Exh. DPK-3T
Docket TP-190976
Witness: Danny Kermode

BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND PILOTS,** **Respondent.**	**DOCKET TP-190976**

CROSS-ANSWERING TESTIMONY OF

Danny Kermode

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Regulatory History, Cost of Capital, Equity, Labor

July 13, 2020

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I. INTRODUCTION

Q. Please state your name.

A. My name is Danny Kermode.

Q. Are you the same Danny Kermode who filed testimony in this docket with the Washington Utilities and Transportation Commission (Commission) on behalf of Commission Staff (Staff) on May 27, 2020?

A. Yes.

Q. Please summarize the purpose of Staff's testimony filed today with the Commission.

A. Staff witness Sevall is filing cross-answering testimony addressing the number of pilots to fund, yacht exemptions, and rate and tariff design. Staff witness LaRue is not filing additional cross-answering testimony, but is filing revised copies of her initial testimony, Exh. AMCL-1T, and Staff's proposed revenue requirement, Exh. AMCL-2, to reflect changes made by other witnesses to inputs incorporated into her revenue requirement model. The changes to Exh. AMCL-1T and Exh. AMCL-2, now filed as Exh. AMCL-1Tr (revised 7/13/20) and Exh. AMCL-2r (revised 7/13/20) respectively, do not change the substance of Staff's analysis, only it's output, as the revisions are intended to mechanically update Staff's model as a result of changed inputs. Finally, I am filing cross-answering testimony to provide an

overview of marine pilotage rate-setting regulatory history and to respond to arguments made by Pacific Merchants Shipping Association (PMSA).

Q. Please summarize the scope of your testimony.

A. Recognizing that the Puget Sound Pilots (PSP) filing in this docket is a case of first impression, Staff believes that a brief overview of the recent regulatory history regarding marine pilotage rate-setting in Washington may be helpful to the Commission's analysis of the issues presented in this case. I am also providing cross-answering testimony responding to the cost of capital testimony filed by John C. Ramirez. Specifically, I am providing a response to his testimony regarding the cost of equity and return on rate base, as well as what he refers to as a fair return on pilotage labor.

II. SCOPE AND SUMMARY OF RECOMMENDATION

Q. What is the purpose of your cross-answering testimony?

A. I am responding to both Capt. Mike Moore and Mr. Ramirez's testimony filed on behalf of PMSA. I am providing additional testimony in response to Capt. Moore's discussion of how the Commission came to be involved in marine pilotage rate-setting. I'm also responding to Mr. Ramirez's testimony on the overall cost of capital, including (1) the cost of equity and (2) return on rate base, and (3) the "fair return on labor" for pilotage service in the Puget Sound.

Q. Please describe your conclusions and recommendations.

A. I recommend that the Commission not rely on Mr. Ramirez's testimony. Mr. Ramirez misapplies business appraisal capitalization models, the Build-up Model and the Modified Capital Asset Pricing Model (M-CAPM), to derive a rate setting-based cost of equity. He incorrectly uses methods designed to value small businesses, not to estimate cost of capital for ratemaking purposes. In my testimony I also critique the derivation of his recommended compensation for individual pilots, which he refers to as "fair return on labor."

Q. Have you prepared any exhibits in support of your testimony?

A. Yes.

Q. What exhibits have you prepared?

A. I have prepared four exhibits:

- Exh. DPK-4 (PSP response to Staff data request 54)
- Exh. DPK-5 (Joint Transportation Committee Final Request for Proposal 2017)
- Exh. DPK-6 (Joint Transportation Committee Final Report 2018)
- Exh. DPK-7 (IRS Rev. Rul. 54-614, 1954-2 CB 271)

III. REGULATORY HISTORY

Q. Please describe the origin of marine pilotage rate-setting in Washington.

A. Although marine pilotage was first required in the Washington Territory in 1863, it was not until 1935 that the legislature passed the first state pilotage law by enacting the Washington State Pilotage Act (Pilotage Act) which established the Board of Pilotage Commissioners (BPC). The Pilotage Act gave the BPC the power to fix rates for marine pilotage services, provided that no rate would be changed more than once a year.[1]

Q. Can you describe how the Commission became involved in rate-setting for marine pilotage?

A. Yes. In 2018, following a review of rate-setting practices of the BPC, the legislature passed SSB 6519 which transferred marine pilotage rate-setting authority to the Commission effective July 1, 2019.

