- “No general rate increase has been taken in the trade in recent years.” Id.
- “Excess capacity in the Guam trade has played a major role in preventing shipping rates from increasing.” Id.

It is my contention that these facts actually support the exact opposite conclusion: there is no effective competition in the Guam trade.

A. THE 1997 DOT REPORT

Defendants claim that “[t]he conclusion that there was effective competition in the Guam trade in September 1996 is strongly supported by the findings in the *1997 DOT Report*.”

Defendants’ Initial Submission, p. 19. DOT made no such conclusion. In fact, the actual recommendations of DOT regarding Guam imply the opposite conclusion was reached by DOT, and that the evidence from the DOT Report was erroneously characterized by Defendants.

1. The DOT's Conclusions and Recommendations

As supplied by Defendants in their Initial Submission, the cover letter to the DOT Report by Secretary Slater states that "economic and competitive conditions differ significantly in each of the major offshore trades studied (Alaska, Hawaii, Puerto Rico, and Guam)." His only recommended changes in the regulation of these trades were two: that "Congress should consider ending tariff filing requirements in the Alaska and Puerto Rico trades," and that "the Congress should consider reducing the Zone of Rate (ZOR) Freedom to between 3 percent and 4 percent." These conclusions reflect anxiety about the weakness of competition in the Guam trade, and not a conclusion that there was "effective competition in the Guam trade."

Mr. Slater's first recommendation was that tariff filing should not be eliminated in the Guam trade. This was a significant recommendation and speaks directly to the fact that DOT did not believe that there is sufficient competition in the Guam trade. GovGuam had requested that, to protect shippers, tariff filing not be eliminated. The reason for this request was that public awareness of the actual rates in the Guam duopoly, rather than have them secret, would make it easier to monitor what the carriers were charging. It would also help the small shippers avoid being charged high rates while the few large shippers, who had some greater leverage on the carriers due to their volumes in the Guam and other trades, would be the only ones to achieve lower rates. By acceding to GovGuam's request, the DOT recognized the competitive problems in the Guam trade as GovGuam expressed them.

Mr. Slater's second recommendation indicates a DOT view about all four domestic trades that is less sanguine regarding competition. The ZOR that was being considered for increases was originally 10 percent, but was ultimately reduced to 7.5 percent. The DOT pushed for 3

percent to 4 percent, clearly signaling a concern about the non-competitiveness of the rate-setting environment in the trades. By comparison, the Federal Maritime Commission (FMC) had a standard whereby General Rate Increases (GRI) of less than 3 percent could go into effect automatically, but higher GRI's required prior FMC approval. It appears DOT had a view of the trades similar to the FMC.

2. The Continuous Duopoly and the Lack of Net Entry in the Guam Trade

The Guam portion of the DOT Report that Defendants attached to their filing in this proceeding indicates that although there have been seven entries into the trade and five exits, there has never been more, nor less, than two operators in the trade at any time since at least 1974.¹ Accordingly, the correct reading of the history of exit and entry in the Guam trade is that no net entry has ever occurred in at least 28 years, and it is net entry that is the economically operative criterion.

The DOT's conclusion, as cited by Defendants, must be interpreted in that light and not as an indication of conventionally understood ease of entry or history of entry. DOT concluded "[t]hus, ocean carriers had been able to acquire vessels, port facilities, and the infrastructure services necessary to provide liner service, indicating that entry barriers are not insurmountable." But this only means that every once in a while, one carrier sold its service to another carrier. These firms were selling assets, including the stream of excess profits expected in the trade, for

¹ The only exception to this was a 1986/7 service, via transshipment via Japan, partnered with Lykes Bros. The feeder service was with two tiny containerships of 130 TEU. The 130 TEU per week capacity was less than 3 percent of the combined APL plus Sea-Land capacity of 2,535 FEU per week in 1997. DOT properly considered this brief feeder service episode irrelevant.

cash.² This was not the kind of net, effective competitive entry that economists mean by the term “entry.”

3. The DOT’s Misplaced Optimism for Future Capacity

The DOT expressed, and the Defendants relied upon at p. 22 of their Initial Submission, some optimism for the future of new capacity for the Guam trade. DOT stated that,

Liner vessels suitable for the Guam trade, and for the other noncontiguous domestic trades, are expected to become more readily available over the next several years, as vessels built in U.S. shipyards with Construction Differential Subsidy (CDS) reach the end of their statutory economic lives (and thus can be redeployed in the domestic trades). Further, as current Operating Differential Subsidy (ODS) contracts expire, U.S. flag vessels now deployed in the foreign trades may be redeployed to the domestic trades.

DOT Report, p. III-19.

The facts since 1997 reveal the opposite occurred. No CDS nor ODS ships have entered the Guam trade. In fact, as explained in my Initial Verified Statement, the Guam trade recently lost two U.S. built ships when APL re-flagged two foreign-built ships, presumably in accordance with the contractual arrangements between APL and Matson.

