SERVICE DATE – FEBRUARY 2, 2007

SURFACE TRANSPORTATION BOARD

DECISION

STB Docket No. WCC-101

GOVERNMENT OF THE TERRITORY OF GUAM
v.
SEA-LAND SERVICE, INC., AMERICAN PRESIDENT LINES, LTD., AND MATSON NAVIGATION COMPANY, INC.

Decided: February 1, 2007

By complaint filed September 10, 1998, the Government of the Territory of Guam (GovGuam) challenged the reasonableness of the rates, rules, classifications and practices for all transportation by water (including the water portion of intermodal transportation) provided by Sea-Land Service, Inc. (now Horizon Lines, LLC) (Horizon), American President Lines, Ltd. (APL), and Matson Navigation Company, Inc. (Matson), in the noncontiguous domestic trade[1] to and from Guam. GovGuam, acting on behalf of its citizens shipping goods in that trade, seeks the prescription of maximum reasonable rates, as well as reparations for past unreasonable rates.

In a decision served on January 6, 1999, the Board adopted a three-step process for addressing this complaint. In Phase I, in a decision served on November 15, 2001 (November 2001 decision), the Board addressed the carriers' joint motion to dismiss the complaint, granting the motion to dismiss with respect to GovGuam's discrimination claim but denying the remainder of the motion. The Board also dismissed APL as a defendant and allowed the Caribbean Shippers Association (CSA) to intervene. In this phase of the case (Phase II), we address the appropriate procedures and methodology for handling this case. On November 16, 2005, the Board heard oral argument on Phase II issues. In Phase III, the Board will rule on the underlying complaint.

[1] The noncontiguous domestic trade is defined at 49 U.S.C. 13102(15) as domestic water carrier transportation "involving traffic originating in or destined to Alaska, Hawaii, or a territory or possessions of the United States." In the past, it was often referred to as the "domestic offshore trade." See Joint ICC/FMC Policy Statement, 8 I.C.C.2d 243 (1991) (ICC/FMC Policy Statement).

BACKGROUND

Historically, regulatory jurisdiction over rates in the domestic offshore trade was bifurcated. The Federal Maritime Commission (FMC) had jurisdiction over complaints challenging the reasonableness of so-called "port-to-port" rates (water carrier rates that do not involve the services of an inland U.S. railroad or motor carrier). The Interstate Commerce Commission (ICC) had jurisdiction – which it was never called on to exercise – over complaints challenging the reasonableness of joint rates in the domestic offshore trade (rates held out jointly by water carriers and inland rail or motor carriers).[2]

In 1989, GovGuam filed with the FMC a complaint against APL and Horizon alleging that port-to-port rates for Guam, in the aggregate, were unjust and unreasonable.[3] In 1998, the FMC issued an Order[4] in which it determined that those rates were unreasonable for the years 1988-1990. The FMC Order remanded the proceeding to an Administrative Law Judge (ALJ) to determine the number of Horizon containers subject to the FMC's jurisdiction and the amount of reparations to be awarded. The ALJ ultimately denied GovGuam's request for reparations and dismissed the complaint because he found that GovGuam had failed to show the "just and reasonable rate" for any specific shipments.[5] In a final decision served on July 11, 2005, the FMC affirmed the ALJ and dismissed the complaint.

In the ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 (ICCTA), Congress abolished the ICC, and transferred certain ICC functions to the Board, effective January 1, 1996, including the responsibility to hear complaints challenging joint rates in the noncontiguous domestic trade. Congress also transferred to the Board the FMC's jurisdiction over complaints challenging the reasonableness of port-to-port rates in the noncontiguous domestic trade.

DISCUSSION AND CONCLUSIONS

This decision addresses four specific issues presented in Phase II of this proceeding. First, we address the new motion to dismiss filed by Horizon and Matson (the Carriers). Second,

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[2] See ICC/FMC Policy Statement.

[3] At the time the proceeding was begun before the FMC, Horizon was still named Sea-Land Services, Inc.

[4] The Government of the Territory of Guam v. Sea-Land Service, Inc. and American President Lines, Ltd., 28 SRR 252 (1998).