Q. Could you briefly discuss what prompted the review of rate-setting practices of the BPC resulting the transfer of rate-setting authority?

A. In 2011, a trainee marine pilot filed a lawsuit against the BPC and PSP. In 2013, PSP was voluntarily dismissed from the lawsuit, which proceeded solely against the BPC. The trainee pilot and the BPC ultimately entered into a settlement agreement resolving the dispute.[2] In 2017 the legislature appropriated money to help fund the BPC's insurance premium and directed the Joint Transportation Committee (JTC) to commission a report regarding marine pilotage in Washington.[3] On May 17, 2017,

[1] Laws of 1935, ch. 18.
[2] Kermode, Exh. DPK-5 at 1.
[3] ESB 5096, §§ 108, 204 (2017).

the JTC issued a request for proposals for a report regarding best practices for the BPC.[4] On January 18, 2018, the Final Report and Recommendations regarding Washington State marine pilotage (Pilotage Report) was filed with the JTC.[5]

Q. What were the conclusions of the Pilotage Report regarding the rate-setting process used by the BPC?

A. The report recognized that the process of developing and setting rates is complex. It also recognized there was no rate-setting process or associated methodology set in statute.[6] Referring to the prior BPC process, the report emphasized the board did not have "…the benefit of a well-defined methodology, data submission and review, and rate-setting expertise."[7]

Q. Regarding rate-setting, did the Pilotage Report provide a recommendation to address the lack of process?

A. Yes. The Washington Pilotage Report recommended using the Commission as the forum for setting marine pilotage rates.[8] The report noted that Oregon, Maryland, and Virginia use a public utility commission for the rate-setting process, and opined that such a process resulted in fewer rates hearing and an increased incentive for parties to settle.[9] The report further concluded that the public utility commission

[4] Kermode, Exh. DPK-5.
[5] Kermode, Exh. DPK-6.
[6] Kermode, Exh. DPK-6 at 37.
[7] Kermode, Exh. DPK-6 at 68.
[8] Kermode, Exh. DPK-6 at 86.
[9] Kermode, Exh. DPK-6 at 69.

model of rate-setting would provide "a clearly defined, transparent, rigorous, enforceable timeline and process, and staff with expertise on rate-setting."[10]

Q. After the release of the final report on Washington Pilotage in January 2018, how did the legislature respond?

A. That same year, the legislature passed SSB 6519 transferring marine pilotage rate-setting authority for both the Puget Sound Pilots and Grays Harbor Port District from the BPC to the Commission effective July 1, 2019. As part of the transfer of authority, the Commission adopted new rules after input from interested stakeholders including PSP and PMSA effective June 3, 2019.[11]

Q. Did SSB 6519 transfer all of the BPC's regulatory authority over marine pilotage to the Commission?

A. No.

Q. Based on your own understanding, what authority was transferred from the BPC to the Commission?

A. The only authority transferred to the Commission was the power to establish tariffs for marine pilotage services not more frequently than annually.

[10] Kermode, Exh. DPK-6 at 69.
[11] See, Docket TP-180402.

Q. Similarly, based on your understanding, what authority was retained by the BPC?

A. All of the authority not explicitly transferred to the Commission is retained by the BPC. The BPC retains authority over all other aspects of the provision of marine pilotage service including, but not limited to, training, safety, and licensing of marine pilots.[12]

Q. Do you have any final observations regarding the transfer of marine pilotage rate-setting authority to the Commission?

A. Cooperation between BPC and Commission is critical to effective regulation of marine pilotage in Washington. Because regulatory authority over marine pilotage is split between two state agencies, it is important to be aware of the roles that both agencies have in the regulatory process. To that end, I believe that it is important to clearly recognize the limitations on the Commission's authority in the context of this proceeding so as to avoid encroaching on the BPC's powers and role in the overall regulatory structure.

IV. COST OF EQUITY

Q. Did you read Mr. Ramirez's testimony filed in this Docket?

A. Yes.

[12] See generally, Chapter 88.16 RCW, Chapter 363-116 WAC.

Q. Did you review the portion of Mr. Ramirez's testimony describing ratemaking and rate-setting methodology?

A. Yes.

Q. Do you agree with his description of the ratemaking process and rate-setting methodologies?

A Generally yes, although not entirely. He correctly describes the basic rate base approach to rate-setting.[13] He does however make several misstatements throughout his discussion, such as describing rate base as not just a utility's investment in facilities but also related capital costs; rate base does not include capital costs such as interest on debt and return on equity.[14]

Q. Mr. Ramirez testifies that the rate base/rate of return (RBROR) regulatory approach to rate-setting is most applicable to this case. Do you agree?