4. Important DOT Conclusions About Lack of Guam Trade Competition Remain Valid

Several of DOT’s explicit conclusions about the lack of competition in the Guam trade are still true:

- “Liner service to Guam is limited by the small volume of cargo . . .” DOT Report

² In the Guam trade, Seatrain sold its ships and Guam service to Matson in 1976. US Lines sold its ships and its publicly known, very profitable Guam service to Sea-Land in 1988. APL sold its ships and presumably highly profitable service to Matson in 1996. The only exception to this pattern was when Matson abandoned its inefficient and unprofitable turnaround service in 1978, left the trade, and was immediately replaced by APL with its efficient and highly profitable pass-by service (as described in my Initial Verified Statement).

at III-19. This is a significant limitation on potential competition.

- “At any given time, there has generally only been two U.S. flag carriers offering service to Guam from the U.S. mainland.” DOT Report at III-15. There has been no net entry.
- “. . . barge service is not competitive with liner service.” DOT Report at III-18. This further inhibits competition in the trade.
- “In short, concentration is high in the Guam trade.” DOT Report at III-18. The STB has itself cited this important summary of the major statistics in the trade.

5. Indirect Competition Is of No Consequence

The Defendants rely upon the DOT Report wherein it states that, “. . . Guam also receives shipping services from foreign-flag carriers based in Asia and Europe, which provides indirect competition to U.S. flag carriers.” DOT Report at III-19. Not only is this competition indirect, it is of no consequence, as Defendants’ own witnesses have shown.

At page 2 of his statement, Mr. Miller states that the two foreign-flag vessels that call Guam (not from the U.S.) do so on a 21-day and monthly rotations [respectively], while Matson and CSX each offer once-a-week service. He claims that, “[t]he foreign flag vessels have a combined carriage of between 40 and 80 containers per week to Guam from Asia and Australia/New Zealand. This represents up to 14% of the total cargo arriving in Guam.”

Mr. Miller’s figures are hardly compelling, and they further demonstrate the lack of effective competition in the trade. It appears that Mr. Miller derived his “up to 14%” estimate by finding the ratio of 80 containers to the sum of 80 containers plus the 500 FEU that he has indicated currently move in the U.S. mainland Guam trade each week. Thus, 80 divided by 580

equals 13.7%, then rounded up to 14%. Of course, if Mr. Miller had used the figure of only 40 foreign flag vessel containers per week, he would have derived an estimate of as little as 7% of the total cargo arriving in Guam: hardly an economically significant component of the trade.³

Mr. Miller further undercuts his claim that there is significant competition when he states, on page 3, that "... the foreign-flag carriers transport some products that are not available from the U.S. mainland, such as Korean food or autos manufactured in Taiwan." Mr. Miller does not quantify those volumes. Since at least some of these products are not available from the U.S. mainland, their carriage to Guam cannot reflect any presence of competition to the U.S. flag carriage to Guam. Therefore, the previously calculated 3.8% to 13.7% of total cargo must be further adjusted downward to reflect the true paucity of foreign source competition for the U.S. flag carriers.

6. Source Competition Is Absent

The absence of source competition in the Guam trade distinguishes it from other captive markets found in U.S. pipelines and railroads. The domestic pipeline and rail industries, in the movement of energy products, have significant source competition. In contrast, there are no substitutes for the kind of American living style that Guamanians prefer and that only imports from the U.S. mainland can satisfy.

³ It also appears that Mr. Miller made a significant error in his calculation. -It appears from his statement that he used containers in the numerator, but FEU in the denominator. The containers in the numerator may well have been only 20-foot containers, not 40-foot containers. The smaller size is more likely, given the small size (under either unit) of the ships and the infrequency of service. As a result, a more accurate statement would have been, "[t]he foreign flag carriers have a combined carriage of between 40 and 80 20-foot, or perhaps 40-foot, containers per week to Guam from Asia and Australia/New Zealand. This represents between 3.8% to 13.7% of the total cargo arriving in Guam."

The Board is aware of the uncompetitive environment of this trade, which represents a classic case of precisely the kind of trade that merits a quantitative regulatory evaluation. I presented some of the salient facts in my initial submission, including a measurement of the degree of concentration and a comparison to the Merger Guideline standards. In particular, I presented a Herfindhal Hirschman Index (HHI) calculation. Even if, purely for the sake of argument, one were to accept that the foreign flag carriers did have 13.7% of the total trade, and the CSX and Matson had equal shares of the remainder, the HHI would be 3818.⁴ The Merger Guidelines consider a post-merger HHI of 1800 as highly concentrated. The Guam trade HHI of 3818 is a figure well above the Merger Guidelines needed to disapprove a merger on competitive grounds.

Finally, these two foreign flag carriers operate without the capital cost burdens of the Jones Act, and there is a large fleet of foreign-flag ships available on the world market. If these two carriers represented an effectively competitive challenge or alternative to the U.S. flag carriers, why do they offer so little service compared to the size of the Guam trade? Why don't they expand their capacity and capture market share away from the U.S. flag carriers?