[5] The Government of the Territory of Guam v. Sea-Land Serv., Inc. and American President Lines, Ltd. – Respondents' Motions for Dismissal of Specified Claims Granted; Proceeding Assigned for Conference; Respondent to Prepare Draft Orders, 29 SRR 894 (administratively final, May 22, 2002) and The Government of the Territory of Guam v. Sea-Land Serv., Inc. and American President Lines, Ltd., 29 SRR 1509 (ALJ 2003).

we discuss our intention, in Phase III, to first explore whether there is sufficient competition in the noncontiguous domestic trade to Guam to preclude the Carriers from exercising significant market power and thus whether the rate complaint should be dismissed before undertaking any review of the reasonableness of the water carrier rates to and from Guam. Third, we address the proper methodology that will be used to assess the reasonableness of the rate levels involved in this rate complaint, should we find insufficient competition. Finally, we address the appropriate application of the Zone of Reasonableness (ZOR) of 49 U.S.C. 13701(d)(1) to the rate levels of the serving water carriers.

I. Motion to Dismiss

Position of the Parties

The Carriers assert that this proceeding should be dismissed because, even if their Guam rates were shown to be unreasonable in the aggregate, the Board would not be able to provide a reasonable and meaningful remedy to shippers with widely varying rates. The Carriers maintain that: (1) all of their rates have been continuously adjusted in response to changing commercial and competitive conditions;[6] (2) the rates vary substantially based on the particular services provided and the prevailing commercial and competitive conditions; and (3) simply reducing each rate by a certain percentage would be inappropriate.

The Carriers contend that it would make no sense to subject the parties and the Board to the burden and expense of an aggregate rate investigation unless such a proceeding could yield a meaningful and reasonable remedy. According to the Carriers, assuming that a standard for judging aggregate rates produced a total excess revenue figure, that determination could not serve as a basis for a reasonable, non-arbitrary remedy, as such a finding would not provide a basis for identifying which specific rates were reasonable and which were unreasonable.

GovGuam relies on 49 U.S.C. 13701 for its statutory right to bring a rate complaint and for the Board's authority and obligation to provide relief that is practicable when a governmental body shows that carriers have not charged reasonable rates. Moreover, GovGuam argues that its right to challenge the Carriers' rates on the basis of total revenues was settled in Phase I. GovGuam asserts that the Board must allow a reasonable methodology for assessing a rate structure complaint in this trade, so that GovGuam is not left without a remedy in the event the rates are found unreasonable.

GovGuam argues that the Board would not have to conduct further proceedings to determine which rates were reasonable and which were not reasonable. Rather, GovGuam maintains that across-the-board rate reductions would be appropriate if the Board finds excess

[6] The Carriers state that there are several factors that affect the levels of each of their rates, including: the demand for transportation; the value of the commodity transported; the rate for similar commodities and services offered by other carriers in the trade; the costs of providing services; and the volume of cargo a customer can commit to shipping.

revenues, that the Board has used across-the-board reductions in rail rate cases, and that the FMC has also used that approach in applying its General Order 11 (GO-11) methodology.

Board Analysis

In our view, dismissal is not appropriate. The Board expressly found in the November 2001 decision that a complaint challenging rates in the aggregate is permissible, and where a complaint is filed by a governmental body on behalf of its constituents, the Board must order reparations if it finds that the revenues exceeded what is reasonable. See 49 U.S.C. 13701(d) (upon finding of a statutory violation based on a complaint by a governmental body, the Board is to fashion a "just" award and require the carrier to return excess amounts (plus interest) to shippers to the extent practicable). Because the statute requires that we address the concerns raised by GovGuam on behalf of its shippers, we will not dismiss this proceeding.

II. Effective Competition

Positions of the Parties

The Carriers argue that the Board must first determine whether there is sufficient competition in the trade to preclude the exercise of market power. They rely on the reasoning in CF Industries, Inc. v. Koch Pipeline Co., L.P., 2 S.T.B. 257 (1997) (Koch Pipeline), where the Board concluded that rate review by the agency is unnecessary where there is effective competition in the market. If there is effective competition, as the Carriers assert, the Carriers maintain that there is no reason for the Board to investigate the reasonableness of the challenged rates.

