BRITISH COLUMBIA
FERRY COMMISSION

ORDER NUMBER: 15-02

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**IN THE MATTER OF**

The Preliminary Decision on Price Caps
for the Fourth Performance Term
Pursuant to Section 40 and 41
of the *Coastal Ferry Act*

**BEFORE**: Gordon Macatee, BC Ferries Commissioner
Sheldon Stoilen, BC Ferries Deputy Commissioner

## PRELIMINARY DECISION

**WHEREAS:**

A. The *Coastal Ferry Act* (the “Act”) requires the commissioners to make a preliminary decision by March 31, 2015 regarding the price caps for the next performance term (“PT4”), which starts on April 1, 2016 and ends on March 31, 2020;

B. Pursuant to subsection 40(1), the ferry operator, British Columbia Ferry Services Inc. (“BC Ferries”), has provided information satisfactory to the commissioners respecting designated ferry routes that are included in a route group for which a price cap is to be set and the commissioners have published this material on their website;

C. Also pursuant to subsection 40(1.1), BC Ferries has provided the commissioners with a long term capital plan and an efficiency plan which the commissioners have published on their website;

D. In accordance with subsection 40(2) of the Act, the commissioners invited and reviewed public comments received on the information referred to in paragraphs B and C above as well as on other information including regulatory reports required to be submitted to the commissioners;

E. The commissioners retained external advisors to assist in the review of BC Ferries' submissions referred to in paragraphs B and C above as well as supplemental information;

F. In accordance with subsection 41(2) of the Act, the commissioners have been guided by the following principles in setting the price caps:

   (a) the price cap must allow for a return sufficient to enable the ferry operator to recover
      (i) the portion of operating expenses, including all financing charges, that can reasonably be applied to the route group,
      (ii) the portion of administrative expenses that can reasonably be applied to the route group, and
      (iii) the reasonable capital costs that are to be incurred in relation to the route group, and amortized in accordance with generally accepted accounting principles on a straight line basis;

   (b) the price cap, when combined with all other price caps applicable to all route groups serviced by the ferry operator, must allow for a return sufficient to enable the ferry operator to
      (i) meet its debt obligations, and
      (ii) maintain access to borrowing rates that, in the opinion of the commissioners, are reasonable in all of the circumstances;

G. BC Ferries and the Province have agreed to continue with the amalgation of all route groups into one route group for purposes of price cap regulation;

H. The Province has indicated that it will maintain service fees throughout PT4 at the level of service fees for the fiscal year ending March 31, 2016. Any change will be reflected in the commissioners' final price cap decision due on or before September 30, 2015;

I. The commissioners have examined the capital expenditures that BC Ferries expects to undertake in the third performance term, and, being satisfied that they are reasonable, has taken them into account in setting price caps for the fourth performance term;

J. The price caps must take into account a productivity gain;

K. The Act allows the commissioners to require the ferry operator to establish fuel deferral accounts and establish terms and conditions for their use;

L. The commissioners have determined a "set" price per litre for fuel as a reasonable forecast of the price that BC Ferries will pay for fuel in the fourth performance term;

M. The commissioners are publishing this Order together with a report on their findings and determinations and are inviting comments from the public through to June 30, 2015.

**NOW THEREFORE** the commissioners' preliminary decision is as follows:

1. The price caps applicable to the amalgamated route group are increased by 1.9% annually from April 1, 2016 to the end of the next performance term at March 31, 2020.

2. BC Ferries is required to maintain the existing fuel deferral accounts under terms and conditions established by separate Order.

3. The set price per litre for the operation of fuel deferral accounts, being a required input into the calculation of fuel surcharges or rebates on the base fares to be charged within the above price caps, shall be 91.5 cents per litre for marine diesel and 46.4 cents per litre for LNG in the first year of PT4 and inflated by 2% per year for the balance of PT4.

**DATED** at Victoria, in the Province of British Columbia, this 18th day of March 2015.

BY ORDER

Gordon Macatee
BC Ferries Commissioner

Sheldon Stoilen
BC Ferries Deputy Commissioner

# British Columbia Ferry Commission

# Report on the Preliminary Price Cap Decision For the Fourth Performance Term

*Prepared and submitted in accordance with Sections 40 and 41 of the Coastal Ferry Act of the Province of British Columbia*

March 18, 2015

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# Report on the Preliminary Price Cap Decision for the Fourth Performance Term

## 1. Governing Legislation under the *Coastal Ferry Act*

Under the *Coastal Ferry Act* (the "Act") the BC Ferries Commissioner and the BC Ferries Deputy Commissioner (the "commissioners") are responsible for setting of price caps for each four year performance term. The guiding principles for the commissioners and the process for setting the price caps are set out in the Act and can be found in Appendix A.

The primary requirement for setting the price caps is that they must allow the ferry operator to earn a return sufficient to recover operating and administrative expenses, amortization of capital costs and all financing charges. The price caps must also take into account any productivity gain that, in the opinion of the commissioners, the ferry operator should achieve in the following performance term.

In setting the price caps the commissioners must determine that the operating and administrative expenses are reasonable and that capital costs incurred in the current performance term or to be incurred in the next performance term are also reasonable.

## 2. Review of the Current Performance Term ("PT3")

In March 2011, the commissioners released the preliminary price cap decision for PT3. The decision was for price cap increases of 4.15% per year on the major routes and 8.23% per year on the minor routes. The commissioners had made all of the determinations set out in the Act, and then applied several measures to "consider the interests of ferry users". These latter considerations were based on a change to the Act in 2010, which was not well defined. After the release of that decision, the ferry operator submitted a legal analysis which challenged the decision on the basis that the price caps would be too low to allow the company to achieve the legislatively prescribed pre-tax return on equity in every year. A subsequent recalculation based on that legal analysis indicated the price cap increases for the first year of the next term would need to be 16.4% on the major routes, 43.1% on the minor routes, and 81.1% on the northern routes.

At that point, the commissioners wrote to the Minister of Transportation and Infrastructure, recommending a review of the Act to determine what might be driving the need for such large price caps. The Minister accepted the recommendation, directed the commissioners to conduct a regulatory Review of the Act ("Review"), and through legislation, set the price cap increase for one year at 4.15% for all routes for the first year of PT3. The Review was completed and submitted to the Minister in January 2012 with 31 recommendations to improve the regulatory model. The full Review document can be found on the commissioners' website at [http://www.bcferrycommission.com/reports-press/governing-statute/coastal-ferry-act-review/](http://www.bcferrycommission.com/reports-press/governing-statute/coastal-ferry-act-review/).

The commissioners' Review encouraged all stakeholders to the ferry system to play a part in making the system financially viable for the operator, sustainable for the taxpayer, and affordable for the ferry user. The point was made that the provincial government representing taxpayers, BC Ferries and ferry users would all need to contribute to achieving that objective. At this point, it's clear that all three of those stakeholders have indeed done their part. Those contributions are detailed in a report which is attached as Appendix B and are summarized in the following discussion.

In response to the commissioners' recommendations in the Review, the government articulated a vision for coastal ferry service as follows:

"*The guiding principles behind all future decisions to affect coastal ferry service will be based on an affordable, efficient and sustainable system which protects basic service to coastal communities for future generations. Affordable responds to the top priority expressed in the public engagement process. The B.C. government will take actions so that ferry fare increases trend toward the Consumer Price Index (CPI). Efficient describes a ferry system that embraces innovation, adopts new and emerging technologies, continues to find operational efficiencies, and strives for continuous improvement. Examples of initiatives currently underway or being explored at BC Ferries include the use of a cable ferry serving Denman Island, the use of liquefied natural gas to fuel vessels and a new reservation and point-of-sale system to improve customer service. Sustainable speaks to a commitment to ensure that future generations have safe, reliable transportation connections to coastal communities. Standardizing vessels for greater interoperability, more "no frills vessels", and seeking federal infrastructure funding to renew the fleet all contribute to a sustainable system. These guiding principles are a framework for BC Ferries and the BC Ferry Commissioner as they consider and implement changes to increase operational efficiencies and develop and implement long-term capital plans. It's a long-term vision that will help ensure our coastal ferry services are affordable, efficient and sustainable for future generations.*"

Government proceeded to amend the Act and expanded the powers for oversight by the commissioners. In changing the legislation the government enshrined the principle that the interests of the ferry user, the operator and the taxpayer must be balanced. It provided $86 million in new funding and eliminated the prohibition on cross subsidization between route groups. The return on equity provisions of the Act were removed and replaced with a model which mirrors the requirements of external lenders for certain financial outcomes, specifically a debt service coverage ratio and total equity not lower than 17.5% of total capitalization. Working with BC Ferries, the government took steps to reduce some underutilized capacity. Together, these initiatives have taken a considerable amount of pressure off fares going forward.