The answer is simply that these two carriers are operating in markets that are different from, and not competitive with, the U.S. mainland to Guam container market. They are irrelevant to an evaluation of competition in the Guam trade. Defendants' inclusion of this foreign flag factor hardly qualifies as a contribution to a "compelling prima facie case that there is effective competition in the Guam trade."

⁴ The four carriers' market shares would measure two at 6.85% and two at 43.15%. The sum of squares of those four numbers, which is the measure of the HHI, is 3818.

7. DOT Reference to Explicit Carrier Collusion Regarding Guam Rates

The DOT Report mentions another factor that supports the conclusion that there is a lack of competition in the Guam trade. "Until June 1989, [the only two carriers in the trade] were authorized to discuss and set rates collectively." DOT Report at p. III-19. Thus, the freight rates that set the level of rates in the trade, as of June 1989, were set not simply by a duopoly; they were set by a duopoly that was legally permitted to agree on each and every rate they charged, and the two carriers charged exactly the same rates as each other for each and every commodity in their common tariff.

I know of no other maritime trade duopoly that has ever come as close to a single monopoly with no fear of entry, as the two Guam carriers were able to achieve through as late as June 1989. I believe it is fair to say that such a situation is properly called extraordinary. Since most, if not all, of the residue of that price collusion remains in effect even today in the form of excessively high and non-competitive freight rates, it is reasonable to conclude that there is a very strong prima facie case that there is not effective, excess-profit-eliminating, competition in the Guam trade.

While the formal rate agreement were terminated in 1989, there exists still other contractual evidence of current inter-carrier agreements in the trade. In his testimony at page 2, Mr. Daniel Downes states that "... CSX purchases space from Matson for CSX cargo moving from Long Beach to Guam." He also writes, at page 3, "[t]he cargo loaded on CHX string ships (i.e., CSX-owned ships) are, with the exception of cargo moving under slot charter with Matson to Hawaii, for the account of CSX." Thus, by their own admission, the two carriers are reciprocally moving cargoes on each other's ships, and they are doing this both for the

California-Guam cargo market and the California-Hawaii market. Such an arrangement can very well be the equivalent of a "joint service," which is the opposite of the two carriers providing effective competition for the shippers in the trade. The joint service is inherently, by definition, an anticompetitive arrangement. It is yet another piece of the strong prima facie case that there is not effective competition in the Guam trade.

8. Overcapacity in the Guam Trade, With No Concomitantly Low Rate Levels, Demonstrates the Lack of Competitiveness of the Pricing in the Trade

At page 23, Defendants rely on Mr. Miller's measure of overcapacity in the trade:

Given the combined capacity of the Matson and Sea-Land vessels calling Guam [in 1996], it is obvious that the trade was [and still is] overtonnaged. Even when the smallest vessel in the Matson rotation called Guam, it alone could carry over three times the total number of containers carried to Guam from the U.S. mainland.

Defendants go on to conclude, "[g]iven this substantial overcapacity, the vigorous competition between Matson and Sea-Land for cargo described by Mr. Wilson is hardly surprising." Defendants' Initial Submission, p. 23.

It is simply erroneous economic analysis that would seek to have just the existence of excess capacity be used to demonstrate "vigorous competition." What is true is that such excess capacity would, under effectively competitive conditions, lead to vigorous price competition and a severe decline in rates. This price pattern has not occurred in the Guam trade.⁵ It has occurred, however, in the highly competitive transpacific westbound trade. This contrast demonstrates

⁵ Defendants have the data, but did not present it, on what has happened to average rates. Significantly, they have not shown that average rates have been bid down close to average variable cost, which is what excess capacity does in a competitive trade with such high, fixed, common costs.

conclusively that there is not any effective competition in the Guam trade, and it vitiates entirely Defendants' arguments on this account.

9. The Significance of Excess Capacity in the Trade

Defendants at page 20 of their Initial Submission cite the DOT's statement that "[e]xcess capacity in the Guam trade has played a major role in preventing shipping rates from increasing." This was not an independent analysis by DOT. It is simply a *post hoc ergo propter hoc* logical fallacy. There was no attempt made to correlate excess capacity with price change. There is an economic possibility lying within that statement: all other things held constant, a trade with more excess capacity will have less upward price pressure than a trade with less excess capacity. No more of an economic statement than that can be made about the Guam trade based on the evidence available to DOT.

Moreover, it is not the time path of rates that must be used as an indicator of effective competition. Rates that are excessive will generally remain excessive even if they do not rise. Instead, one must determine how close the rates are to variable costs, how close the rates are to the costs of an efficient carrier serving the trade, and how much excess profit the current carriers are earning. This is the evidence needed, and this is the evidence missing from Defendants' submission.