GovGuam responds that there is no statutory basis for making absence of competition in the Guam trade a prerequisite for investigating the reasonableness of the Carriers' rates.[7] It submits that the Board looked at competition in Koch Pipeline because the particular statutory provision involved there (49 U.S.C. 15503) specifically directs the Board to take into account whether there are other economic transportation alternatives. Because there is no similar provision for ocean carriers, GovGuam asserts that ineffective competition is not a prerequisite to rate relief and that an effective competition test should not be applied here.

In any event, GovGuam maintains that, even though there are two water carriers serving Guam, meaningful competitive pressures do not exist, because neither the carriers themselves (U.S. flagged carriers) nor the commodities shipped (U.S. goods subject to section 27 of the Merchant Marine Act of 1920) are subject to substitution.

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[7] GovGuam also argues that this is a "threshold legal issue" that should have been raised in Phase I, and, because it was not raised in Phase I, the Carriers are barred from raising it now. We disagree. This issue is part of the methodology inquiry. While it could have been raised in Phase I, we see no reason it cannot be addressed in this Phase.

Board Analysis

Under 49 U.S.C. 13701(a), a rate charged by a water carrier in the noncontiguous domestic trade "must be reasonable." The Supreme Court "has repeatedly held that the just and reasonable standard does not compel the [agency] to use any single pricing formula . . . ."[8] And the federal courts have found that, where there is a competitive market, regulatory agencies may rely on market-based prices to assure a "reasonable" result even without a particular statutory provision directing such an approach.[9] The courts reason that, in a competitive marketplace, it is rational to assume that terms voluntarily accepted by the shipper are reasonable.[10]

Thus, the fact that our statute is silent on this issue does not mean the agency should not examine the competitive nature of a particular trade it is asked to regulate. It is true that, in the rail provisions of the Interstate Commerce Act, Congress expressly barred the agency from regulating rail rates where there is effective competition for the transportation to which the rate applies. 49 U.S.C. 10707(b). But the fact that no such language appears in the noncontiguous domestic trade provisions does not mean, as GovGuam argues, that Congress precluded a similar competitive analysis where water carrier rates are involved. Rather, we believe that Congress left it to the agency to decide whether to conduct a market power inquiry in such cases.

The purpose of rate regulation is to simulate competitive rates that will provide a reasonable return on investment. <u>See</u> <u>Coal Rate Guidelines, Nationwide</u>, 1 I.C.C.2d 520, 542-43 (1985) (<u>Guidelines</u>), <u>aff'd sub nom.</u> <u>Consol. Rail Corp. v. United States</u>, 812 F.2d 1444 (3d Cir. 1987). As the Board explained in <u>Koch Pipeline</u>, 2 S.T.B. at 263, if the marketplace is effectively competitive, "then [interference by the agency] can only distort the economically efficient rate(s). Such ill-advised action would contravene the policy to promote adequate, economical and efficient transportation, and to encourage sound economic conditions in transportation." Accordingly, we do not believe that we are required to actively regulate rates charged in the noncontiguous domestic trade where there is effective competition.

Therefore, the first question we will examine in Phase III is whether transportation alternatives constrain each of the carriers from exercising significant market power.[11] In rail

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[8] <u>Mobil Oil Exploration v. United Distrib. Co.</u>, 498 U.S. 211, 224 (1991).

[9] <u>See</u> <u>California v. FERC</u>, 383 F.3d 1006 (9th Cir. 2004) (discussing "just and reasonable" requirement of the Federal Power Act); <u>Louisiana Energy & Power Authority v. FERC</u>, 141 F.3d 364 (D.C. Cir. 1998) (same); <u>Elizabethtown Gas Co. v. FERC</u>, 10 F.3d 866 (D.C. Cir. 1993) (<u>Elizabethtown Gas</u>) (discussing the "just and reasonable" requirement of the Natural Gas Act).

[10] <u>See</u> <u>Texas Power Corp. v. FERC</u>, 908 F.2d 998, 1004 (D.C. Cir. 1990).

[11] <u>See</u> <u>Koch Pipeline</u>, 2 S.T.B. at 263. This standard is comparable to that used by the Federal Energy Regulatory Commission (FERC) to assure that gas and electric prices are "reasonable" within the meaning of the Federal Power Act and the Natural Gas Act.

