

AT RICHMOND, SEPTEMBER 11, 2006

APPLICATION OF

J. WILLIAM COFER

On behalf of himself and all other licensed
branch pilots in the Commonwealth of
Virginia who are members of the
Virginia Pilot Association

CASE NO. PUE-2006-00046

For approval of a change in the basis for
determining pilotage charges and a revision
of rates and charges for pilotage

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FINAL ORDER

On March 31, 2006, J. William Cofer, on behalf of himself and all other licensed branch pilots in the Commonwealth of Virginia who are members of the Virginia Pilot Association ("Association" or "Virginia Pilots"), filed an application with the State Corporation Commission ("Commission") for approval to revise the rates and charges for pilotage services rendered in the Commonwealth of Virginia. The application proposes, among other things, to implement a new methodology for determining pilotage charges and to increase the Association's annual revenues by \$1,103,855, which represents a 6.34% increase in revenues based on the Association's operations for the test year ended April 30, 2005.

On April 10, 2006, the Commission issued an Order for Notice and Hearing that docketed the application, directed the Association to provide public notice of the application, scheduled a public hearing on the application to commence on July 25, 2006, and established a procedural schedule for the filing of public comments, notices of participation, and testimony and exhibits. Carnival Corporation ("Carnival") filed a notice of participation on May 18, 2006, indicating it would participate as a respondent opposing the application.

The application came on for hearing before the Commission on July 25 and 26, 2006. Counsel appearing at the hearing were C. William Waechter, Jr., Esquire, and Mark T. Coberly, Esquire, for the Association; Charles S. Cumming, Esquire, and David H. Sump, Esquire, for Carnival; and Glenn P. Richardson, Esquire, for the Commission Staff. David Wooley, an employee of Atlantic Container Line, and Robbert C. van Pelt, an employee of Wallenius Wilhelmsen Logistics, appeared and made statements as public witnesses opposing the application. Briefs were filed by the Association, Carnival and the Commission Staff on August 21, 2006.

NOW THE COMMISSION, having considered the record, the pleadings, and the applicable law, is of the opinion and finds as follows:

This application was filed with the Commission pursuant to Va. Code § 54.1-918, which grants the Commission authority to prescribe and enforce the rates of pilotage in Virginia. In performing our statutory duties under this statute, we are directed to fix pilotage rates that represent a "fair charge for the service rendered." When establishing a fair charge for pilotage services, Va. Code § 54.1-918 provides that:

The Commission shall have due regard for necessary operating expenses, maintenance of, depreciation on, and return on investment in properties used and useful in the business of pilotage, and the rates and charges of pilotage at comparable and competing ports of the United States.

Accordingly, our analysis in this case must focus on two central issues: (1) whether the proposed pilotage rates will allow the Virginia Pilots to recover their operating costs and a reasonable return on their investment, and (2) whether the pilotage rates developed through a cost of service analysis are competitive with the pilotage rates and charges at comparable and competing ports in the United States.

There were several issues raised by Carnival and the public witnesses in support of their claim that the Association's proposed rates do not represent a "fair charge for the service rendered." Our findings on the disputed issues are set forth below.

Ship Units v. Gross Tonnage

Pilotage charges are currently determined by applying a volumetric measurement called ship units to a specific schedule of rates approved by the Commission.¹ The number of ship units is a volumetric measurement of a ship's hull.² Ship units are determined by: (1) multiplying Overall Length x Extreme Breadth x Depth from Uppermost Continuous Deck; and (2) dividing the result by ten thousand. The number of ship units is then applied to a schedule of rates approved by the Commission to determine pilotage charges.³ A larger number of ship units results in a higher charge for pilotage.

The Association requests authority to abandon the ship unit method, claiming it no longer produces pilotage charges that bear a reasonably consistent relationship to the physical size of all ships piloted by the Association. According to the Association, modern ship design over the last twenty years has produced ships with extremely large superstructures, such as cruise ships and vehicle carriers, which are not assessed their fair share of pilotage charges. Since the ship unit method only measures the size of a ship's hull, the Association maintains the ship unit method no

¹ The ship unit method was approved by the Commission in *Application of R.L. Counselman, Jr., et al., For permission to make changes in rates of pilotage*, Case No. 18736, 1969 S.C.C. Ann. Rept. 173, (Final Order, December 12, 1969).