For its part, BC Ferries adjusted to the new financial model and the private bond rating agencies responded with stable or improved credit ratings. The company is on track to exceed the $54 million efficiency target set for PT3. Administrative costs were cut and executive compensation levels were reduced. The company has embraced the innovation challenge with initiatives to achieve greater fleet standardization and interoperability, multi-vessel procurements, a cable ferry, LNG powered vessels and new technology systems to support flexible pricing, expanded reservation systems, and yield management. Ancillary revenues have continued to grow, bringing in revenue which would otherwise need to come from fares.

Ferry users have done their part as well. They have adapted to revised service levels, ridership declines have leveled off, utilization of ferry capacity has improved, revenue from ancillary business lines are growing, commercial business has grown, and customers are buying BC Ferries' vacation packages. The Ferry Advisory Committees have provided valuable input and ably represented the interests of the ferry users in their communities.

These measures by the key stakeholders to the ferry system have contributed to reducing pressure on fares. With the changes to the Act in 2012 and the amendments to the Coastal Ferry Services Contract ("CFSC"), the commissioners were able to set price cap increases at 4.1, 4.0 and 3.9% for the final three years of the PT3. These price caps were a considerable improvement over what had been projected before the changes to the legislation and the CFSC. Still, those increases were higher than the target set out in the Review for price caps at or below the rate of inflation.

## 3. Review of BC Ferries' Submissions

### a) PT4 Submission

BC Ferries' submissions for the next performance term, ("PT4") can be found in full at http://www.bcferrycommission.ca/reports-press/governing-statute/act-s40-and-s41-price-cap-review/. The submissions included information regarding core ferry services, revenues and expenses for the current performance term; a long term capital plan and an efficiency plan.

PricewaterhouseCoopers' ("PwC") conducted an assessment of the submissions and their report can be found at http://www.bcferrycommission.ca/wp-content/uploads/2011/04/PWC-Assessment-of-BC-Ferries-PT4-Submissions.pdf. Based on PwC's assessment and the commissioners review of the submissions, the commissioners find that:

- BC Ferries has complied with the Act in providing the submissions to the commissioners for purposes of setting the preliminary price caps for the next performance term;
- The expenses, including operating, administrative and amortization costs, appear reasonable;
- The value of the capital assets deployed is appropriate; and
- The information contained in BC Ferries' submissions as well as supplemental information provided to the commissioners can be relied on to support the commissioners' PT4 forecast model.

### b) Long Term Capital Plan

The 12 year capital plan submitted by BC Ferries is based on the current CFSC. Accordingly, it contemplates no changes in capacity, service levels, route configurations or efficiency measures. This is to be expected, and is noted here to underline the fact that any such changes to the contract before the final price cap decision in September 2015, may result in changes to the preliminary price cap, either up or down depending on the nature of any change.

The capital plan contemplates replacement of 18 vessels, the replacement of major infrastructure at the Horseshoe Bay terminal, three major IT projects, and over 700 minor capital projects. The estimated cost is in excess of $3.1 billion over the period. The significant trends that are evident in the plan include standardization of the fleet and terminals, a move toward LNG fuel and a modernization of the IT infrastructure to support improved customer service, optimizing of capacity utilization, and improved cost controls.

All capital projects above a specified threshold must come to the commissioner for approval under Section 55 of the Act. There will be a future opportunity to address each project in considerable detail before final approvals are granted.

### c) Efficiency Plan

BC Ferries complied with the requirement in the Act by submitting a plan as to how it intends to provide services more efficiently in the upcoming performance term. The efficiency plan can be found at: http://www.bcferrycommission.ca/reports-press/governing-statute/act-s40-and-s41-price-cap-review/. The plan had the following four elements:

- LNG fuel alternative for vessels;
- New customer focused information technology systems;
- Major Routes Strategy; and
- Southern Gulf Islands Strategy.

## 4. Performance Reviews

### a) Efficiency Review

PwC conducted an external review of efficiencies at BC Ferries in operating, financing, maintenance, administrative costs, overall labour costs, and organizational design. The full review is posted on the BC Ferry Commission website at http://www.bcferrycommission.ca/wp-content/uploads/2011/04/Performance-Review-of-the-Efficiency-of-BC-Ferries-March-2015.pdf.

Key findings of the report are as follows:

- BC Ferries is demonstrating good cost control, especially in the area of administrative expenses;
- Cost control has been achieved while maintaining good outcomes with customer satisfaction and safety;
- BC Ferries appears to have a strong culture of efficiency;
- Executive compensation compares well with provincial crown corporations and appears to be appropriate for an organization of its size and complexity;
- Public Sector Employers Council ("PSEC") guidelines are being complied with regarding executive holdbacks, organizational layers and the number of direct reports to the CEO;
- Administrative expenses declined by 15.1% since 2009;
- Labour costs have tracked slightly above the rate of inflation;
- Unscheduled overtime has declined by almost 16%;
- Absenteeism rates are below the average for comparable businesses;
- Employee turnover has declined from 10.14% to 2.94%;

- Executive compensation has declined significantly over the period, from $3.0 million in 2009 to $1.8 million in 2014, and is at the low end of the five largest provincial crown corporations; and
- Of the 4,234 employees at BC Ferries, 650 are exempt from the bargaining unit, and of those, 179 meet the definition of "management", in so far as having budget authority and direct reports. PwC found that the higher percentage of exempt labour has provided the company with more flexibility to manage overall labour costs.

In conclusion, the commissioners are satisfied that overall efficiency in the areas assessed by PwC is generally good.

**b) Fuel Management**

PwC conducted an independent review of BC Ferries' policies and procedures for procurement of fuel, the reasonableness and effectiveness of hedging strategies, management of fuel consumption and a benchmarking of fuel management policies and procedures against comparable organizations. The full review is posted on the BC Ferry Commission website at http://www.bcferrycommission.ca/wp-content/uploads/2011/04/Performance-Review-of-BC-Ferries-Fuel-Management-March-2015.pdf.

Key findings in the review are as follows:

- BC Ferries' efforts to manage and minimize consumption of fuel have been effective;
- BC Ferries have defined procedures in place to manage consumption and costs and are compliant with these procedures;
- The current deferral account mechanism in place that acts as a hedge against fuel price volatility is considered appropriate; and
- BC Ferries has adopted the policy of locking into fixed price swaps when pricing is available at or below the indicative set price. There is no strong evidence that suggests that the indicative set price is the optimal point to hedge fuel costs. Although the decisions to lock into fixed price contracts at or below the indicative set price are being driven to avoid fuel surcharges and provide fare certainty for periods of time, the strategy does not necessarily result in the best value for fare payers. As a policy that is in the interest of users, fuel hedging may be used to limit increases in fares to the rate of inflation.

In conclusion the commissioners find that the fuel management policies and procedures are generally acceptable. Fuel hedging should only be employed when it is possible to lock in prices below the rate of inflation and only then when it is clearly in the interests of ferry users to do so. The fuel deferral accounting mechanism will be continued in PT4.

### c) Homeporting

PwC conducted an assessment of the rationale and efficiency of current homeporting arrangements and any alternative arrangements which might enhance the efficiency of the business. The full review is posted on the BC Ferry Commission website at http://www.bcferrycommission.ca/wp-content/uploads/2011/04/Performance-Review-of-BC-Ferries-Homeporting-Arrangements-March-2015.pdf.

Homeporting refers to the location where the vessels are docked overnight. The decision can drive cost if the vessels are not in the optimum location for starting the next day's service, and need to be deadheaded to the starting location. Homeporting decisions have evolved over time, and may not always have been based on efficiency or other financial considerations.