10. Rate Actions are Irrelevant Indicators of Competitiveness in the Trade

The testimony of Mr. Peter Wilson alleges, at page 1, that "[t]he offshore domestic trade to Guam is highly competitive." In support of his statement he refers, at page 2, to the fact that "[t]he carriers in the Guam trade must match each others [sic] rates in order to remain competitive." Then, without providing dates or amounts of reductions, he states about a dozen of

such matches in rates. At page 22 of their Initial Submission, Defendants rely on the testimony of Mr. Wilson and state that “. . . Matson must match any reductions taken by CSX in order to retain cargo.”

Defendants’ mere anecdotes do not constitute rigorous economic evidence or economic theory. Merely because Sea-Land and Matson charged the same prices for shipping a number of different commodities does not indicate a highly competitive market. The employee-witnesses’ statements about some of their pricing events have no probative value as regards the adequacy of competition in the trade. It is an established theorem in industrial organization theory, investigations, and in court interpretations of market events that one cannot infer anything about the degree of competitiveness, market power or excess profit of two duopolists in a duopoly merely from the description of their pricing behavior. This is especially true when that description covers only rivalrous responses and not price versus cost comparisons.

To take a simple, yet apt example: if the sellers in an industry were perfectly competitive, such as the corn or soybean industry, all sellers would charge the exact same price; and, all price changes over time would be exactly the same, since all sellers would always sell at the same price. And, what about in a monopolistic cartel that had perfect coordination, control, and management of the colluders? The exact same result would occur: all of the colluding sellers would charge the same price and they would make the same price changes over time.

This observation about the inability to infer competitiveness from pricing is true in general. It is all the more true here, where the anecdotes reflect small price changes that sometime arise, that the sellers match or copy each other’s prices, or that one seller withdraws a price change when the competitor does not respond in kind, etc. These are all evidence of the

kinds of “rivalry” price behaviors an industrial organization economist expects in very uncompetitive, oligopolized markets *and* in very competitive markets. The key issue for competition is not the day-to-day rivalrous pricing behavior, but rather how much excess profit has their acknowledged mutual interdependence and stability and lack of external competitive pressure permitted them?

11. Evidence of a Lack of Pursuit of Competitive Advantage

There is yet additional strategic evidence that the trade is not competitive. DOT wrote that, “[l]iner service from the U.S. mainland [to Guam] is economically viable only if it is offered in conjunction with continuing service to the Far East or as part of liner service to Hawaii.” DOT Report at p. III-15. When serving Guam, there is a significant utilization advantage, and therefore cost advantage, to also serve Hawaii.

Before APL sold its service to Matson, APL did not call Hawaii. Only with the sale to Matson did the APL ships become legally able to serve Hawaii.⁶ Most likely, Matson’s initial small price reductions in 1996, when it first took over the vessels, was a signal to the shippers and to Sea-Land that it was prepared to use its new capability to capture a larger trade share. This is precisely the kind of price signaling one would expect in a well-coordinated duopoly, intent on maximizing duopoly excess profits.

In 1998 the California-to-Hawaii-to-Guam option disappeared for Matson, and since then Matson ships have not called at Hawaii. Thus, from late 1998 until now, CSX has a distinct competitive advantage over Matson in the Hawaii trade. The question arises: why doesn’t CSX

⁶ Until the sale, APL was bound by the decision in the Maritime Subsidy Board Hearing in S-801 which prevented their entry into the Hawaii trade with their Guam trade ships.

take advantage of that cost and pricing advantage and expand its market share and, perhaps even drive Matson out of the trade? Why didn't Sea-Land do this to APL before Matson entered the trade? The likeliest answer is that while an effectively competitive industry would have seen such an event – an operator with a significant and non-duplicable advantage using it to drive its competitors out of the market – the Sea-Land strategy created more profits for Sea-Land over the long term with a “live and let live” pricing policy. It is likely that Sea-Land earned greater profits while sharing the market with APL/Matson, than it would earn by competing vigorously against them. That failure to compete vigorously is exactly the strategy that a smart duopolist would engage in, even without any formal collusion or cooperation between the two operators.

12. The Quantitative Insignificance of the Alleged Rate Actions

Defendants state at page 10 of their Initial Submission that “Matson has taken approximately 3,400 separate rate actions adjusting particular rates, the vast majority of which have resulted in rate reductions.” This is meant to suggest that there is an imposingly large number of adjustments, mostly downward, and therefore a sign of effective competition in the trade.

Before one can attach any significance to the figure of 3,400 rate actions, it is necessary to compare this number to the total number of items in Matson's tariff. At page 3 of Mr. Wilson's statement he states that, “[i]n September, 1996, the STB-filed tariffs [of Matson] contained 292 separate commodity items, and the two exempt circulars contained 283 separate items.” The total number of separate commodity items is, therefore, 575. Those 3,400 rate actions in about 6 years (since Matson's entry in 1996) amount to about 567 rate actions per year. Therefore, Matson on average has changed each price only once a year. This is in a trade that has

experienced a new carrier identity in 1996, another new identity in 1999 when CSX took over its Sea-Land service, and has suffered a decline in volume of 20% in just the last four years. Such rate actions are of no material consequence. It is also disappointing and unhelpful that Mr. Wilson did not indicate the weighted average impact of those mostly downward rate adjustments.