² *Petition of Virginia Pilot Association, For a declaratory judgment that the Virginia Pilot Association is correctly calculating pilotage fees for certain vessels operated by Carnival Corporation*, Case No. PUE-2004-00061, 2005 S.C.C. Ann. Rept. 352, (Final Order, December 7, 2005).

³ The Association's current schedule of rates and charges was approved by the Commission on November 25, 2003, in *Application of Virginia Pilots Association, To revise rates of pilotage and other charges*, Case No. PUE-2003-00330, 2003 S.C.C. Ann. Rept. 557, (Final Order, November 25, 2003).

longer accurately measures the physical size of passenger ships and vehicle carriers because their superstructures are totally ignored when determining pilotage charges. The Association therefore proposes to abandon the ship unit method and begin assessing pilotage charges based on a ship's gross tonnage as determined in accordance with the International Convention on Tonnage Measurement of Ships, 1969.⁴ According to the Association, the use of gross tonnage will restore the physical size of a ship as the primary determinant for pilotage charges.

Carnival opposes the gross tonnage method, claiming that gross tonnage will not produce a fair charge for its cruise ships. Carnival asserts gross tonnage is unfair because it will cause Carnival to be charged significantly higher pilotage charges while other types of ships will only see modest increases if gross tonnage is approved. Carnival also claims gross tonnage is unfair because it will not assess any additional pilotage charges for containers carried above the weather deck on container ships. This same concern was voiced by the public witnesses in this case, who operate roll on/roll off ("RORO") ships and combined RORO container ships.

We find that the Association's proposal to begin assessing pilotage charges based on gross tonnage as determined in accordance with the International Convention on Tonnage Measurement of Ships, 1969 should be approved. In Virginia, pilotage charges have always been based on a ship's physical size, with larger ships paying more for pilotage than smaller ships. The physical size of a ship represents a fair basis upon which to assess pilotage charges because the size of a ship, more than any other factor, best reflects the overall difficulty, responsibility, and value of service rendered when piloting a ship. Indeed, any method that does not charge larger ships more for pilotage services than smaller ships would not represent a "fair

⁴ Gross tonnage is a volumetric measurement of all the enclosed spaces in a ship, with one gross ton being equal to 100 cubic feet.

charge for the service rendered" because it would require smaller ships to pay a disproportionately larger share of the costs incurred by the Association to provide service.

Assessing pilotage charges based on the physical size of a ship is also not unique to Virginia. Most ports in the United States use the physical size of a ship as the primary determinant of pilotage charges because it represents the most fair and equitable basis upon which to allocate the costs of providing pilotage services. We will not depart from this fundamental rate design concept when setting pilotage rates in Virginia

We also agree with the Association that the ship unit method no longer measures the physical size of all ships piloted in Virginia. The evidence presented in this case clearly demonstrates that the overall physical size of passenger ships and vehicle carriers is not captured under the ship unit method because their superstructures are totally ignored when calculating ship units and determining pilotage charges. Accordingly, current pilotage charges for passenger ships and vehicle carriers bear little relationship to their overall physical size.

The gross tonnage method will assure that all ships piloted in Virginia pay pilotage charges based on their physical size, and will also assure that all the costs incurred by the Association to provide pilotage services are allocated with reasonable fairness among all types of ships calling on Virginia ports. This method has the virtue of relative simplicity and is less likely to engender factual disputes concerning its application. We will therefore approve the Association's proposal to begin assessing pilotage charges based on a ship's gross tonnage as determined in accordance with the International Convention on Tonnage Measurement of Ships, 1969.

However, our approval of the gross tonnage method in this case may require further refinement in the Association's next rate case. Carnival and those public witnesses operating

ROROs and combined RORO container ships oppose basing pilotage charges on a ship's gross tonnage because containers carried above the weather deck on container ships are not assessed any additional charges for pilotage and, as a result, containers carried above the weather deck receive a free ride. This apparent disparity raises serious concern. However, this record is insufficient to allow us to design pilotage rates that allocate greater costs to container vessels.

