

**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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1 I. INTRODUCTION

2

3 Q. Please state your name.

4 A. My name is Danny Kermode.

5

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

9 A. Yes.

10

11 Q. Please summarize the purpose of Staff’s testimony filed today with the  
12 Commission.

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

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

3  
4 **Q. Please summarize the scope of your testimony.**

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

13  
14 **II. SCOPE AND SUMMARY OF RECOMMENDATION**

15  
16 **Q. What is the purpose of your cross-answering testimony?**

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

1 **Q. Please describe your conclusions and recommendations.**

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

9  
10 **Q. Have you prepared any exhibits in support of your testimony?**

11 A. Yes.

12  
13 **Q. What exhibits have you prepared?**

14 A. I have prepared four exhibits:  
15 • Exh. DPK-4 (PSP response to Staff data request 54)  
16 • Exh. DPK-5 (Joint Transportation Committee Final Request for Proposal 2017)  
17 • Exh. DPK-6 (Joint Transportation Committee Final Report 2018)  
18 • Exh. DPK-7 (IRS Rev. Rul. 54-614, 1954-2 CB 271)

19

20 **III. REGULATORY HISTORY**

21

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

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

7

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

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

13

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

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

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<sup>1</sup> Laws of 1935, ch. 18.

<sup>2</sup> Kermode, Exh. DPK-5 at 1.

<sup>3</sup> ESB 5096, §§ 108, 204 (2017).

1 the JTC issued a request for proposals for a report regarding best practices for the  
2 BPC.<sup>4</sup> On January 18, 2018, the Final Report and Recommendations regarding  
3 Washington State marine pilotage (Pilotage Report) was filed with the JTC.<sup>5</sup>  
4

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

7 A. The report recognized that the process of developing and setting rates is complex. It  
8 also recognized there was no rate-setting process or associated methodology set in  
9 statute.<sup>6</sup> Referring to the prior BPC process, the report emphasized the board did not  
10 have "...the benefit of a well-defined methodology, data submission and review, and  
11 rate-setting expertise."<sup>7</sup>  
12

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

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

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<sup>4</sup> Kermode, Exh. DPK-5.

<sup>5</sup> Kermode, Exh. DPK-6.

<sup>6</sup> Kermode, Exh. DPK-6 at 37.

<sup>7</sup> Kermode, Exh. DPK-6 at 68.

<sup>8</sup> Kermode, Exh. DPK-6 at 86.

<sup>9</sup> Kermode, Exh. DPK-6 at 69.

1 model of rate-setting would provide “a clearly defined, transparent, rigorous,  
2 enforceable timeline and process, and staff with expertise on rate-setting.”<sup>10</sup>

3

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

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

11

12 **Q. Did SSB 6519 transfer all of the BPC’s regulatory authority over marine**  
13 **pilotage to the Commission?**

14 A. No.

15

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

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

20

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<sup>10</sup> Kermode, Exh. DPK-6 at 69.

<sup>11</sup> See, Docket TP-180402.

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

3 A. All of the authority not explicitly transferred to the Commission is retained by the  
4 BPC. The BPC retains authority over all other aspects of the provision of marine  
5 pilotage service including, but not limited to, training, safety, and licensing of marine  
6 pilots.<sup>12</sup>

7  
8 **Q. Do you have any final observations regarding the transfer of marine pilotage**  
9 **rate-setting authority to the Commission?**

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

17

18 **IV. COST OF EQUITY**

19

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

21 A. Yes.

22

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<sup>12</sup> See generally, Chapter 88.16 RCW, Chapter 363-116 WAC.

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

3 A. Yes.

4  
5 **Q. Do you agree with his description of the ratemaking process and rate-setting**  
6 **methodologies?**

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

12  
13 **Q. Mr. Ramirez testifies that the rate base/rate of return (RBROR) regulatory**  
14 **approach to rate-setting is most applicable to this case. Do you agree?**

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

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<sup>13</sup> Ramirez, Exh. JCR-1Tr at 3:14 – 5:8.

<sup>14</sup> Ramirez, Exh. JCR-1Tr at 4:24, fn.2.

<sup>15</sup> Ramirez, Exh. JCR-1Tr at 6:12-19.

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

3  
4 **Q. Could you please explain why the RBROR approach is applicable to this**  
5 **proceeding?**

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

13  
14 **Q. Did you review Mr. Ramirez's cost of equity calculations?**

15 A. Yes. Mr. Ramirez bases his cost of equity recommendation on the use of the M-  
16 CAPM and the Build-up Model.<sup>16</sup>

17  
18 **Q. Please describe the M-CAPM Mr. Ramirez relies on to make his**  
19 **recommendation.**

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

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<sup>16</sup> Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

1 it includes additional risk premiums not included in CAPM. In this case Mr. Ramirez  
2 adds a return premium for “size equity” and “company-specific equity risk.”<sup>17</sup>

3 Although Mr. Ramirez added 440 basis points<sup>18</sup> to the cost of equity  
4 associated with both of his M-CAPM calculations, he provides no related testimony  
5 explaining the adjustments.<sup>19</sup>

6

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

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

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<sup>17</sup> Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

<sup>18</sup> One basis point equals 0.01%, such that 100 basis points would equal 1%.

<sup>19</sup> Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

<sup>20</sup> Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

1 monopoly service with revenue in excess of \$30 million requires a 340 basis point  
2 upward equity return adjustment.<sup>21</sup>

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

11  
12 **Q. Mr. Ramirez uses eight publicly traded companies to derive rates of return and**  
13 **the beta used in his M-CAPM analysis. Do you agree that the companies**  
14 **selected by Mr. Ramirez are sufficiently comparable to the marine pilotage**  
15 **service at issue in this proceeding?**

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

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<sup>21</sup> Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

<sup>22</sup> Ramirez, Exh. JCR-3r at 12, Sub-Exh. 9.