Mr. Wilson explicitly mentioned five rate adjustments. At page 2 of his statement, he identified examples of "respons[ive] rate reductions," all of which were in the period September 21, 1996 to October 11, 1996, shortly after Matson bought the service from APL:

- for refrigerated containers, of \$200 per container;
- for mixed groceries, by \$100 on 20-foot containers and \$250 on 40 and 45-foot containers
- for beer, from \$96 to \$91.50 per 2000 pounds;
- for non-alcoholic beverages from \$85 to \$80 per 2000 pounds.

These rate reductions on these few commodities are on the order of approximately 5%. My own analysis, based on publicly available information which was presented along with GovGuam's submission to the DOT Report, showed that the Guam carriers' rates produced windfall profits to them that greatly exceeded revenues compared to a just and reasonable standard. Placed within that perspective, the few, minor 5% rate decreases that Mr. Wilson selected to show to the Board certainly do not indicate that there is effective competition in the Guam trade.

13. A Structural Analysis of the Trade

A structural analysis of the trade suggests that the two carriers behave similar to how they would behave if they in fact do have an explicit agreement to coordinate their activity with each other. The conditions of this trade allow them to come very close to the optimal duopoly price

simply by their conscious parallelism, monitoring each other's activity closely, effective signaling, and cautious, circumspect decision-making. Nonetheless, it is instructive to compare this market with the market that Professor Herbert Hovenkamp sees as coming from a cartelized environment. The parallels are close. However, the parallels merely indicate the obvious: this trade is a duopoly that is able to tacitly recognize interdependence and achieve price well above marginal cost and average cost, and excess joint profits.

This analysis is taken from Professor Herbert Hovenkamp's *Federal Antitrust Policy, The Law of Competition and its Practice* (1994). In Chapter 4, "Antitrust Policy Toward Collusion and Oligopoly," he identifies six conditions that support the continued existence and success of a cartel:

- a. High barriers to entry;
- b. Large share of the market;
- c. Ability to arrive at an agreement about output;
- d. Ability to detect "cheating";
- e. Ability to punish "cheating";
- f. Ability to do these things without being detected from the outside.

Each of these conditions is satisfied in the Guam liner trade, as I explain below. The Defendants' Initial Submission provide many of the relevant facts.

- a. High barriers to entry. These include the Jones Act, the small volume, the need to also serve the transpacific trade, and the extremely high capital costs required for that. Guam has been served by a two carrier cartel since the 1970s (and perhaps earlier). There have been no net entries.

- b. Large share of the market. Sea-Land and Matson have a complete share of the market between them, and their shares are close to 50% with Matson having slightly more, according to page 2 of Mr. Miller's statement.
- c. Ability to arrive at an agreement about output. Each carrier has the capacity to serve one to two times more than the entire trade according to Mr. Miller, at p. 1 of his statement. However they choose instead nearly equal shares and have a side agreement for moving containers on each other's vessels.
- d. Ability to detect "cheating." Price cheating is detected by the publication of tariffs. Volume cheating is detected by the use of a single terminal in Guam where containers can be counted on each ship, so each carrier can know, with accuracy, the volumes carried by the other. Such awareness of each other's volumes is very important for achieving profit stability.
- e. Ability to punish "cheating." The reciprocal response to public tariff actions of each carrier (matching or not matching) signals the acquiescence or the disagreement of one carrier to the tariff action of the other. The pricing anecdotes that Mr. Wilson described that reflect the carriers matching each other's price changes or forcing one carrier to rescind a price change, are consistent with each carrier "punishing" the other "cheater."
- f. Ability to do these things without being detected from the outside. While output and prices are detectable from the outside, the profit maximizing pricing is not detectable. Only the Guam rate case (FMC Docket No. 89-26) exposed the excessive profitability of the Guam trade. And that is only the profit over fully

distributed costs. The incremental profit earned by the pass-by service as part of a transpacific service is even higher.

14. The Insignificance of the Remaining Arguments Regarding “Effective Competition”

- “Aggregate revenue per container for the U.S. mainland to Guam trade showed a 1995 level of less than 80 percent of the 1990 level, after adjusting for inflation.” Defendants’ Initial Submission, p. 20.
- “No general rate increase has been taken in the trade in recent years.” Defendants’ Initial Submission, p. 20.

As explained above, these statements do not reflect anything meaningful about nominal rates, about rate levels, or about effective competition. The most likely interpretation of these facts is that this is a stable duopoly, whose price is approximately equal to its joint-profit-maximizing price, and its best strategy to retain duopoly stability is to avoid significant price changes.