(… continued)

cases, because a finding of market dominance is a threshold jurisdictional requirement, we place the burden of proof on the shipper to show that there is not effective competition. In water carrier cases, by contrast, the availability of competitive alternatives is an affirmative defense. For that reason, on the market power issue we will place the burden of production and persuasion on the Carriers.

The Carriers have requested that the Board bifurcate this proceeding to obtain evidence on and address the market power issue first. As the Board stated in Koch Pipeline, 2 S.T.B. at 263-64, in the rail area experience has shown that bifurcation of the market power and rate reasonableness phases can unnecessarily prolong a proceeding, as the agency usually finds market dominance over the movement at issue. However, that is not an inflexible practice, and the Board has bifurcated the market dominance and rate reasonableness inquiries where the evidence submitted by the defendant rail carrier raised "considerable doubts as to the complainants' ability to demonstrate market dominance."[12] Here, the Carriers have submitted a recent report from the U.S. Department of Transportation's Maritime Administration (MARAD) that presents some indication of effective competition.[13] While we make no finding at this time on whether or not there is effective competition for transportation to Guam, an examination into the presence or absence of effective competition in the Guam market is warranted prior to any examination of rate reasonableness.

Accordingly, in Phase III, the Carriers will have 45 days from the service date of this decision to submit additional evidence on the degree of competition in this market (other than product and geographic competition).[14] GovGuam will have 75 days from the date of service of this decision to reply to that evidence. The Board will endeavor to issue a decision within 60 days after receiving all evidence on the presence or absence of effective competition. If the Carriers satisfy their burden of proof to show effective competition, we can assume that the

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Elizabethtown Gas, 10 F.3d at 870-71 (noting that FERC will examine whether the market is sufficiently competitive to preclude the carrier from exercising significant market power); Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, 74 FERC ¶ 61,076 (1996).

[12] Sierra Pacific Power Company and Idaho Power Company v. Union Pacific Railroad Company, STB Docket No. 42012, slip op. at 5 (STB served Jan. 26, 1998).

[13] See Competition in the Noncontiguous Domestic Maritime Trades (MARAD, May 2006). That study is an update of a 1997 Department of Transportation analysis of the economic factors affecting the demand and supply of liner services in the four domestic offshore markets (Alaska, Guam, Hawaii and Puerto Rico).

[14] We will not consider arguments regarding product and geographic competition, given the Board's experience with this issue in rail rate cases. See Market Dominance Determinations, 3 S.T.B. 937 (1998), aff'd, Assoc. of Amer. Railroads v. STB, 306 F.3d 1108 (D.C. Cir. 2002).

challenged rates are reasonable and we will dismiss the complaint. If, on the other hand, the Carriers fail to show that there are competitive forces that can be relied upon to assure that the rates are not the result of significant market power, we will proceed to investigate the reasonableness of the challenged rates. Should such an investigation become necessary, the Board's market dominance decision will contain instructions regarding a procedural schedule.

III. Rate Reasonableness Methodology

Positions of the Parties

GovGuam argues that, because it is only challenging rates for the water portion of any movements, the Board should apply the public-utility type of rate-of-return methodology promulgated by the FMC in what is generally referred to as GO-11.[15] GovGuam maintains that, while the Board should make several modifications to the GO-11 methodology (to reflect the characteristics of the Guam trade), we should not disregard procedures designed by a sister federal agency that has more experience with ocean common carriers.

GovGuam argues that principles developed for public utility regulation, such as those that GovGuam asserts are embodied in GO-11, should be applied to the carriers here because the GO-11 methodology is time-tested and has withstood judicial scrutiny. GovGuam further argues that we should not experiment here with new methodologies. GovGuam objects to any method that would permit even a small amount of excess revenue, which could then be compounded and might be shielded by the ZOR, resulting in significant excess over time. GovGuam asserts that applying GO-11 will ensure reasonable base rates and reasonable rates going forward.

The Carriers point out that, historically, the GO-11 methodology was used only to determine whether general rate increases were appropriate and that the only time it was used to address the reasonableness of rate levels generally was in the Guam proceeding before the FMC. The Carriers note that there is no judicial precedent for the use of GO-11 other than in the context of a general rate increase. The Carriers argue that, because GovGuam has put forward three versions of GO-11 – the version applied in the FMC order (GO-11 prior to 1995), GO-11 after 1995, and GovGuam's expert's version (GO-11 after 1995 plus modifications) – GovGuam is itself asking the Board to experiment with new methodologies.