A. I agree with his conclusion, but not his reasoning. He bases his opinion on a limited understanding of the application of two common methods of rate-setting, the RBROR and operating ratio approaches. Mr. Ramirez claims that operating ratio is more applicable for capital intensive industries, concluding that the remaining RBROR approach is more applicable for his analysis of PSP's current tariff.[15] However, based on my experience, I have found that the operating ratio approach is

[13] Ramirez, Exh. JCR-1Tr at 3:14 – 5:8.
[14] Ramirez, Exh. JCR-1Tr at 4:24, fn.2.
[15] Ramirez, Exh. JCR-1Tr at 6:12-19.

actually well suited for industries with relatively small capital investments, such as the common carrier and solid waste industries.

Q. Could you please explain why the RBROR approach is applicable to this proceeding?

A. Rate-setting requires a regulated business be given the opportunity to (1) recover its costs and (2) earn a return on its investment. The RBROR approach provides both opportunities. In this case, the rate-setting process should be primarily focused on the recovery of operating costs, including pilot compensation, because PSP's operating costs dwarf its comparatively small capital investment. However, because PSP has negative equity when one accounts for the off-book liability, there is no equity return on investment in the present case.

Q. Did you review Mr. Ramirez's cost of equity calculations?

A. Yes. Mr. Ramirez bases his cost of equity recommendation on the use of the M-CAPM and the Build-up Model.[16]

Q. Please describe the M-CAPM Mr. Ramirez relies on to make his recommendation.

A. The M-CAPM has the same basic attributes of the standard Capital Asset Pricing Model (CAPM), using a risk-free return and adding a risk premium based on the market volatility (beta) of its comparables. M-CAPM is different from CAPM in that

[16] Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

it includes additional risk premiums not included in CAPM. In this case Mr. Ramirez adds a return premium for "size equity" and "company-specific equity risk."[17]

Although Mr. Ramirez added 440 basis points[18] to the cost of equity associated with both of his M-CAPM calculations, he provides no related testimony explaining the adjustments.[19]

Q. Please describe the Build-up Model Mr. Ramirez relies on to make his recommendation.

A. The Build-up Model takes the risk-free rate of 20-year US Treasury bonds and "builds" a cost of equity by adding additional risk premiums, including a general equity risk premium, a small company risk premium, and a company-specific risk premium. As with the M-CAPM adjustments, no testimony was provided supporting his addition of 1,200 basis points to the risk-free rate in his Build-up Model. For example, he adds 70 basis points to his Build-up Model for industry equity risk premium without any explanation of his reasoning, other than citing Duff & Phelps Cost of Capital Navigator.[20] Similarly, Mr. Ramirez's company-specific equity risk premium adjustment lacks explanation as to how it was computed or why a

[17] Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.
[18] One basis point equals 0.01%, such that 100 basis points would equal 1%.
[19] Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.
[20] Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

monopoly service with revenue in excess of $30 million requires a 340 basis point upward equity return adjustment.[21]

In Staff's opinion, reliance on a generalized cost of capital calculator raises concerns regarding the accuracy of the adjustments as applied to marine pilotage, particularly given the specific training and risks associated with that profession. For instance, Mr. Ramirez relies on water transportation risk premiums included in Duff & Phelps for an industry specific risk premium for marine pilotage, despite the fact that the Duff & Phelps entry also contains data related to other water transportation industries such as shipping agents, steamship terminals, and freight-transport on the Great Lakes.[22]

Q. Mr. Ramirez uses eight publicly traded companies to derive rates of return and the beta used in his M-CAPM analysis. Do you agree that the companies selected by Mr. Ramirez are sufficiently comparable to the marine pilotage service at issue in this proceeding?