III. THE TWO CARRIER ISSUE

Defendants argue that because there are two carriers whose rates are being examined in this complaint, the use of a GO-11 type of approach is inappropriate. Defendants’ Initial Submission, p. 4. Specifically, Defendants claim that, “[m]easuring the reasonableness of rates by the actual costs and rate bases of the two carriers involved would be particularly inappropriate in a two-carrier market because by such measurements the maximum permissible levels would necessarily differ for the two carriers which would have perverse results if any prescriptive relief were imposed against one or both carriers.” Id.

Defendants do not and cannot allege that this trade cannot be regulated simply because there are two operators. Instead, they assert that the results of that regulation, with two carriers being simultaneously subject to the GO-11 analyses, may produce anomalies. The only relevant issue is that the GO-11 analysis of each carrier may yield two different maximum rate structures.

If the carriers have different cost levels, the Board has an obligation to facilitate the more efficient operator charging the lower rates. It is highly unlikely that this differential will drive the second carrier out of the trade. Because profitability is so high, and incremental costs are so much below average costs, forcing one carrier to reduce rates to below its maximum allowable rates will only mean that the Guam trade will contribute somewhat less to that carrier's overhead.

If the two maximum rates are vastly different, then the carrier with the far higher maximum rate level may choose to leave the trade, thereby allowing the more efficient carrier to expand its service, gain more economies of scale, and have lower costs, which are passed on to the shippers. In that competitive situation, which the application of regulation will have brought about, the carrier is more cost efficient, the shippers are far better off, and the Board will have performed its statutory function.

However, this will clearly not occur. One carrier will not be driven out of the trade because of the application of GO-11. Defendants' threat that one of the two carriers may be driven out of the trade due to being the higher cost/less efficient carrier, is hyperbole. Mr. Miller clearly stated that each carrier has more than enough capacity to serve the entire Guam trade. Rather, Defendants' suggestion such a result could occur appears to be a tacit admission that one of the carriers is significantly more efficient than the other, but has been foregoing meaningful price competition to keep prices high enough to permit the inefficient carrier to survive, allowing

both carriers to earn excessive profits. This is also an implicit admission of the lack of competitiveness in the trade.

On a more practical and realistic level, it is highly unlikely that the GO-11 will produce maximum rates that differ significantly as between the two carriers. This is because their circumstances are so similar: both carriers offer weekly pass-by service to Guam using similar ships, and they have roughly equal market shares.

I also note that this proceeding will set maximum allowable rates, based on a fully distributed GO-11 cost analysis. These are essentially maximum allowable average costs. As demonstrated in my Initial Verified Statement, these rates, even after the Board adopts my recommended modifications to GO-11, will still be well above incremental cost. It is only incremental cost that is the criterion for determining exit. Thus, it is extremely likely that the GO-11 results will leave both carriers with significant profits in the Guam portion of their services.

Defendants also allege that having two different rate maximums, one for each carrier, is a "commercial impossibility." Defendants' Initial Submission, p. 29. The carriers are wrong. One of the carriers can set rates below his allowable maximum.

At footnote 24, Defendants note the service patterns that Mr. Downes refers to -- that the two carriers move cargo on each other's ships under slot charter agreements. Defendants challenge the applicability of GO-11 to the Guam trade, alleging these service differences create the problem of "[a]ttempting to allocate common 'unattributable' costs over these diverse services would be extraordinarily difficult and inherently arbitrary . . . and would result in widely varying results between the two carriers." Id.

Defendants are wrong. GO-11 has always been able to address cost allocations to several non-regulated trade segments, whether foreign non-regulated trades or domestic non-regulated trades. The multiplicity of routings that Mr. Downes mentions actually improves the cost analysis, rather than rendering it “arbitrary,” because it adds additional data, information, and analysis to the process.⁷

The simultaneous application of the cost-based GO-11 to the two carriers in the Guam trade will produce rational and shipper-friendly results, both on a reparations basis for past excess freight rates, and on a prescriptive basis for the future. There is no merit to the claim by Defendants that “perverse results” will come from applying GO-11 to the two carriers.

IV. DEFENDANTS’ ECONOMIC ARGUMENTS ON THE INAPPROPRIATENESS OF GO-11 ARE WITHOUT MERIT

Defendants assert a number of economic arguments as to why the application of GO-11 would be inappropriate. They are summarized as follows:

- The general revenue analysis of GO-11 leaves completely unsettled issues about the lawfulness of particular commodity rates;
- Significant obstacles are presented in allocating costs between the various components of mixed regulated/unregulated service of which Guam is a relatively

⁷ The reciprocal space charter confers a distinct benefit to the analysis: presumably, each carrier charges the other an explicit, arm’s length charge for the voyage part. The cargo handling expense at the transfer point, in Hawaii, is also a simple and relatively small expense that is easy to determine. There would be nothing arbitrary in those cost determinations, and little, if any, unattributable costs involved in the relay operations in Hawaii. Finally, the CSX relay service via Hawaii to Guam, simply means that the analysis must measure the California-Hawaii voyage expense. This is just another part of the cost allocations that the Guam trade requires, and that the GO-11 handles. Again, it is a cost that can be compared to the explicit space charter fee that, presumably, the carriers charge each other.

small regulated component;

- Because no historic period will yield actual operating results that match a presently conducted GO-11 analysis, the misapplication of FMC methodology to historic data could force an anomalous ratemaking outcome that would render impossible forward planning by carriers; and
- FMC general revenue analysis depended on the routine annual filing by carriers of financial reports conformed to the requirements of GO-11, which the Board does not have.