<sup>23</sup> Ramirez, Exh. JCR-1Tr at 12:13-14.

1 trucking company, two aviation companies, and five companies specializing in  
2 shipping and logistics services.<sup>24</sup>

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

15  
16 **Q. Did Staff perform a M-CAPM or Build-up Model analysis to determine cost of**  
17 **equity as part of its review for this case?**

18 A. No.

19  

---

<sup>24</sup> Ramirez, Exh. JCR-3r at 24-31, Sub-Exhs. 15a-15h.

1 **Q. Why not?**

2 A. Any derived return on equity would be zero because PSP's accrual-basis equity  
3 balance is negative.<sup>25</sup> As such, Staff did not calculate a cost of equity as part of its  
4 review.

5  
6 **Q. Do you have an opinion on the soundness of the methods used by Mr. Ramirez  
7 to derive his cost of equity estimates?**

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

14

15 **V. RETURN ON RATE BASE**

16

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

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

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<sup>25</sup> Kermode, Exh. DPK-4.

<sup>26</sup> Ramirez, Exh. JCR-1Tr at 4:24, fn.2.

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

7  
8 **Q. What is the distinction between a return on investment verses return on rate  
9 base?**

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

15  
16 **Q. Please briefly discuss the process Mr. Ramirez used to derive his required  
17 return on equity.**

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

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<sup>27</sup> Ramirez, Exh. JCR-3r at 3, Sch. C; Ramirez, Exh. JCR-3r at 10, Sub-Exh. 7.

1 million on his own, disregarding the actual smaller \$4.36 million balance reflected  
2 on PSP's 2018 modified-cash balance sheet.<sup>28</sup>

3

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

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

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

12 Additionally, by not using PSP's reported financial equity balance and  
13 ignoring its unrecorded liability for call backs, Mr. Ramirez's equity valuation  
14 exceeds the pilot's actual equity investment by over \$20 million.<sup>31</sup>

15

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

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

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<sup>28</sup> Norris, Exh. JN-04.

<sup>29</sup> Ramirez, Exh. JCR-3r at 10, Sub-Exh. 7.

<sup>30</sup> Ramirez, Exh. JCR-3r at 10, Sub-Exh. 7.

<sup>31</sup> Norris, Exh. JN-04, Kermode, Exh. DPK-4.

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

## 6 VI. PILOTAGE LABOR EXPENSE

7  
8 **Q. Did you review Mr. Ramirez’s testimony regarding return on pilotage labor?**

9 A. Yes.

10  
11 **Q. Do you agree with Mr. Ramirez’s approach to deriving a “fair return on  
12 pilotage labor?”**

13 A. No. Mr. Ramirez’s analysis conflates the concept of hired laborers with services  
14 provided by skilled professionals that act as independent contractors that have come  
15 together to work as an association “...formed to collect pilotage fees, pay expenses,  
16 and disburse the net earnings from pilotage fees to its members.”<sup>32</sup> It is not  
17 uncommon for professional organizations such as law firms or accounting firms, to  
18 use an association of some form, to provide the supporting infrastructure allowing  
19 them to more effectually provide their services.

20 PSP is a professional organization which acts as a conduit for the net earnings  
21 of the pilots.<sup>33</sup> This is an essential difference that distinguishes the PSP business

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<sup>32</sup> Kermode, Exh. DPK-7 at 1.

<sup>33</sup> Kermode, Exh. DPK-7.

1 model from other industries regulated by the Commission. The distributions received  
2 by the pilots are not payment for employee labor, but instead, earnings from self-  
3 employment.<sup>34</sup>

4  
5 **Q. Did you review Mr. Ramirez’s testimony and exhibits supporting his**  
6 **recommended return on labor?**

7 A. Yes. I reviewed Mr. Ramirez’s testimony and the data he supplied regarding his  
8 return on labor calculations.<sup>35</sup>

9  
10 **Q. Do you have an opinion of the approach used by Mr. Ramirez to derive a fair**  
11 **return on the PSP Pilotage labor?**

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

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

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<sup>34</sup> Kermodé, Exh. DPK-7.

<sup>35</sup> Ramirez, Exh. JCR-1Tr at 10:3 – 11:11; Ramirez, Exh. JCR-3r at 8, Sub-Exh. 5.

<sup>36</sup> Ramirez, Exh. JCR-1Tr at 10:3 – 11:11; Ramirez, Exh. JCR-3r at 8, Sub-Exh. 5.

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

4  
5 **Q. Do you have an opinion on Mr. Ramirez's recommendation regarding a return**  
6 **on pilot labor?**

7 A. I disagree with his recommendation. Mr. Ramirez's testimony and exhibits  
8 addressing a fair return on pilot labor appear to compare PSP as a professional  
9 association of independent contractors to wage laborers under an employer/employee  
10 relationship. Regulation must recognize the reality of the business form used by  
11 pilots to conduct business and not attempt to impose an imaginary business structure  
12 for the convenience of moving pilot earnings from net income to a labor expense.  
13 Therefore, the Commission should not rely on Mr. Ramirez's analysis regarding a  
14 fair return on labor because it fails to properly acknowledge PSP's structure as an  
15 association of independent contractors and does not explain why a comparison to the  
16 90<sup>th</sup> percentile of BLS wage data is reasonable.

17  
18 **Q. Please summarize your conclusions and recommendations.**

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

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

7

8   **Q.    Does this conclude your testimony?**

9    A.    Yes.

10