The Carriers maintain that none of the three GO-11 versions is appropriate here, and that the basic GO-11 methodology is at odds with economic scholarship and prevailing regulatory principles. The Carriers' expert contends that using an historic review of overall revenue levels conducted pursuant to fully distributed cost methodologies borrowed from another statutory

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[15] CSA also supports use of the GO-11 methodology to determine rates in the aggregate. It argues that the Board should address prior rates and future rates separately because the Carriers that serve Guam have changed ownership or "sold out foreign." As the Carriers stated at oral argument, the named parties are the correct parties and subject to the Board's jurisdiction.

context would not provide effective regulation and would risk harm to shippers and carriers because over time the carrier would not be able to earn a reasonable rate of return.

The Carriers further argue that the statutory framework that created GO-11 is not compatible with the statutory mandate of the Board. Under the 1933 Intercoastal Shipping Act (1933 Act),[16] the FMC was directed to review, suspend and investigate general rate increase proposals by carriers. The statutory regime administered by the Board, in contrast, focuses on challenges to past or already existing rates. The Carriers express further concern that, because each of them likely has a unique cost structure and its own efficiencies, applying the GO-11 methodology would impact them differently and, depending on where the rates are set, could result in squeezing one carrier out of the trade by forcing its rates below levels that would warrant continued participation in the trade.

The Carriers argue that, rather than GO-11, we should apply the stand-alone cost (SAC) methodology set forth in Guidelines, because it would measure the reasonableness of the Guam rates without reference to the actual costs or rate bases of the Carriers. Rather, SAC examines the costs of a hypothetical efficient carrier in a competitive market. The Carriers argue that using a SAC analysis would avoid prescribing rates that can be charged by a carrier in a two-carrier market based in part on the costs and rate bases of the other carrier.

The Carriers assert that a SAC analysis would be more appropriate than applying the Board's revenue adequacy constraint,[17] because whether a carrier's revenues are adequate to support its entire system has no relevance to the reasonableness of the rates for a single segment of its system. The Carriers argue that a revenue adequacy test might be appropriate in the context of a general rate increase, but not to challenge existing rate levels. Nor, they say, is the revenue adequacy test appropriate in a two-carrier system, because it could result in a finding that the same rates are reasonable as to one carrier but not as to the other, or that the same rates are unreasonable to different degrees.

GovGuam argues in response that the use of the Board's CMP guidelines is neither mandatory nor appropriate in these circumstances. It asserts that, as with the FMC's GO-11 methodology, the CMP principles are based on the economics and operations of a particular industry (the rail industry). GovGuam argues that CMP was designed, in response to the Staggers Rail Act of 1980,[18] to provide railroads with additional rate freedom and to ensure the financial health of rail carriers, but that there has been no comparable Congressional concern with respect to carriers serving the noncontiguous domestic trade. Additionally, GovGuam

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[16] 46 U.S.C. 843, as amended, Pub. L. No. 95-475, 92 Stat. 1494 (1978).

[17] Guidelines contains alternative approaches, which can be used in a rail rate case, collectively referred to as Constrained Market Pricing (CMP). The revenue adequacy constraint focuses on whether the carrier involved earns an overall return on investment that exceeds its cost of capital.

[18] 49 U.S.C.10101 et al., as amended, Pub. L. No. 96-448, 94 Stat. 1895 (1980).

argues that CMP is designed for use in situations where the carrier has market dominance. GovGuam maintains that application of CMP, and specifically the SAC test, would be problematic here because of the difference between Guam rates and rates in the Carriers' other, openly competitive trades, which are confidential.

GovGuam maintains that the Carriers have not demonstrated that CMP principles are a more effective regulatory tool than GO-11. Citing Koch Pipeline, GovGuam argues that, unless the Board concludes that a particular methodology would produce unreasonable results, the Board should give the complainant its choice of the type of case to present. But if the Board should require the parties to use CMP procedures in Phase III, GovGuam argues that the Board should allow GovGuam to select which particular CMP constraint would be appropriate. And if GovGuam were to use the SAC test, it asks that the Board recognize the Jones Act as a barrier to entry that prohibits potential competition from foreign flag carriers. Additionally, GovGuam asks that it be permitted to develop a model that includes backhaul traffic and services.