Key findings are as follows:

- Existing homeporting arrangements are not necessarily the most efficient choice, but it would be cost prohibitive to change them at this point;
- Future homeporting decisions should only occur when major decisions are being made on existing routes;
- A homeporting policy should be developed for future guidance, when new routes are established, or existing routes are faced with major changes; and
- Crew accommodations on the new Intermediate Class Ferries (ICF) may allow BC Ferries to achieve savings without changing the homeporting arrangements.

In conclusion, the commissioners feel that while some homeporting arrangements may not be ideal there is no compelling reason to alter any arrangement at this time. However, for any new vessels proposed for any of the minor or northern routes, consideration should be given to on board crew accommodation where possible.

### d) BC Ferries Vacations

BC Ferries Vacations was established to package ferry travel with accommodation and activities in targeted vacation destinations. The business operates out of retail space in downtown Vancouver, and serves walk-in, call-in and website customers. The commissioners have heard a great deal about the service, and perceptions that it may not be making a positive contribution to net income, due to its location and business model.

PwC conducted an external review of the business model and the financial performance to date, and to provide an opinion on whether the enterprise is contributing to keeping fares down for ferry users.

Key findings are as follows:

- BC Ferries Vacations is meeting its intended goals;
- Gross and net revenue expectations have exceeded the initial targets;
- The contribution and costs of a centrally located service centre in downtown Vancouver do not appear unreasonable; and
- The business line has yet to reach a mature state and has potential to expand further.

In conclusion, the commissioners are satisfied that BC Ferries Vacations is making a positive contribution to net income at BC Ferries and as such is helping to keep fares lower than they would otherwise need to be. The full review is posted on the BC Ferry Commission website at http://www.bcferrycommission.ca/wp-content/uploads/2011/04/Performance-Review-BC-Ferries-Vacations-March-2015.pdf.

## 5. Summary of Public Comments

The commissioners received public comments which can be found at http://www.bcferrycommission.ca/wp-content/uploads/2011/04/PT4-Public-Comments.pdf. The following table summarizes the most frequently raised topics.

| Topic | # | Main Comments |
|---|---|---|
| Capital and Efficiency Plans | 22 | • Reducing the number of terminals on Saltspring Island makes sense<br>• Opposed to reduction in service from Horseshoe Bay to Nanaimo<br>• A fixed link should be pursued between the Sunshine Coast and Howe Sound<br>• Provincial government should study the feasibility of bridges system wide<br>• Dimethyl ether should be considered as an alternative to diesel fuel<br>• Electric ferries should be considered to run on shorter routes |
| Fares | 12 | • Price cap increases over PT4 should be consistent with inflation<br>• High fares have resulted in lost revenue for coastal communities<br>• Fare structure should be adjusted to eliminate route inequalities<br>• Excess or underutilized capacity needs to be discounted<br>• Speciality discount should be introduced for residents of ferry dependent communities |
| Return to Public Sector Entity | 5 | • BC Ferries should be absorbed into the Ministry of Transportation and Infrastructure<br>• Ferry service is not a luxury but an essential piece of transportation infrastructure for coastal communities |
| BC Ferries Compensation | 4 | • Management compensation should be consistent with comparable Crown Corporations<br>• The number of directors and total remuneration paid to directors should be reduced<br>• Wages under the Collective Agreement should be consistent with levels which prevail in the open BC labour market |
| Capital Expenditures | 2 | • Refurbishments recently completed were unnecessary as vessel was essentially new |
| BC Ferries Vacations | 1 | • BC Ferries Vacations is a drain on resources |
| Usefulness of Information | 2 | • Public information provided is insufficient to appropriately analyze |

| | | |
|---|---|---|
| | | the performance of BC Ferries<br>• BC Ferries' submission did not include a financial projection for PT4 |

## 6. Preliminary Decision on Price Caps for the Next Performance Term ("PT4")

The Act requires the commissioners to ensure that price caps are set in order for the ferry operator to be able to meet certain financial targets, specifically a target debt to equity ratio, and a target debt service coverage ratio. Accordingly the following determinations have been made:

### a) Financial Targets

For PT3 the commissioners established financial targets for BC Ferries to sustain access to external financing. The two targets were a debt service coverage ratio "DSCR" of 2.5 or higher, and equity not lower than 17.5% of total capitalization. For PT4, the equity target will be met at all times, and the target for DSCR will be achieved by the end of the term and will not drop below 2.3 at any point. This is still above the levels specified in financial covenants with the external lenders. Projections for Performance Term 5 (PT5) indicate that the DSCR will rise above 2.5 for the duration of that term.

### b) Operating and other costs

BC Ferries is expected to manage its operating and administrative costs during PT4 at or below inflation, which for purposes of price cap setting is assumed to be 2% per year. Labour cost settlements are assumed to be consistent with public sector agreements. The review of the submissions and other information provided by BC Ferries together with the results of the performance reviews indicate that all operating and administrative expenses as well as amortization and financing costs projected for PT4 are reasonable.

### c) Efficiency Targets

BC Ferries is on track to exceed the $54 million efficiency targets set out in PT3. For purposes of setting PT4 price caps, it is assumed that those efficiencies will be sustained during the next term. In addition, an efficiency of $4.9 million per year must be realized within the service levels currently defined in the CFSC. An additional productivity gain of $2 million per year has been assumed and incorporated in setting the price caps for PT4. The total efficiency target for PT4 is $27.6 million.

**d) Long Term Capital and Efficiency Plans**

The capital plan for PT4 is accepted for price cap setting purposes. Acceptance does not imply approval. Each project, which exceeds the threshold for review by the commissioners, must be brought forward as a Section 55 application. The threshold is presently $30 million for terminals and vessels, and $5 million for IT projects. The thresholds are set out in commissioners' memoranda and may change from time to time in the future.
The capital plan for PT5 does not impact PT4 price caps. However, the commissioners recognize that capital decisions need to be made well in advance of the performance term in which the expenditures are made. The Major Routes Strategy outlined in BC Ferries' "Strategies for Enhanced Efficiencies in Performance Term Four and Beyond" (Efficiency Plan) speaks to avoiding some of the future capital investments at the Horseshoe Bay terminal. It is estimated that a rebuild will cost "over $200 million". In addition there are 6 major vessel replacements associated with this terminal over the next 15 years, at a total capital cost of $1.1 billion. Avoiding at least some of that capital cost would have a positive effect on fares in PT5 and beyond. For purposes of planning for PT5, BC Ferries is directed to revisit its capital plan with a view to reducing the total long term capital plan by $100 million. To do this, the company will need to continue its planning and analysis on the Major and Minor Routes strategies, including a revisit of its plans for the Horseshoe Bay terminal and consolidation of terminals. Planning should assume that vehicle ferry service will continue to be provided between Horseshoe Bay and Nanaimo. Significant public consultation would be necessary before any decisions could be made.

Other efficiency opportunities included a shift to LNG fuel on specified vessels, and business transformation strategies supported by new IT systems which are expected to deliver fare flexibility and an improved customer experience. Both of these efficiency proposals have been accepted for price cap setting purposes with the associated benefits reflected in the determination of the price caps for PT4.

### e) Fuel Set Price

The price of oil and refined products are in a state of considerable volatility and uncertainty. At the time of drafting this decision, the West Texas Intermediate ("WTI") barrel price for oil has been hovering in the $45-50 US dollar range; less than half the price that existed only months earlier. Predictions for the future are varied, and differ in probable direction, duration, and timing for a return to more "normal" levels. Suffice it to say, that fuel price predictions are not considered reliable at this point in time. The fuel set price used in the PT4 price cap is an important decision but carries a very high likelihood of being incorrect over the 5 year period to which it will apply. The fuel set price decision will have a very considerable impact on the price caps, and if set too high, will lock in higher price caps for the full 4 year period than might be necessary if fuel prices turn out to stay low for the duration. If set too low, the fuel deferral mechanism can be depended on to make needed adjustments over time.