Combination gross tonnage/draft charges are imposed in numerous ports in the United States, including Charleston, South Carolina and Savannah, Georgia. This method of calculating pilot charges may represent one means available to recognize containers carried above the weather deck on container ships. Container ships generally have greater drafts than passenger ships and vehicle carriers, and a draft charge could have the effect of allocating a greater portion of the Association's costs to container ships when setting future pilotage rates.

Accordingly, the Association is directed to assemble the information and data necessary to allow the Commission to consider implementing combination gross tonnage/draft charges in the context of the Association's next rate case. At a minimum, this information shall consist of the actual draft and gross tonnage of each ship piloted by the Virginia Pilots during the test year in their next rate case. In addition, the Association is directed to file two tariffs in its next rate case: one tariff that assesses pilotage charges using gross tonnage and a second tariff that assesses pilotage charges based on combination gross tonnage/draft charges. We will re-examine the Association's rate design in its next rate case to determine whether combination gross tonnage/draft charges should be implemented in Virginia.

The Virginia Pilots' Cost of Service

The Association filed financial information based on its operations for the fiscal year ending April 30, 2005, in support of its proposed increase in rates. The Association also

explained the additional operating expenses and investments it has incurred, or will incur, after fiscal year 2005, in order to continue providing pilotage services in Virginia. These additional expenses and investments include, among other things, a new 41 foot launch, a new boat lift, new automobiles for pilot transportation, upgrades to the Association's computer systems, and salary and benefit increases for existing employees, apprentices, and retired pilots.

The Commission Staff audited the books and records of the Association. The Staff's audit found the proposed rates will produce total operating revenues of \$18,514,898; total operating expenses of \$6,366,854; and an annual distribution to the Virginia Pilots of \$12,148,043. The Staff does not oppose the Association's proposed increase because it will produce a gross distribution per pilot of approximately \$276,092, which the Staff represents is comparable to the compensation received by pilots in other states.

We find that Staff witness Handley's accounting analysis should be accepted for purposes of determining whether the Association's proposed rates represent a "fair charge for the service rendered" as required by Va. Code § 54.1-918. We have traditionally set pilotage rates based upon a review of the Association's operations for a historic test year, adjusted for known and measurable changes in revenues, expenses, and investments that will occur during the time the new rates are in effect. In this regard, our financial analysis in this case is very similar to the approach we use for rate increase applications filed by regulated public utilities under Chapter 10, Title 56 of the Code of Virginia.

In making this finding, we reject Carnival's challenge to several cost of service items allowed in the Staff's analysis. Carnival's witness is not an expert witness on accounting and financial issues, and we believe this lack of expertise causes Carnival to question several items that are appropriately included in the Association's cost of service.

Carnival suggests that the operating expenses included in the Association's application are unreliable because the expenses differ from the expenses reported in its income statement for fiscal year 2005. However, the differences in the reported expense levels are due to a different treatment and categorization of group health insurance and depreciation expenses in the audited income statement and application. In other words, contrary to Carnival's assertion, there are no material differences between the expense levels reported in the Association's fiscal year 2005 income statement and the application filed in this case.

We will also approve the proposed 6% increase in benefits for retired pilots. The Virginia Pilots' unfunded retirement plan has existed for years in Virginia, and we have traditionally approved these expenditures when setting pilotage rates. Unfunded retirement plans are also not unusual for pilots operating in other states. As the record reveals, there are at least twelve pilot associations in eleven different states that have unfunded retirement plans that pay benefits from current revenues.

In addition, the Virginia Pilots have historically filed a rate application approximately every three years with the Commission. Based on a three-year time horizon, the proposed 6% increase in this case represents an effective annual increase of approximately 3% per year. We find this modest increase in retirement benefits to be reasonable, and we will allow it as an operating expense in the Association's cost of service.