Board Analysis

In Phase III, should this case proceed to an examination of the reasonableness of the rates at issue, GovGuam is instructed to use the Board's CMP standards set forth in Guidelines. CMP pricing principles can be simply stated. A captive shipper should not be required to pay more than is necessary for the carrier involved to earn adequate revenues. Nor should it pay more than is necessary for efficient service. And a captive shipper should not bear the cost of any facilities or services from which it derives no benefit. Guidelines, 1 I.C.C.2d at 523-24.

CMP contains three main constraints on the extent to which a carrier may charge differentially higher rates on traffic.[19] By comparing the carrier's return on investment with its cost of capital, the revenue adequacy constraint ensures that a captive shipper (or, as in this case, group of assertedly captive shippers) will "not be required to continue to pay differentially higher rates than other shippers [or types of shippers] when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs." Id. at 535-36. By reviewing the carrier's operations to eliminate costs resulting from identified inefficiencies, the management efficiency constraint protects shippers from paying for avoidable inefficiencies (whether short-run or long-run) that are shown to increase a carrier's revenue needs to a point where the shipper's rate is affected. Id. at 537-42. Alternatively, by simulating the competitive rate in a contestable market (a market that is free from entry barriers), the SAC constraint protects a shipper from bearing costs of inefficiencies or from cross-subsidizing other traffic by paying more than what a new, optimally efficient carrier would need to charge for the service at issue. Id. at 542-46.

When Congress transferred jurisdiction over this industry to the Board, the agency was using CMP principles to regulate rates for captive rail and pipeline shippers. Although Congress

[19] A fourth constraint – phasing – can be used to limit the introduction of otherwise-permissible rate increases when necessary for the greater public good. Guidelines, 1 I.C.C.2d at 546-47.

did not expressly require the Board to apply its existing CMP approach to cases involving the noncontiguous domestic trade, it clearly did not direct the agency to apply GO-11 either. CMP principles are well suited for an industry with high fixed costs and a mix of competitive and captive traffic (such as railroads, pipelines, or water carriers), and therefore we see no reason why they should not be applied to assess the reasonableness of noncontiguous domestic trade rates.

GovGuam has argued that GO-11 should be prescribed because it is a time-tested way of measuring rate reasonableness in the water carrier industry. But in fact, the GO-11 methodology—which relies on routine annual filings of financial reports with the FMC, none of which are filed at this agency—has only once been used in a case involving a challenge to the reasonableness of carrier rates. GovGuam has failed to show that any of the three versions of the GO-11 methodology that it has advanced is superior to CMP or that CMP is not a fully adequate standard for captive water shippers. Therefore, should we proceed to a review of the Carriers' rate levels, we will apply our CMP standard.

We disagree with the Carriers that GovGuam should be limited to using only the SAC constraint of CMP. We impose no such limitation on rail or pipeline shippers,[20] and the Carriers have shown no reason why we should do so here. GovGuam is free to choose between making a "top-down" presentation for each carrier that examines each of the carriers' own operations (applying the revenue adequacy and management efficiency constraints) or a "bottom up" presentation that shows what a hypothetical, optimally efficient carrier would need to charge (the SAC constraint).

We have an established body of precedent on the application of the SAC test, which we would presume would apply with equal force to a water carrier case absent persuasive argument to the contrary. Although we will place no advance limits on the type of hypothetical stand-alone water carrier (SAWC) GovGuam could construct to show that the rates exceed those that would prevail in a contestable market, the reasonableness of the various assumptions of the SAWC would be subject to challenge by the Carriers.

The advantage of the SAC test is that it is designed to show directly whether, and the extent to which, the shippers involved in the complaint (here, Guam shippers) are bearing costs resulting from inefficiencies or costs associated with facilities or services from which they derive no benefit. The economic theory of contestable markets, upon which the SAC test is based, does not depend on a large number of competing firms in the marketplace to assure a competitive outcome. Id. at 528. In a contestable market, even a monopolist must offer competitive rates or lose its customers to a new entrant. Id. In other words, contestable markets have competitive characteristics which preclude monopoly pricing.