A refiner margin and Canadian dollar exchange rate are added to the WTI price and then converted to a price per litre. The refiner margin has varied over recent years between $0.11/litre and $.30/litre. The margin tends to be higher in times of volatility, and at present it is above the "normal" range. The high degree of volatility in the market at present is attributed to the effects of a west coast refinery being temporarily out of service, a strike at western refineries and extreme weather conditions in eastern North America. These are all considered to be short term factors. For price cap setting purposes, the commissioners have elected to assume a refiner margin of $0.25/litre and an exchange rate of 1.25 Canadian vs US dollar. If the spread proves to be higher or lower than that over time, the difference will be corrected with the fuel deferral account mechanism.

The WTI price is at a very low point at present, and it would not be reasonable to establish a set price at the current price, with an assumption that prices are likely to stay that low for the full 5 year period. The commissioners have elected to establish the set price for fuel at a more conservative level. The set price for fuel is based on an assumed WTI price of $65 per barrel starting in the first year of PT4 and inflating at 2% per year over the performance term. Assuming a refiner margin of 0.25/litre, that barrel price translates to a fuel set price of $0.915/litre. If fuel prices are below that set price at the beginning of the term, the fuel deferral account mechanism will deliver fuel rebates to ferry users. If prices do rise above the set price in future, the fuel deferral account mechanism will require fuel surcharges to be applied.

**f) Fuel Deferral Mechanism for PT4**

The fuel deferral mechanism in place at the end of PT3 will continue through PT4, with certain modifications. The order presently requires the deferral account to be brought to a zero balance once every two years. For PT4, this requirement will be modified, so that the deferral account must be brought to a zero balance once during PT4. The purpose for this change is to recognize the unpredictability of fuel prices at the outset, and the likelihood that fuel prices may rise at some point during the performance term. The ability to build up a cushion at the beginning of the term will allow some softening of any negative impacts later in the term. The trigger for a fuel surcharge will remain at 2% of total revenue. The trigger for a fuel rebate will be set at 4% for the first 2 years of PT4, and revert to 3% for the 3rd year and 2% for the final year.

**g) Traffic Forecasts**

There are a number of factors which need to be considered in deciding on a traffic forecast for price cap setting purposes, some of which were not yet evident when the submission was filed. The dramatic drop in oil prices has created a considerably different economic situation, which may bode well for ferry traffic in coming years. The price of gasoline at the pump has fallen. The US economy is performing well. The low Canadian dollar may encourage more tourism from the US, and keep more Canadians closer to home for their vacation travel. Consumers have more disposable income as a result of fuel cost savings. The implementation of US border requirements for a passport has been in place for several years now, and the number of US citizens in possession of a passport has increased. If ferry fares in BC can be constrained to a rate which is near the rate of inflation, there is reason to expect some growth in traffic.

For all of these reasons, the commissioners believe it is reasonable to take a more optimistic view of traffic potential in PT4 than was put forward when BC Ferries filed its submission. The recent approval of the Fare Flexibility and Digital Experience capital project was based on a traffic growth projection of 3 to 5%. The application assumed the 3% outcome. The commissioners are building the more optimistic assumption into this price cap decision. The combination of an improved economy and new technology make it reasonable to assume modest traffic growth over the term. The commissioners have therefore based the price cap calculations on the assumption that traffic will increase by an additional 2% by the end of PT4. Making this assumption takes a considerable amount of pressure off the price cap, and will contribute to keeping fares lower than would otherwise be the case.

If the traffic projection used to set the price cap proves to have been overly optimistic by the midpoint of PT4, the commissioners will consider an application for a revision to the price caps.

### h) Government funding for service fees

For PT4 price cap setting purposes, the commissioners have assumed that the service fees provided by the Province will remain constant at fiscal 2016 levels for the duration of PT4. Any adjustment up or down from that assumed level will be addressed in the final price cap decision in September of 2015.

### i) Ancillary revenues

Ancillary revenues from non-regulated business activities are a key contributor to keeping fares lower than would otherwise be the case. Revenue from food service, parking, gift shops, terminal services, BC Ferries Vacations and others contribute to the company's bottom line. The commissioners do not regulate these activities, but consider them essential to keeping fares low. The price caps are based on the assumption that BC Ferries will continue its efforts to maximize ancillary revenues from existing and new sources over time. The projections provided in the submission have been accepted for price cap setting purposes.

### j) Price Cap Index

The price cap index is used by the commissioners to oversee compliance with the price caps during the performance term. At the beginning of PT3 the index was reset to 100. The index will again be reset to 100 at the beginning of PT4.

## 7. Preliminary Decision PT4 Price Caps

The preliminary price caps for PT4 are 1.9% increase each year.

## 8. Appendices

A. Governing Legislation for Setting Price Caps

B. Review of Performance Term Three

## 9. Reference Links

C. PwC Assessment of BC Ferries' PT4 Submissions

D. Public Comments

E. PwC Performance Review of the Efficiency of BC Ferries

F. PwC Performance Review of BC Ferries' Fuel Management

G. PwC Performance Review of BC Ferries' Homeporting Arrangements

H. PwC Performance Review of BC Ferries Vacations

British Columbia Ferry Commission

# APPENDIX A

## GOVERNING LEGISLATION FOR SETTING PRICE CAPS

*Coastal Ferry Act*

### a) Role of commissioner

**Section 38** (1) Without limiting any other power of the commissioner under this Act, the commissioner must, after considering public feedback obtained under this Act, regulate each ferry operator in relation to the core ferry services that are to be provided by that ferry operator and the tariffs, including, without limitation, reservation fees, that may be charged for those core ferry services, and must undertake that regulation in accordance with the following principles:

(a) the primary role of the commissioner is to balance, in the manner the commissioner considers appropriate,

(i) the interests of ferry users,

(ii) the interests of taxpayers, and

(iii) the financial sustainability of ferry operators;

(b) ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;

(c) ferry operators are to be encouraged to seek additional or alternative service providers on designated ferry routes through fair and open competitive processes;

(d) ferry operators are to be encouraged to be innovative and to minimize expenses without adversely affecting their safe compliance with core ferry services;

Section **38 (2)** For the purposes of subsection (1), the commissioner is to do the following in relation to each ferry operator:

(c) establish, in accordance with section 40, in advance of each performance term under the Coastal Ferry Services Contract, other than the first performance term, the price cap that is to apply to each route group to which the contract applies;

## b) Establishment of Price Caps for Subsequent Performance Terms

**Section 40** (1) For the purposes of section 38 (2) (c), each ferry operator must, at least 18 months before the beginning of a performance term for which a price cap is to be set, provide to the commissioner, the Authority and the Minister of Transportation and Infrastructure information, satisfactory to the commissioner, respecting the following in relation to each designated ferry route that is included within a route group for which a price cap is to be set:

(a) the core ferry services that the ferry operator has provided, and reasonably expects to provide, in the current performance term;

(b) the tariffs for core ferry services, including, without limitation, reservation fees, that the ferry operator has charged, and reasonably expects to charge, in the current performance term;

(c) the service fees that have been paid, and that the ferry operator reasonably expects will be paid, by the government in the current performance term;

(d) the revenues from all sources that the ferry operator has earned, and reasonably expects to earn, in the current performance term;

(e) the following expenses that the ferry operator has incurred, and that the ferry operator reasonably expects will be incurred, in the current performance term:

(i) the operating expenses, including amortization of capital costs, that the ferry operator has reasonably allocated to the designated ferry route;

(ii) the portion of the ferry operator's administrative expenses that the ferry operator has reasonably allocated to the designated ferry route;

(iii) the portion of the expenses applicable to the terminals serving the applicable designated ferry route that the ferry operator has reasonably allocated to the designated ferry route, and the methodology by which those amounts have been allocated among its routes;

(f) the requests for proposal issued, or other actions taken, in the performance term by the ferry operator in accordance with section 69, the responses received by the ferry operator to those requests or actions, any unsolicited proposals received in the performance term by the ferry operator for the provision of ferry services by additional or alternative service providers on the designated ferry route and the results of those requests, actions, responses and proposals;

(g) any other records considered by the ferry operator to be relevant to the setting of the price cap.

(1.1) Each ferry operator must provide to the commissioner, with the information submitted under subsection (1),

(a) a plan as to how the ferry operator intends to provide services more efficiently in the upcoming performance term, and

(b) the most recent capital plan prepared under section 64.1.

(1.2) Promptly after receiving the information referred to in subsections (1) and (1.1), the commissioner must, subject to subsection (1.3), publish that material on the commissioner's website.