Carnival further suggests that the rate increase should be denied because a significant portion of the increase is not due to increased operating expenses, but is caused by the Association's attempt to restore the revenues the Virginia Pilots lost as a result of our decision in Case No. PUE-2004-00061. Carnival's witness further suggests that the current application was filed in retaliation for Carnival prevailing in that case.

The Association's motive in filing the current application is not relevant to our inquiry under Va. Code § 54.1-918. The only question presented for our consideration is whether the proposed rates represent "a fair charge for the service rendered." In making this determination, we must examine the Association's cost of service to determine whether the proposed rates will allow the Virginia Pilots to recover their "necessary operating expenses, maintenance of, depreciation on, and return on investment in properties used and useful in the business of pilotage."

Carnival further suggests the Virginia Pilots are already adequately compensated under current rates because their compensation during fiscal year 2005 far exceeded the salaries of federal pilots employed by the Department of Defense. We disagree with Carnival's suggestion that the Virginia Pilots' current compensation should be reduced because it exceeds the salary of federal pilots. While federal pilots provide a necessary and valuable service when piloting U.S. Navy ships, the nature of their work and the financial risks they assume when piloting Navy ships in protected waters are fundamentally different than the working conditions and financial risks assumed by the Virginia Pilots.

The Virginia Pilots assume greater operating and financial risks than their federal counterparts in terms of job training, working conditions and the personal investments they make to provide pilotage services in Virginia. A basic tenet of financial theory is that higher risk investments require a higher rate of return to attract capital. We find the same fundamental risk-return tradeoff should apply with equal force when setting the compensation levels for Virginia Pilots. The greater risks assumed by Virginia Pilots justify a higher compensation level for their services than the salaries paid to federal pilots. The two jobs are simply not comparable in terms of their job responsibilities and the risks assumed to pilot ships.

We find the compensation for Virginia Pilots should be comparable to the compensation paid to pilots in other state pilot associations because the job requirements, responsibilities, and operational and financial risks assumed by all state pilots are similar. The evidence presented in this case shows that the proposed rates will produce a gross annual distribution of approximately \$276,092 per pilot. Staff witness Handley testified that after all deductions the net distribution per pilot would be approximately \$205,373. However, even with the proposed increase, Virginia Pilots will be paid considerably less than their state counterparts in Florida and Louisiana. Indeed, based on the Association's evidence presented in this case, the proposed rates will produce distributions to the Virginia Pilots that are significantly lower than other state pilots and, as a result, the Association's proposed annual distribution to each pilot appears quite reasonable when compared to the compensation levels of other state pilots. Accordingly, we will not reduce the compensation that will be paid to the Virginia Pilots under the proposed rates. We find the compensation that will be paid to Virginia Pilots under the proposed rates to be reasonable.

In conclusion, and based on our review of the record, we find the proposed rates will produce sufficient revenues to allow the Virginia Pilots to recover their "necessary operating expenses, maintenance of, depreciation on, and return on investment in properties used and useful in the business of pilotage" as required by Va. Code § 54.1-918. We further find the annual distribution per pilot produced by the proposed rates is reasonable.

Rates and Charges at Comparable and Competing Ports

Our final inquiry when setting a "fair charge" for pilotage services under Va. Code § 54.1-918 requires us to consider "the rates and charges of pilotage at comparable and competing ports of the United States." The purpose of this statutory directive is to assure that the

rates we approve remain competitive with the pilotage charges in other ports of the United States.

When considering the competitiveness of pilotage rates in past Association rate cases, we have compared Virginia's pilotage rates with the rates for pilotage in the ports of New York, Philadelphia,⁵ Baltimore, Charleston, and Savannah. We have previously held these ports to be direct competitors of Virginia ports in past rate cases, and there is no evidence in the record suggesting that these ports are no longer comparable or competing ports for purposes of our analysis under Va. Code § 54.1-918. The ports are all geographically close to Virginia ports, they are located on the Eastern Seaboard of the United States, and the ports are in or near major metropolitan areas that compete with Virginia for shipping traffic.