[20] See Koch Pipeline, 2 S.T.B. at 265 (holding that complainants may use any methodology that is consistent with CMP ratemaking principles, including SAC or revenue adequacy).

To simulate the competitive price that would result if the market for noncontiguous domestic water service to Guam were contestable, the costs and other limitations associated with entry barriers must be omitted from the SAC analysis. Id. at 529. This removes any advantages that the existing carriers would have over a new entrant that create whatever monopoly power the existing carriers might be found to have. Thus, a SAWC would need to be hypothesized that could serve the traffic at issue if the water industry were free of entry barriers (costs not borne by the Carriers in serving Guam). Under the SAC constraint, the rates at issue cannot be higher than what the SAWC would need to charge to serve Guam while fully covering all of its costs, including a reasonable return on investment. Id. at 542.

To make a SAC presentation, GovGuam would design a SAWC that would have the optimum size and number of ships. It would then provide evidence on the operating costs that the SAWC would incur, and the replacement costs of the assets the SAWC would need. GovGuam would have to design two separate SAWC's – one to handle each carrier's share of the market. It could not design a SAWC that would combine the traffic and revenues of the two Carriers, as the Carriers themselves do not enjoy that benefit.[21] GovGuam would need to provide appropriate documentation to support each aspect of its SAWC, as would each Carrier in its responsive evidence.

In a SAC analysis, it should be assumed that SAWC capital investments normally would be made prior to the start of service, that the SAWC would continue to operate into the indefinite future, and that recovery of the investment costs would occur over the economic life of the assets. The SAC analysis should cover at least a 10-year period, assessing the revenue requirements of the SAWC based on the operating expenses that would need to be incurred over that period and the portion of capital costs that would need to be recovered during that period.[22] A computerized DCF model should be used to simulate how the SAWC would likely recover its capital investments, taking into account inflation, Federal and state tax liabilities, and a reasonable rate of return. The annual revenues required to recover the SAWC's capital costs (and taxes) would then be combined with the annual operating costs to calculate the SAWC's total annual revenue requirements.

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[21] See Arizona Electric Power v. The BNSF Ry. Co. & Union Pacific RR Co., 6 S.T.B. 322 (2002). It would be inappropriate to test the rates of either Horizon or Matson by reference to revenue from traffic in which that carrier does not participate.

[22] In Major Issues In Rail Rate Cases, STB Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006), we reduced the period for the discounted cash flow (DCF) analysis in rail SAC cases to 10 years. In rail cases, a 10-year period encompasses both past and future shipments. In this case, however, given the delays and initial jurisdictional and methodological disputes, there are already 10 years of past shipments covered by the complaint. Therefore, to have any ability to obtain rate prescriptions for future movements, GovGuam would need to use a longer SAC analysis period. However, as discussed below, any benefits from the added complexity of a longer analysis period would be limited in light of the ZOR, as there would not likely be any need for future rate prescription in this case. And use of a 10-year analysis period would simplify the SAC presentation by removing any disputes over forecasts.

The revenue requirements of the SAWC would then be compared to the revenues that the particular carrier has already earned (and, depending on the SAC analysis period chosen,[23] would be expected to earn) from the traffic group. Any future revenue contributions from that traffic would be determined by forecasting traffic and rate level trends for that traffic group into the future. The Board would then compare the total revenue requirements of the SAWC against the total revenues generated by the traffic group over the full SAC analysis period. Because the analysis period is lengthy, a present value analysis would need to be used that takes into account the time value of money, netting the annual over-recovery and under-recovery as of a common point in time.

If the present value of the revenues generated by the traffic served by the SAWC were less than the present value of the SAWC's revenue requirements, then GovGuam would have failed to demonstrate that the challenged rates violate the SAC constraint. If, on the other hand, the present value of the revenues from the SAWC traffic group were to exceed the present value of the revenue requirements of the SAWC, then GovGuam would have demonstrated that the total revenues collected by the carrier are unreasonable.

The Board has little precedent applying the revenue adequacy and managerial efficiency constraints of CMP. Thus, should GovGuam elect to make a "top-down" presentation (a presentation based on the Carriers' own revenue needs), we cannot address in advance methodological issues that may arise. But we can say that, to prevent any inappropriate cross-subsidies between a carrier's foreign and domestic trades, the analysis for each carrier would need to focus only on the Guam portion of that carrier's operations and allocate its system-wide costs between the Guam trade and the other traffic that it serves.