Defendants' Initial Submission, pp. 35-36.

Defendants' first point is completely without merit. GovGuam is not complaining about a specific commodity rate, or whether particular commodity rates within a rate structure are too high or too low. GovGuam is challenging the overall rate structure. Whether specific commodity rates within a rate structure are too high or too low are irrelevant for purposes of this proceeding. Once a determination is made of the appropriate percentage reduction in the overall rate structure, then the carriers will have the opportunity to adjust any set of rates they choose, provided those adjustments remain revenue neutral.

Defendants quote from the FMC Decision that, "GovGuam cannot rely on a finding that overall revenues are unreasonably high to establish the unreasonableness of individual commodity rates." Defendants' Initial Submission, p. 38. This quote from the FMC decision dealt specifically with the 18 individual commodities and not GovGuam's challenge to the overall rate structure. The FMC went on to hold that, "[a]s a general rule, the Commission finds that G.O. 11 is the appropriate methodology to be used in complaint cases . . . to determine

whether a carrier's general level of rates is just and reasonable." Government of the Territory of Guam, et al. v. Sea-Land Service, Inc. and American President Lines, LTD., 28 SRR 252 (FMC 1998), slip op. 57.

At page 33 of their Initial Submission, Defendants state, "[t]he Commission, other regulatory agencies, and the courts have recognized that the issues in a specific general-revenue case are essentially different from those in specific commodity cases." Once again Defendants are addressing an issue that is not raised in this proceeding. The Board has already ruled that this is a base rate case covering all of Defendants' rates in the Guam trade. Defendants' references and arguments regarding individual commodities are irrelevant.

Defendants' second point regarding cost allocation in a mixed regulated/unregulated service is discussed in the previous section, at pp. 20-21. As noted above, Defendants are wrong in their assertion. GO-11 has always been able to address cost allocations to several non-regulated trade segments, and in fact improves the cost analysis.

Third, Defendants' claim that reliance on historical rather than current data would render impossible forward planning by carriers is also without merit. Initially, Defendants' statements ignore the fact that GovGuam's complaint was filed in 1998, not 2002. No issue related to past decision-making can be impacted, because those decisions have long since been made. The carriers may have a legitimate concern only about decision-making for the future.

More importantly, however, no rate methodology -- whether it is GO-11 or SAC -- subordinates rate reasonableness to investment certainty. To the extent that the carriers made investment decisions predicated upon rates that are found to be unlawful, that is not a decision making process that this Board has any obligation to support.

Defendants' fourth point concerning filing requirements of financial reports for GO-11 is similarly unpersuasive. Annual GO-11 filings are not onerous, and data retrieval back to 1996 is facilitated by computerized databases. Both Matson and Sea-Land/CSX have experience filing GO-11's as Matson has filed them for decades in the Hawaii trade and Sea-Land previously filed them in both the Guam trade and the Hawaii trade.

Defendants also allege that GO-11 would "deprive carriers of an incentive to control their costs." This is wrong. Cost savings are always enjoyed by the operator until such time as the regulator mandates that some of that cost savings get passed on to the consumer. There is at least an interim profit advantage to the carrier for engaging in cost savings. Also, the goal in a competitive market is precisely to render these savings to the advantage of the customers. The cost savings, even when passed on to the customers, preserve the carrier's existing profits and the value of his existing assets, preventing someone else's increased efficiency from rendering one's less efficient assets worthless. Thus, carriers have strong incentives to control their costs under GO-11 regulation.

There will still be lots of scope for cost savings. The Guam trade is served in common with service to the other trades by the pass-by carrier. If a carrier controls his cost, he can drive down prices and earn a much bigger share of the market, which is a permitted advantage when using the fully distributed model for rate regulation. A carrier can allocate more resources to the high rate of return Guam trade instead of the low rate of return westbound pacific trade. The carrier can make his normal profit on a larger volume, which is an incentive for any competitive carrier.

Defendants further argue that GO-11 was intended to address only dedicated turn-around

trades. Defendants' Initial Submission at p. 37. Defendants cite to testimony from FMC Docket 89-26 by Robert Ellsworth that "[t]he G.O. 11 regulations . . . were intended by the FMC to address dedicated turn-around trades of the sort typified by Hawaii and Puerto Rico in the late 1960s and 1970s. The FMC never applied on its own motion G.O. 11 standards to the peculiarities of the Guam trade."

This is misleading. The FMC was well aware of Guam and never established special treatment for the Guam trade. And, while not on its own motion, the FMC still found GO-11 appropriate to apply to the Guam trade in Docket 89-26.