As in past Association rate cases, the Virginia Pilots and Staff presented studies comparing the proposed rates in Virginia with the pilotage rates for the ports of New York, Philadelphia, Baltimore, Charleston, and Savannah. The Association's study found that the proposed pilotage rates in Virginia are less than the average pilotage rates for the ports of New York, Philadelphia, and Baltimore and, for the most part, only slightly higher than the ports of Charleston and Savannah. The Staff's study, based on a seven ship sample group, reached the same conclusion.

Carnival maintains these studies are flawed and unreliable because they fail to consider other extraneous factors, such as the volume of traffic at the comparable and competing ports, how the volume of traffic might affect the number of pilots and rates at these ports, and the operational differences and variations in infrastructure. These factors, however, have little

⁵ The port of Philadelphia is located on the Delaware River and ships are piloted to Philadelphia by Delaware pilots.

relevance to our consideration of the "competitiveness" of pilotage rates at comparable and competing ports.

The factors cited by Carnival are, of course, relevant to the Association's cost of service. For example, if the evidence revealed the Virginia Pilots incurred excessive expenses for infrastructure compared to other comparable and competing ports, that evidence could be used to justify a possible reduction in the Association's test year expenses along with a corresponding reduction in pilotage rates. Similarly, if the volume of shipping traffic in Virginia was insufficient to support the current number of Virginia Pilots, that information would be relevant to the Association's cost of service and could be used to reduce the proposed rates. Indeed, any test year expenses that were unnecessary, extravagant, or imprudently incurred by the Association could be removed from the cost of service along with a corresponding reduction in the proposed pilotage rates.

However, when examining the competitiveness of rates, our inquiry must, by necessity, be conducted from the perspective of a ship operator whose primary consideration is always focused on the pilot charges that must be paid to call at a port. Accordingly, a direct comparison of the proposed rates with the rates at comparable and competing ports represents the best indicator of the "competitiveness" of the pilotage rates we approve in this case.

Based on the evidence in this case, we find that the proposed pilotage rates will allow Virginia ports to have a competitive advantage over the pilotage rates for the ports of New York, Philadelphia, and Baltimore. While the proposed pilotage rates are higher than the current pilotage rates for the ports of Charleston and Savannah, these differences should diminish over time as the annual cost of living increases are implemented by these southern ports. Based on our review of the comparison studies presented by the Association and our Staff, we find the

proposed pilotage rates are competitive with the pilotage rates in comparable and competing ports in the United States.

Accordingly, IT IS ORDERED THAT:

(1) As provided by § 54.1-918 of the Code of Virginia, this application is granted and the revised rates and charges prescribed therein are approved.

(2) The revised rates and charges approved herein shall become effective at 12:01 a.m. on October 1, 2006.

(3) The Association shall promptly file with the Clerk of the Commission a schedule of rates of pilotage and other charges as approved and prescribed by this Order. The schedule shall bear at the foot of each page the following caption:

Prescribed by the State Corporation Commission in Case No.
PUE-2006-00046 and effective on and after 12:01 a.m.,
October 1, 2006.

(4) The Association shall file the following information and tariffs in its next rate case:
(i) information and data detailing the gross tonnage and draft of each vessel piloted by the Virginia Pilots during the test year in their next rate case, (ii) a tariff that assesses pilotage charges based on gross tonnage and is designed to produce the total revenues proposed in the Association's next rate case; and (iii) a tariff that assesses pilotage charges based on combination gross tonnage/draft charges and is designed to produce the total revenues propose in the Association's next rate case.

(5) This case be dismissed from the Commission's docket of active cases.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to:
C. William Waechter, Jr., Esquire, Williams Mullen, 1021 East Cary Street, P.O. Box 1320,
Richmond, Virginia 23218-1320; Mark T. Coberly, Esquire, Vandeventer Black, LLP,

500 World Trade Center, Norfolk, Virginia 23510; Charles S. Cumming, Esquire, Fowler, Rodriguez and Chalos, 366 Main Street, Port Washington, New York 11050; David H. Sump, Esquire, Crenshaw, Ware, and Martin, 1200 Bank America Center, One Commercial Place, Norfolk, Virginia 23510; and to the Commission's Office of General Counsel and Division of Public Utility Accounting.