(1.3) The commissioner need not, under subsection (1.2), publish information that, under section 17 or 21 of the *Freedom of Information and Protection of Privacy Act*, the commissioner may or must refuse to disclose in response to a request made under that Act.

(2) The commissioner must, at least 12 months before the beginning of a performance term for which a price cap is to be set,

(a) review the information and plans provided to the commissioner under this section,

(a.1) make public a request for public comment in relation to the following:

(i) the reports maintained under section 68 (3);

(ii) the information and plans provided to the commissioner under this section;

(iii) any other information on the commissioner's website that relates to the commissioner's powers and duties under this section,

and review the comments received in response;

(b) make the determinations referred to in section 41 (3),

(c) prepare a report that describes the findings of the review under paragraph (a) of this subsection and the determinations made under paragraph (b),the findings of the review under paragraph (a) of this subsection and the determinations made under paragraph (b), and indicate in that report the commissioner's preliminary decision about what the price cap for each route group will be for the next performance term,

(d) issue the report referred to in paragraph (c) to the ferry operator and the government, and

(e) publish the report referred to in paragraph (c) in a manner that the commissioner is satisfied will bring it to the attention of the public.

(3) At least 9 months before the beginning of the performance term for which the price cap is to be set, a ferry operator referred to in subsection (1) must submit to the commissioner the most current version of the Coastal Ferry Services Contract that is to apply in respect of that upcoming performance term to indicate the changes, if any, to be made to

(a) the core ferry services, and

(b) the service fees to be provided to the ferry operator by the government.

(4) After receiving the Coastal Ferry Services Contract referred to in subsection (3), and at least 6 months before

the beginning of the performance term for which the price cap is to be set, the commissioner must

(a) reconsider the preliminary decision included in the report referred to in subsection (2) (c) in the light of

(i) the Coastal Ferry Services Contract,

(ii) any additional information received by the commissioner from the ferry operator or from the government, and

(iii) any public comment received on the report, and

(b) issue the commissioner's final decision on the application to the ferry operator and the government.

## c) Principles Applicable to Price Cap Review

**Section 41 (1)** [Repealed 2012-28-2.]

(2) In setting a price cap applicable to a route group, the commissioner must be guided by the following principles:

(a) the price cap must allow for a return sufficient to enable the ferry operator to recover

(i) the portion of operating expenses, including all financing charges, that can reasonably be applied to the route group,

(ii) the portion of administrative expenses that can reasonably be applied to the route group, and

(iii) the reasonable capital costs that are to be

(A) incurred in relation to the route group, and

(B) amortized in accordance with generally accepted accounting principles on a straight line basis;

(b) the price cap, when combined with all other price caps applicable to all route groups serviced by the ferry operator, must allow for a return sufficient to enable the ferry operator to

(i) meet its debt obligations, and

(ii) maintain access to borrowing rates that, in the opinion of the commissioner, are reasonable in all of the circumstances;

(c) the price cap must take into account the anticipated productivity gain determined under subsection (5);

(d) the ferry operator is, on an ongoing basis, to actively seek additional or alternative service providers to provide ferry services on the designated ferry routes included in the route group in order to reduce the costs of providing those services.

## d) Determinations Required

**Section 41(3)** For the purposes of subsection (2) (a) to (c), the commissioner must, in setting a price cap for a route group,

(a) determine the portion of the following that, in the commissioner's opinion, acting reasonably, can reasonably be applied to the route group:

(i) operating expenses;

(ii) administrative expenses;

(iii) the expenses applicable to the terminals serving the designated ferry routes included in that route group,

(b) take into account, for the purposes of subsection (2) (a), only the portion of the expenses that the commissioner determines, under paragraph (a) of this subsection, can reasonably be applied to the route group,

(c) determine whether it was reasonable, in the commissioner's opinion, acting reasonably, for the ferry operator to have incurred capital expenses in relation to a designated ferry route included in the route group, and take into account only those capital expenses that

(i) are determined under this paragraph to be reasonable, or

(ii) had been approved under section 55,

(d) attribute to capital assets deployed within or in support of the route group a value that, in the commissioner's opinion, acting reasonably, is appropriate in all of the circumstances, and

(e) include in the price cap any reservation fees applicable to the route group.

(4) [Repealed 2012-28-2.]

(5) For the purposes of this section, the commissioner must determine the productivity gain that, in the commissioner's opinion, acting reasonably, the ferry operator should achieve in the following performance term.

(6) The commissioner may, in the price cap set for a route group under this section, provide for that price cap to change annually during the applicable performance term at a specified rate equal to the British Columbia consumer price index minus a productivity factor for the route group, which productivity factor

(a) is established by the commissioner,

(b) may be positive or negative, and

(c) reflects the anticipated productivity gain determined by the commissioner under subsection (5).

## e) Fuel deferral account

**Section 41.1** (1) The commissioner may

(a) require a ferry operator to establish a fuel deferral account in relation to one or more route groups, and

(b) establish terms and conditions for the use of any fuel deferral account established by the ferry operator.

(2) The commissioner may, on any conditions the commissioner may specify,

(a) allow a ferry operator to add a temporary fuel surcharge, or

(b) require the ferry operator to provide a temporary discount,

to reflect fluctuations in the fuel deferral account for any period.

## f) Obligation to keep information confidential

**Section 54** Despite any obligation imposed on the commissioner under this Act to obtain, maintain or make available information or records, the commissioner, every deputy commissioner, every employee of the commissioner and every inspector must not disclose or be compelled to disclose any information or record that is obtained in, or that comes to the person's knowledge during, the course of the administration of this Act or the course of any inspection authorized under this Act, unless and only to the extent that such disclosure is consistent with the *Freedom of Information and Protection of Privacy Act*.

# British Columbia Ferry Commission

# Appendix B

# Review of Performance Term Three

*Prepared and submitted in accordance with*
*Sections 40 and 41 of the Coastal Ferry Act*
*of the Province of British Columbia*

March 18, 2015

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## Review of Performance Term Three

### Introduction

The *Coastal Ferry Act* (“Act”) requires the Commissioners to establish a price cap for each route group as specified in the Coastal Ferry Services Contract (“CFSC”) between British Columbia Ferry Services Inc. (“BC Ferries”) every four years. Performance Term 3 (“PT3”) concludes at the end of March 2016. Performance Term 4 (“PT4”) runs from April 1, 2016 through March 31, 2020.

The price cap is an index of the maximum permitted ceiling of average fares by route group. The Act is prescriptive about how price caps are to be calculated. In setting the preliminary price cap levels for PT3, the Commissioners endeavoured to consider the interests of ferry users with several initiatives. The resulting price cap increases for PT3 were then set on a preliminary basis at 8.23 percent per year for the northern and minor routes, and at 4.15 percent per year for the major and Langdale routes. At these levels, public feedback was very negative, and conveyed a high level of concern with increases that were considered to be excessive.

Subsequent to the announcement of the preliminary price cap decision, BC Ferries provided the Commissioners with a legal analysis and expressed the view that the Commissioners may not have had the authority to implement the specific initiatives. A recalculation of the price cap decision without those initiatives indicated that much larger price cap increases would be required if all the initiatives were successfully challenged. The increases which would have been necessary for just the first year of PT3 alone, would have been 16.4 percent for the major routes, 81.1 percent for the northern and 43.1 percent for the minor routes. The Commissioners were very concerned about increases of this magnitude and did not believe the Act intended to produce such results.

Faced with a legislative requirement to make a final price cap decision by September 30, 2011, which would remain in place for four years, the Commissioners felt the Act needed to be reviewed on a priority basis. The Minister of Transportation and Infrastructure, who is the Minister responsible for the Act, concurred and brought forward the *Coastal Ferry Amendment*

*Act, 2011* ("Bill 14") which directed the Commissioners to undertake a review of the Act before issuing their final decision on price caps for the balance of PT3.

Under Bill 14, which was enacted June 2, 2011, the Province imposed a price cap increase of 4.15 percent on all routes for the first year of PT3 (April 1, 2012 – March 31, 2013) and, pending the outcome of the review, deferred a final price cap decision for the remaining three years of PT3 to September 30, 2012, to allow sufficient time for the Province to consider the recommendations in the Commissioners' report.