V. COMPARISON OF GO-11 TO SAC

The Defendants have urged the Board to choose SAC over GO-11. While the two approaches have similarities, certain important differences make GO-11 the better methodology for this proceeding. In essence, GO-11 is more practical, less theoretical, and more fair in principle to both the shippers and the carriers. Additionally, unlike SAC, GO-11 does not require access to confidential information from foreign third parties.

Guam is efficiently served only via a pass-by service. Therefore, any proposed SAC hypothetical competitor will, of necessity, group additional (Asian) traffic into the service and include more than just the traffic moving to and from Guam.

There are three steps in a GO-11 analysis: (1) determine the Guam cost; (2) determine the excess revenue in the Guam trade; and (3) determine the reparations for the Guam shippers.

Step one of GO-11 begins with the known total cost. This greatly simplifies the GO-11 methodology as compared to CMP. It allows use of an "actual cost system," that is, the actual cost of the service provider. It has all the ethical and fairness virtues of being the *actual* carrier

cost, rather than the carrier being compared to a hypothetical cost standard. GO-11 then determines the discreet portions of the cost, here the Guam cost and the Asian cost.

GO-11 provides the proper and requisite guidance to determine the Guam share of the total cost. There will undoubtedly be issues concerning which evidence is relevant to the Guam trade cost or the Asian portions of the trade, however, GO-11 is familiar with these issues, having been previously applied in this trade creating widespread experience among carriers and shippers in this trade.

CMP SAC also starts with the total cost of the Asia/Guam service. Contrary to GO-11, SAC must design a hypothetical efficient long-run system, designed to properly serve this particular trade. This hypothetical service may not be the exact service as is currently plied by the carriers. Rather than have the relatively simple task of discovering the actual carriers' current costs based on empirical data, SAC adds another layer of analysis by requiring a hypothetical, more efficient, cost structure.

The next step in SAC is to determine the long-run value for Asian revenue, a very problematic endeavor. The transpacific Asian trade is very competitive and very cyclical, with extreme changes in rates as excess supply is created and then eliminated. Secular, cyclical, and seasonal variations must be dealt with. The rates for approximately 80 percent of the cargoes are rates for confidential services contracts that are not available to the public. Unlike the rail sector, there exist no long term maritime service contract rates that are easily available to the Board. While the contract rates also are confidential in rail proceedings, such rates are discoverable from domestic railroads in a maximum rate proceeding. In contrast here, the vast majority of the contracts and agreements in the Asian trade may only be available from third party foreign

companies. Further, the service contracts that do exist in the maritime sector are confidential, short (usually less than 3 years) and involve shipper-specific service terms that can often be satisfied by service from one of several, alliance-linked carriers.

Moreover, most of the Asian cargo is intermodal, destined for or originating in the eastern and mid-western United States. The rates are genuine, long-distance-overland, intermodal rates. Finding the ocean or port-to-port portion of those rates will add another layer of difficulty. Also, forecasting these port-to-port rates, over the long term that abstracts away from the secular, cyclical, and seasonal variations, will be an extremely difficult, time-consuming, and expensive task.

Once Asian revenues have been determined, the SAC approach adds those revenues to the Guam trade revenues, to reach the total revenue. That revenue is compared to the total cost. Excess revenue for the entire service is then determined as total revenue minus cost of the service. The next issue is to determine how much of the excess revenue is attributable to the Guam trade as well as how much of the excess revenue should be returned as reparations to the Guam shippers. This issue and its related problems do not arise under the GO-11 methodology.

GO-11 takes into account the differences in subsets of total revenue. For that reason, unlike SAC, reparations to Guam shippers would not be limited to the Guam proportion of total revenue. The conventional SAC attribution -- allocation of excess revenue to the Guam trade and the Asian trade proportional to their actual revenues -- is wholly inappropriate. Only the Guam trade is "captive" and none of the excess in the Guam rates should subsidize the extremely competitive Asian transpacific trade.

Finally, the SAC model may result in compounding of any errors in the hypothetical

assumptions. A small mistake in the Asian analysis would be multiplied when applied to the Guam trade. If the Asian rates are set too low then the excess revenue and rollback requirement disappears, even if it would otherwise appear that the Guam rates are too high. If the Asian rates are set too high and the reparations, rates and rollback is increased, this would be an unfair result for the carriers. An error could easily occur through an incorrect statement in the port-to-port revenue, or through an incorrect statement of the through intermodal rate since both types of revenue are found in confidential sources where no database currently exists.

Accordingly, given all the problematic issues and uncertainty with SAC, GO-11 is by far the more desirable methodology to employ for the Guam trade.

VERIFICATION

STATE OF CALIFORNIA

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CITY OF EMERYVILLE

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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

Ernest Nadel

Sworn to and subscribed
before me this 13 day
of June, 2002.

Ellen R. Strauss
Jan 1, 2005