A. No. After reviewing the eight companies, I do not agree that they are appropriate comparables for marine pilotage rate-setting purposes. Mr. Ramirez notes that there are no publicly traded companies providing pilotage service, so instead he selected eight publicly traded transportation companies.[23] His proxy group appears to use one

[21] Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.
[22] Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.
[23] Ramirez, Exh. JCR-1Tr at 12:13-14.

trucking company, two aviation companies, and five companies specializing in shipping and logistics services.[24]

On its face, Mr. Ramirez's selection fails as a proxy group for comparability with marine pilotage services in Washington. Marine pilots provide professional services that require highly skilled individuals to navigate and maneuver ships of varying size and types safely though Washington's waterways, they do not provide maritime shipping services or transport goods. Insofar as the proposed proxy group appears to include shipping and logistic companies and no maritime pilotage businesses, the proxy group does not reflect the risks and demands of marine pilots generally or PSP specifically. Even assuming that the proxy group was comparable to marine pilotage, there has been no explanation of how to harmonize and account for the differences in the businesses' operations, which involve ground, air, and sea transportation services, or the fact that PSP is organized as a professional association.

Q. Did Staff perform a M-CAPM or Build-up Model analysis to determine cost of equity as part of its review for this case?

A. No.

[24] Ramirez, Exh. JCR-3r at 24-31, Sub-Exhs. 15a-15h.

Q. Why not?

A. Any derived return on equity would be zero because PSP's accrual-basis equity balance is negative.[25] As such, Staff did not calculate a cost of equity as part of its review.

Q. Do you have an opinion on the soundness of the methods used by Mr. Ramirez to derive his cost of equity estimates?

A. Yes. My understanding of the M-CAPM and the Build-up Model is that these methods are primarily used by appraisers to estimate the capitalization rate to value a company. Both methods as presented here are highly subjective and unexplained, and each relies on comparisons to a proxy group that does not appear to be comparable to the marine pilotage service at issue in this proceeding. As such, the Commission should not rely on PMSA's cost of equity analysis to resolve this case.

V. RETURN ON RATE BASE

Q. Assuming for argument purposes that the cost of capital recommended by Mr. Ramírez was valid, would his remaining analysis be useful?

A. No, it would not be. Even though Mr. Ramirez correctly describes the RBROR approach, he improperly equates rate base with invested capital.[26] Rate base represents the value of those assets used to provide service to the ratepayer. Rate

[25] Kermode, Exh. DPK-4.
[26] Ramirez, Exh. JCR-1Tr at 4:24, fn.2.

base is distinct from invested capital because an entity's total investments typically exceed the total assets that are used and useful in the provision of service. Stated another way, an entity's assets that provide useful service typically account for only a portion of an entity's total investments. Building a rate base allows the regulator to provide returns only on those assets identified as used and useful in the provision of service.

Q. What is the distinction between a return on investment verses return on rate base?

A. A return on investment is the return earned on the total funds provided by investors. This concept includes any excess investment or investment being used to finance nonregulated functions. However, a return on rate base is limited to a return on only those assets that are used and useful in the provision of service, while excluding those assets which do not provide value to the rate payer directly or indirectly.

Q. Please briefly discuss the process Mr. Ramirez used to derive his required return on equity.

A. Mr. Ramirez computes a required return on equity of $2.8 million by taking his recommended equity return of 14% based on the M-CAPM and Build-up Model, and applying it to an imputed $19.9 million equity balance.[27] He created the $19.9

[27] Ramirez, Exh. JCR-3r at 3, Sch. C; Ramirez, Exh. JCR-3r at 10, Sub-Exh. 7.

million on his own, disregarding the actual smaller $4.36 million balance reflected on PSP's 2018 modified-cash balance sheet.[28]

Q. Did you find any problems with Mr. Ramirez's return on equity calculation?

A. Yes. Mr. Ramirez's approach violates the ratemaking principle that requires an investor only receive a return on actual invested capital that has been dedicated to the provision of the regulated public service and not its fair market value.

Mr. Ramirez computes his equity amount based on the three-year average earnings of a pilot multiplied by the number of pilots.[29] His calculation doesn't recognize the value of the original contribution when a pilot bought in to PSP nor does it reflect the impact of PSP's off-balance sheet liabilities.[30]

Additionally, by not using PSP's reported financial equity balance and ignoring its unrecorded liability for call backs, Mr. Ramirez's equity valuation exceeds the pilot's actual equity investment by over $20 million.[31]

Q. Do you have an opinion on the usefulness of his cost of capital recommendations in this proceeding?

A. In my opinion his cost of capital recommendation is not helpful to the Commission. The processes used to derive his recommendation are flawed in numerous areas and his models rely on proxy groups that are of questionable comparability to marine

[28] Norris, Exh. JN-04.
[29] Ramirez, Exh. JCR-3r at 10, Sub-Exh. 7.
[30] Ramirez, Exh. JCR-3r at 10, Sub-Exh. 7.
[31] Norris, Exh. JN-04, Kermode, Exh. DPK-4.

pilotage. In addition, even if Mr. Ramirez used the correct inputs, his failure to correctly recognize the actual equity balance of PSP and the proper definition and scope of rate base means his recommendations are of limited, if any, value to this proceeding.