IV. Zone of Reasonableness

Positions of the Parties

We are also called upon in this proceeding to interpret the ZOR provision of 49 U.S.C. 13701(d)(1). That provision reads, in pertinent part, as follows:

> For purposes of this section, a rate or division of a . . . water carrier for port-to-port service in [the noncontiguous domestic] trade is reasonable if the aggregate of increases and decreases in any such rate or division is not more than 7.5 percent above, or more than 10 percent below, the rate or division in effect 1 year before the effective date of the proposed rate or division.

As discussed in the Board's November 2001 decision, the ZOR provides a safe harbor for rate changes. Under the ZOR, a rate increase is deemed reasonable if the amount by which it exceeds the prior year's rate is within the ZOR. But the language and legislative history of the ZOR indicate that the provision was intended to apply only to "base rates" that themselves are at reasonable levels. Thus, a party may challenge the base rate to which the ZOR is applied.

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[23] See supra note 22.

GovGuam argues that, under Trailer Bridge, Inc. v. Sea Star Lines, LLC, STB Docket No. WCC-104 (STB served Oct. 27, 2000), the ZOR should be used only to determine if specific rates are unreasonably high or low. Here, because it is not challenging particular rates or rate increases taken by the Carriers, GovGuam argues that its challenge to the overall revenues of the Carriers should not be affected by the ZOR. Rather, it asserts that the Board should find that the Carriers' rates charged after September 10, 1996 (the earliest date covered by its complaint), may be no higher than the maximum reasonable base rates that the Carriers could charge as of that date, with no escalation pursuant to the ZOR.

The Carriers maintain that, if the base rates, i.e., the rates in effect on September 10, 1996, are found to be unreasonable, the ZOR should be applied to the maximum reasonable rate as of that date to increase the maximum lawful rates for succeeding years. The Carriers further contend that, if the base rates on September 10, 1996, are found reasonable, GovGuam cannot challenge any rates charged after that date because the Carriers' rates have not gone up in each successive year by more than what is allowed under the ZOR.

Board Analysis

We conclude that, if the aggregate rate levels that were in effect as of September 10, 1996, are found to be unreasonable, the ZOR can be applied to the maximum lawful aggregate base rates for that date to increase the maximum lawful aggregate rates for subsequent years, as argued by the Carriers. The ZOR was established primarily to protect a water carrier's ability to increase rates within the congressionally set limits. Had the Carriers known that the aggregate rates they were charging as of September 10, 1996 would be ordered to be reduced, they presumably would have exercised their right to increase all of their rates by the full amount permitted by the ZOR for succeeding years until they reached their desired aggregate rate level, i.e., the aggregate level of the challenged rates. To adopt GovGuam's position would, in effect, penalize the Carriers for the regulatory delay in this proceeding.

V. Remedy

Finally, questions have been raised regarding how to devise and administer an appropriate remedy in the event the challenged aggregate rate levels are found to have been unlawful. With respect to any excessive amounts collected in the past, section 13701(d)(4) directs that, when the complaint was filed by a governmental authority, the Board is to make such orders "as are just and [to] require the carrier to return, to the extent practicable, to shippers all [excessive revenues] plus interest." We doubt that a prescription of future aggregate rate levels would be necessary, given the cumulative effect of the ZOR over the 10-year period during which this complaint has been pending.

GovGuam states that it is prepared to explore "flexible approaches to reparations" and "creative options [that] may be worth exploring in Phase III" that would be appropriate under section 13701(d)(4).[24] Should we find that there is not effective competition in this trade,

[24] GovGuam Reply filed June 17, 2002, at 10.

GovGuam should follow up in Phase III on its commitment to develop and propose appropriate remedial actions.

It is ordered:

1. The Carriers' renewed motion to dismiss is denied.

2. The Carriers shall submit all additional evidence regarding effective competition in the Guam market by March 19, 2007.

3. GovGuam shall submit its reply evidence regarding effective competition in the Guam market by April 18, 2007.

4. This decision is effective on its date of service.

By the Board, Chairman Nottingham, Vice Chairman Buttrey, and Commissioner Mulvey.

Vernon A. Williams
Secretary