After extensive public consultations in all coastal communities served by BC Ferries and consideration of over 200 written submissions, the Commissioners submitted their report to the Minister on January 24, 2012. The report contained 31 recommendations to improve the regulatory model.

In their report, the Commissioners also highlighted the need for a three-pronged approach, whereby taxpayers, ferry users, and the ferry operator would each contribute to support solutions that would enable coastal ferry services to be provided affordably and efficiently in the future. Looking back over the past several years, it is clear that each party responded and made the necessary contributions.

**Legislative Changes**

In May 2012, the Province introduced the *Coastal Ferry Amendment Act*, *2012* ("Bill 47"). Bill 47 was enacted in June 2012 and made fundamental changes to the regulation of ferry fares and the rules for the determination of price caps, including those to be set for the final three years of PT3. Bill 47 was intended to reduce pressure on ferry fares, while ensuring accountability to taxpayers and the continued financial viability of the ferry operators. The changes included:

a) a change in the primary responsibility of the Commissioners from priority placed on the financial sustainability of the ferry operator to responsibility to balance, in the manner the Commissioners considers appropriate, the interests of ferry users, taxpayers and the financial sustainability of the ferry operator;

b) the ability to cross subsidize from the major routes to other ferry routes;
c) the elimination of user pay as a regulatory principle;
d) a requirement that the Commissioners approve the capital plans and major capital expenditures of the ferry operator, with the provision that the Commissioners is to decide what level of capital expenditure would trigger a requirement for their approval;
e) a requirement to set price caps in such a way as to allow for a financial return sufficient to enable the ferry operator to meet its debt obligations and maintain access to reasonable borrowing rates; and
f) explicit authorization for the Commissioners to approve the establishment by the ferry operator of fuel deferral accounts and to set the terms and conditions for their use, including fuel surcharges and rebates.

In addition, the legislative changes gave the Commissioners the explicit authority to, among other things:

g) use measures other than fare increases to respond to extraordinary situations facing the ferry operator;
h) conduct routine performance reviews of the ferry operator; and
i) require the ferry operator to review its policies and undertake public consultation.

Bill 47 was a foundational piece in the response to the Commissioners' recommendations. It set the stage for additional actions which would see each of the three parties in the ferry system – taxpayers, ferry users and the ferry operator – contribute in greater measure to keep future price cap increases at levels lower than they otherwise would be.

**PT3 Price Caps**

The Commissioners set the price cap increases for the final three years of PT3 on September 30, 2012. The legislative changes brought about by Bill 47, together with the enhanced funding from the Province, additional efficiency commitments by BC Ferries, and expected adjustments in service levels, served to lessen significantly the magnitude of the required price cap increases for PT3, as compared to those originally envisaged in the preliminary PT3 price cap ruling of

March 31, 2010. The final price cap increases authorized by the Commissioners for all route groups for the final three years of PT3 were as follows:

- April 1, 2013 – 4.1 percent
- April 1, 2014 – 4.0 percent
- April 1, 2015 – 3.9 percent

As part of their ruling on the final price caps, the Commissioners also reset the price cap index at a level of 100 as of April 1, 2012, based on the weighted average tariffs that existed as of March 31, 2012.

**Long Term Vision**

The Commissioners expressed a concern that there needed to be a long term vision established to guide future capital investments in vessels and terminals. The vessels scheduled for retirement were selected over 40 years ago to serve the needs of the day. As we look 40 years or more in to the future, the question is whether the needs of the future will be different. Government responded to this recommendation by enunciating a vision for BC Ferries as follows:

*"The guiding principles behind all future decisions to affect coastal ferry service will be based on an affordable, efficient and sustainable system which protects basic service to coastal communities for future generations. Affordable responds to the top priority expressed in the public engagement process. The B.C. government will take actions so that ferry fare increases trend towards the Consumer Price Index (CPI). Efficient describes a ferry system that embraces innovation, adopts new and emerging technologies, continues to find operational efficiencies, and strives for continuous improvement. Examples of initiatives currently underway or being explored at BC Ferries include the use of a cable ferry serving Denman Island, the use of liquefied natural gas to fuel vessels and a new reservation and point of sale system to improve customer service. Sustainability speaks to a commitment to ensure that future generations have safe, reliable transportation connections to coastal communities. Standardizing vessels for greater interoperability, more "no frills vessels", and seeking federal infrastructure funding to renew the fleet all contribute to a sustainable system.*

*These guiding principles are a framework for BC Ferries and the BC Ferry Commissioners as they consider and implement changes to increase operational efficiencies and develop and implement long term capital plans. It's a long-term vision that will help ensure our coastal ferry services are affordable, efficient and sustainable for future generations."*

**Financial Sustainability of the Operator**

Consistent with the regulatory principles set out in the Act, the price caps for the final three years of PT3 were established by the Commissioners in consideration of the need to ensure that BC Ferries is financially sustainable, such that it can continue to provide core ferry services over the long term. Essentially, this requires that BC Ferries must continue to be in a position to:

- meet its contractual obligations with current investors;
- earn a return sufficient to maintain access to reasonable borrowing rates; and
- earn adequate levels of net earnings as an important source of funding for future capital expenditures.

As part of the amendments arising from Bill 47, the section of the Act prescribing a pre-tax return on equity as the basis for determining price caps was eliminated. As recommended by the Commissioners, this was replaced with the requirement that price caps be set at a level that allows for a return sufficient to enable the ferry operator to meet its debt obligations and maintain access to borrowing rates that, in the opinion of the Commissioners, are reasonable. In compliance with this requirement the Commissioners established the price caps for the final three years of PT3 with the intention of allowing BC Ferries to achieve, by the end of PT3, equity not lower than 17.5 percent of total capitalization and a debt service coverage ratio of 2.5x or higher. This change in methodology significantly moderated the required price caps for PT3.

In its updated financial outlook for the four years of PT3, BC Ferries projects an increase in net regulatory earnings of $71 million. This reflects a decrease of $39 million in tariff revenue mainly due to a lower revised traffic forecast, a minimal variance given a five-year forecast. BC Ferries is projecting to reduce operating expenses by approximately $30 million from levels incorporated in the PT3 price cap determination. This is in addition to the efficiency and service adjustment targets set out in the determination. As a result of strong cost management, key financing and capital investment strategies, favourable borrowing conditions, additional ferry transportation fees and growth in ancillary revenue, BC Ferries continues to project a strong financial position, enabling continued asset reinvestment and ongoing sustainable service.

**Bond Ratings**

The two credit rating agencies, which rate BC Ferries and its bonds, initially expressed concerns regarding the legislative changes. However, both agencies maintained BC Ferries' bond ratings: Standard & Poor's (S&P) at A+ with a stable outlook, and DBRS at A with a stable trend. Subsequently, S&P raised BC Ferries' rating from A+ to AA-. This upgrade was largely attributed to a change in the agency's rating methodology for BC Ferries, but also reflected the increased comfort the agency apparently had with BC Ferries' revised regulatory structure. Since the Bill 47 amendments to the Act, BC Ferries has successfully issued two series of 30-year bonds totalling $400 million at favourable interest rates. Both issues were over-subscribed, indicating strong investor support.

**Taxpayer Support**

In their report, the Commissioners observed that the interests of taxpayers are to keep funding for the ferry system as low as reasonably possible and to ensure that there is effective governance, transparency and accountability in the operation of the ferry system. The Commissioners noted that, while the British Columbian coastal ferry system is less dependent on public funding than many other ferry systems in the world, the reinvestment that would be required over the ensuing decade is only going to be possible with more contributions from the taxpayer. In response, the Province is providing over $86 million in additional funding for BC Ferries over the period 2012 to 2016. By the end of PT3 the annual contributions from the Province to BC Ferries will total $176.5 million. This is a 65 percent increase from the level of funding provided at the start of the model in fiscal 2004.

Effective April 1, 2014, BC Ferries implemented the Province's decision to reduce the passenger fare discount for British Columbia seniors travelling Monday to Thursday from 100 percent to 50 percent on the designated routes with the exception of the northern routes, which did not change.

The savings from this change were directed back to BC Ferries to reduce pressure on fares for all classes of customers.