VI. PILOTAGE LABOR EXPENSE

Q. Did you review Mr. Ramirez's testimony regarding return on pilotage labor?

A. Yes.

Q. Do you agree with Mr. Ramirez's approach to deriving a "fair return on pilotage labor?"

A. No. Mr. Ramirez's analysis conflates the concept of hired laborers with services provided by skilled professionals that act as independent contractors that have come together to work as an association "…formed to collect pilotage fees, pay expenses, and disburse the net earnings from pilotage fees to its members."[32] It is not uncommon for professional organizations such as law firms or accounting firms, to use an association of some form, to provide the supporting infrastructure allowing them to more effectually provide their services.

PSP is a professional organization which acts as a conduit for the net earnings of the pilots.[33] This is an essential difference that distinguishes the PSP business

[32] Kermode, Exh. DPK-7 at 1.
[33] Kermode, Exh. DPK-7.

model from other industries regulated by the Commission. The distributions received by the pilots are not payment for employee labor, but instead, earnings from self-employment.[34]

Q. Did you review Mr. Ramirez's testimony and exhibits supporting his recommended return on labor?

A. Yes. I reviewed Mr. Ramirez's testimony and the data he supplied regarding his return on labor calculations.[35]

Q. Do you have an opinion of the approach used by Mr. Ramirez to derive a fair return on the PSP Pilotage labor?

A. I disagree with Mr. Ramirez's approach. Mr. Ramirez uses a data sample from the Bureau Labor Statistics (BLS) that is a simply a compilation of wage data from captains, mates, and pilots of water vessels. From that aggregation of wage data, Mr. Ramirez takes the top 90th percentile for the Seattle – Tacoma – Bellevue regions.[36]

Mr. Ramirez does not provide additional explanation of how much of the sample is made up of what maritime occupation or what percentage and range of his sample reflects the wages of the Puget Sound pilots. In the absence of a more detailed breakdown of the data sample, I was not able to verify whether the wages in the 90th percentile share sufficient characteristics to be considered comparable to state marine pilotage wages. That is, I could not determine whether the purported

[34] Kermode, Exh. DPK-7.
[35] Ramirez, Exh. JCR-1Tr at 10:3 – 11:11; Ramirez, Exh. JCR-3r at 8, Sub-Exh. 5.
[36] Ramirez, Exh. JCR-1Tr at 10:3 – 11:11; Ramirez, Exh. JCR-3r at 8, Sub-Exh. 5.

comparable wages contained similar benefits, organizational structures, employment relationships, or work hours and responsibilities, or even whether data regarding state licensed marine pilots was included in the BLS statistics.

Q. Do you have an opinion on Mr. Ramirez's recommendation regarding a return on pilot labor?

A. I disagree with his recommendation. Mr. Ramirez's testimony and exhibits addressing a fair return on pilot labor appear to compare PSP as a professional association of independent contractors to wage laborers under an employer/employee relationship. Regulation must recognize the reality of the business form used by pilots to conduct business and not attempt to impose an imaginary business structure for the convenience of moving pilot earnings from net income to a labor expense. Therefore, the Commission should not rely on Mr. Ramirez's analysis regarding a fair return on labor because it fails to properly acknowledge PSP's structure as an association of independent contractors and does not explain why a comparison to the 90^{th} percentile of BLS wage data is reasonable.

Q. Please summarize your conclusions and recommendations.

A. I recommend that the Commission not rely on Mr. Ramirez's analysis. Mr. Ramirez's models, M-CAPM and Build-up Model, contain generalized and unexplained adjustments and are compared to a proxy group with businesses that bear little resemblance to marine pilotage service. Mr. Ramirez concedes that there are no publicly traded companies that provide only marine pilotage service, and

instead proposes a proxy group that includes trucking and air transportation services. Additionally, his cost of equity analysis does not acknowledge the actual equity balance of PSP and does not appear to use a proper rate base. Finally, Mr. Ramirez's determination of a fair return on pilot labor does not appear to acknowledge PSP's organizational structure as an association and relies on wage data without explaining why his selected wage range is reasonable.

Q. Does this conclude your testimony?

A. Yes.