**Cross Subsidization**

The amendments to the Act arising from Bill 47 removed the prohibition to cross subsidize from the major routes to the other regulated routes. This regulatory principle had resulted in there being different price cap percentages in each route group, with the price caps on the non-major route groups being significantly higher than those for the major route group. For example, the preliminary PT3 price cap increases for northern and minor routes were double that of the major routes. The allowance of cross subsidization, in combination with increases in provincial contributions, significantly moderated the price caps applicable to the non-major routes. The impact on major routes is insignificant, and the benefit to all other routes is considerable.

**Efficiency Targets**

As part of the PT3 price cap determination, the Commissioners established a $54 million efficiency target for BC Ferries. This target was considered to be both aggressive and challenging. With one year left before the end of PT3, BC Ferries is on track to beat the target by a considerable margin.

For example, in response the economic decline in fiscal 2009, BC Ferries eliminated 35 management and administrative positions, imposed a hiring freeze on all non-essential positions, and imposed a two-year wage and salary freeze for exempt employees.

**Labour Cost Management**

In PT3, BC Ferries has also undertaken financially reasonable steps to manage its work force. In February 2012, BC Ferries and the BC Ferry & Marine Workers' Union signed an extension of the Collective Agreement through October 2015 – making it a 12-year agreement, with modest wage increases averaging 1.3 percent per year over the last five years of the Agreement. This has resulted in stability for BC Ferries and to its passengers. Also during PT3, BC Ferries converted approximately 150 shipboard employees, such as Senior Chief Stewards and other vessel management staff, to excluded positions outside the Union. These new exclusions were conversions of existing positions.

### Executive Compensation

At the senior executive level, the Province amended the Act in 2010 to, among other things, bring the compensation of certain senior executives of BC Ferries into alignment with provincial public sector employers. Recognizing BC Ferries' contractual obligations to existing executives, the legislation stipulated that these new compensation limits would apply only to newly-appointed senior executives. Over the last few years, BC Ferries has reduced the number of executives by half. Since 2008, executive compensation has also been reduced by 50 percent.

### Administration Costs

A continuous focus on efficiency has enabled BC Ferries to hold the line on administration costs. When comparing administration costs from fiscal 2009 to fiscal 2014, BC Ferries has reduced overall costs by over $5.0 million per year, as shown in Table 3.

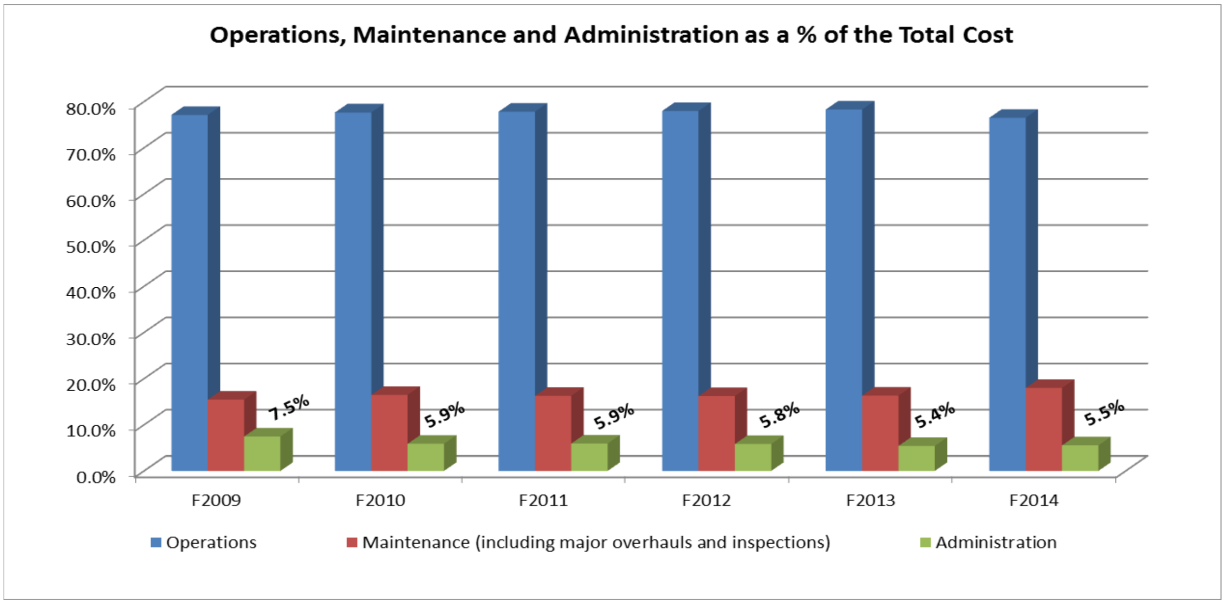
**Table 3**

**BC Ferries Administration Costs**

| | F2009 | F2010 | F2011 | F2012 | F2013 | F2014 |
|---|---|---|---|---|---|---|
| Administration Costs (millions) | $37.2 | $30.3 | $31.2 | $31.0 | $29.6 | $31.6 |

As indicated in Figure 1, administration costs as a percentage of total costs have reduced since fiscal 2009.

**Figure 1**




## Fuel Cost Management

BC Ferries continues to utilize its fleet effectively to minimize fuel consumption, and has reduced its annual fuel consumption by approximately 1.3 percent since fiscal 2009, as shown in Table 4.

**Table 4**

**BC Ferries Fuel Consumption** (in million litres)

| | F2009 | F2010 | F2011 | F2012 | F2013 | F2014 |
|---|---|---|---|---|---|---|
| Fuel Consumption | 118.2 | 120.2 | 119.5 | 118.8 | 116.7 | 116.7 |

## Meeting the Efficiency Targets

A summary of the actions BC Ferries has taken to manage its costs include:

- daily fuel consumption monitoring;
- utilizing vessels which consume less fuel than others while still meeting demand;
- managing the ‘minutes’ to improve on time performance and reduce overtime costs;

- monitoring customer volumes and preferences to increase ancillary revenues and its contribution to minimizing fares;
- planning the maintenance life cycle of its assets to minimize costs while ensuring a highly reliable service;
- monitoring hydro consumption to minimize costs;
- assessing the cost of materials and their effectiveness, for example the use of brine for de-icing versus road salt;
- requiring that the filling of all vacant positions and new hires to be approved by the President & CEO;
- requiring senior management approval of any new issue of an information technology asset or use of software; and
- monitoring the usage of software to limit license costs.

**Safety**

While actively controlling its costs, BC Ferries has continued its focus on safety as its number one priority, resulting in reduced injuries, absenteeism, and WCB savings without compromising service reliability.

As a result of BC Ferries' accomplishments in safety improvement, in 2014, BC Ferries was recognized with WorkSafeBC's Certificate of Recognition ("COR"). As a consequence, BC Ferries received a rebate of $600,000 in WorkSafeBC premiums, in addition to the $500,000 in premium savings BC Ferries realized in 2014. The COR certification provides for annual premium rebates from WorkSafeBC of up to 15 percent, which will help drive further safety initiatives going forward.

Table 5 below highlights some of BC Ferries' achievements since fiscal 2004.

**Table 5**

**BC Ferries Performance against Key Performance Indicators**

| **Performance** | **F2004 Results** | **F2014 Results** | **Improvement since F2004** |
|---|---|---|---|
| Employee Safety<br>(Employee time loss injuries) | 365 | 143 | 60.8% |
| Passenger Safety*<br>(# of passenger injury incidents / 1 million passengers) | 22.54 (F2009) | 13.28 | 41.1% |
| Fleet Reliability<br>(% of scheduled sailings delivered) | 99.14% | 99.71% | 0.57% |
| Fleet On-time Performance<br>(% of sailings within 10 minutes of schedule) | 85.2% | 91.5% | 6.8% |
| Overall Customer Satisfaction<br>(Rating out of 5 where 5 is very satisfied and 1 is very unsatisfied) | 3.99 | 4.17 | 4.5% |
| Employee Absenteeism<br>(Hours of illness and other paid leave) | 379,238 | 251,325 | 33.7% |

* New reporting methods in fiscal 2009 significantly improved reporting of incidents, effectively making prior year comparisons misleading.

**Ancillary Revenue**

The revenues that BC Ferries generates from non-regulated ancillary goods and services, such as catering and retail sales both on and off the vessels, as well as its commercial drop trailer service, the sale of vacation and travel packages, staterooms, parking and other services, has also help reduce pressure on fares.  These services include innovative ways BC Ferries has developed to take advantage of crew sizes onboard its vessels that are mandated by Transportation Canada Minimum Safe Manning Regulations, and excess capacity aboard its vessels during off peak periods.  These activities have shown considerable growth over PT3.

Commercial Services

BC Ferries’ drop trailer service – where the commercial customer drops its trailer at one location and BC Ferries transports it on the ferry to the other terminal for pick-up - has seen significant growth since inception in 2009. The net contribution from this service was $8.0 million in fiscal 2014. This is expected to grow to $8.7 million in fiscal 2016.

BC Ferries Vacations

BC Ferries Vacations, which now offers more than 100 travel packages in 45 destinations, has proven to make a positive financial contribution. In fiscal 2014, the net contribution from this service was $1.0 million, and is expected to continue to grow through PT3 and beyond.

Food and Retail Services

Customer experience with BC Ferries’ food and retail services continues to track favourably in BC Ferries’ customer satisfaction surveys. In addition, this is a growing component of BC Ferries overall revenues, both in absolute terms and on the basis of average passenger spend.

Earnings from these services are expected to grow to $49.2 million in fiscal 2016. BC Ferries’ efforts to increase and improve the variety, quality and availability of its offerings and outlets has continued to pay dividends for all ferry users through revenue generation that helps keep fares lower than they would otherwise be. This is an accomplishment given the general decline in traffic levels experienced since the global economic crisis in fiscal 2009.

Overall average passenger spend has grown from $4.83 in fiscal 2009 to $5.11 in fiscal 2014, and BC Ferries expects this to increase to $5.20 in fiscal 2016.

**Capital Plan**

BC Ferries operates a fleet of 35 vessels from 47 terminals. Since 2003, the inception of BC Ferries in its current form, a significant amount of investment has occurred in these and other assets, as BC Ferries has moved forward to renew its fleet and terminals, and to improve service reliability and the overall travel experience for its customers. Over the past 11 years, BC Ferries has invested more than $2.1 billion, including $1.4 billion in its vessels (which includes $742 million to bring seven new vessels into service) and $455 million in terminal and other shore side infrastructure projects. To date in PT3, BC Ferries has invested $330 million in its capital program to ensure a safe, reliable and sustainable ferry service. This includes:

- Westview replace trestle, ramp aprons, towers, wingwalls and turning dolphin and upgrade active lift;
- Little River ramp, abutement, tower, wingwall and dolphin 13 replacement;
- *Tachek* life extension;
- *Queen of Chilliwack* life extension;
- McLoughlin Bay berth modification and vessel tie up capability;
- *Kwuna* ¾ life upgrade;
- Tsawwassen Berth 3 mid-life upgrade and shoreline stabilization;
- Sewage treatment program;
- Information Technology Disaster Recovery Centre;
- Horseshoe Bay ramp upgrades on Berths 1,2 and 3 and life extension on transfer deck;
- Major overhauls and inspections on 37 vessels;
- Cable ferry system under construction;
- Three new intermediate class vessels under construction to replace the aged *Queen of Burnaby* and *Queen of Nanaimo;*
- *Queen of Capilano* mid-life upgrade;
- Automated Customer Experience Program (including reservations and point of sale); and
- Payroll system replacement.

Over the next 12 years, BC Ferries anticipates the need to invest a further $3 billion in its fleet and infrastructure, of which $1.27 billion is forecast for PT4. The potential impact of a capital program of this magnitude on price caps and ultimately the fares paid by ferry users is significant and, in recognition of this, the Commissioners in their review recommended greater regulatory oversight of the capital investments of BC Ferries. The Province concurred and, by Bill 47, amended section 55 of the Act to require that all major capital projects (i.e. new vessels and mid-life upgrades, terminal upgrades, information technology initiatives above a threshold determined by the Commissioners) be pre-approved by the Commissioners, based on a determination that such investments are reasonable, prudent and consistent with the current CFSC and BC Ferries' long term capital plan, the latter of which is also subject to the Commissioners review.

By Order 12-04, the Commissioners defined a major capital expenditure as *"any capital expenditure which exceeds $30 million, inclusive of component programs and interest during construction, and irrespective of the level of expenditure, any new vessel or terminal, and any vessel life extension which extends the life of the vessel by more than five years. In addition, upgrades to information (IT) systems in excess of $5 million which support ticketing and reservations"*.

To date in PT3, BC Ferries has sought and received approval from the Commissioners (with conditions) for four major capital expenditures:  the cable ferry project, the new intermediate class vessels project, the Spirit class mid-life upgrade project and the Fare Flexibility and Digital Experience Initiative.  These large projects together comprise a capital investment in the order of $500 million.  The Commissioners sought and considered public comment on BC Ferries applications for these projects and, with the assistance of independent advisors, also undertook in depth reviews into the viability of them.  The Commissioners determined that each of the projects represents a reasonable and prudent investment on the part of BC Ferries.  In addition, the Commissioners found that these projects incorporate new and innovative approaches which are expected to generate positive benefits in terms of enhancing BC Ferries ability to deliver safe, effective and efficient service.

**Innovation**

In their review, the Commissioners emphasized the need for BC Ferries to continue to explore innovative ways of delivering its service, particularly in the context of its long term capital plan, with a view to finding ways to reduce cost, while offering a better overall service.  Government incorporated a principle encouraging innovation in the Act.

The Commissioners made a number of suggestions in their report for areas of potential focus by BC Ferries.  These and other initiatives have been actively pursued by BC Ferries and are described in BC Ferries' *Strategies for Enhanced Efficiency in Performance Term Four and Beyond,* filed with the Commissioners in accordance with section 40(1.1)(a) of the Act. Initiatives such as these aim to ensure that the investments which are necessary to keep the coastal ferry system reliable and sustainable are made in the most efficient way possible in order reduce pressure on future fares across the entire system.

Liquefied Natural Gas ("LNG")

Fuel is a significant operating expense for BC Ferries. In fiscal 2014, BC Ferries spent $125 million on marine diesel, the sole fuel utilized by BC Ferries to date. The Commissioners recognized in their review that the move to operate BC Ferries' vessels on LNG offers the single largest opportunity for improving efficiency within the current terms and conditions of the CFSC. The use of LNG will also have the added benefit of cleaner exhaust emissions for a reduced environmental impact.

In PT3, BC Ferries awarded a contract to Remontowa Shipbuilding S.A. of Gdansk Poland to build three new intermediate class ferries which will be the first of BC Ferries' ships to operate as dual-fuel vessels capable of using LNG or diesel fuel for propulsion. In its filing with the Commissioners, BC Ferries indicated that the new intermediate class ferries are expected to save BC Ferries in the order of $3.5 million per year in fuel costs in PT4 commencing during fiscal 2017. BC Ferries also has commenced the project to convert its two Spirit class vessels to operate as dual-fuel vessels as part of their mid-life upgrades. These two vessels currently account for 15 percent of total fleet-wide fuel consumption. Savings associated with the conversion to dual fuel, as indicated in BC Ferries' filing, are expected to be an average of $12.0 million per year.

These projects require significant capital and related operating expenditures in the short term. However, the net benefit over the longer term is expected to be substantial, and will reduce pressure on future fares across the entire coastal ferry system. Beyond PT4, BC Ferries expects to replace other vessels with assets capable of operating on LNG.

Cable Ferry

BC Ferries is currently building a cable ferry system to replace its traditional ferry service between Buckley Bay on Vancouver Island and Denman Island. This will reduce both capital and operating costs, as a cable ferry system is less expensive than a conventional ferry, with expected savings in the order of $2 million per year over the 40-year life of the ferry.

This innovative service will be fully operational in the last year of PT3 and is an example of applying new ways of delivering more efficient marine transportation where the opportunity is available.

Fleet and Terminal Standardization

Since the Commissioners' review of the Act, BC Ferries has continued to refine its approach to new vessel replacements with a concerted effort to achieve both efficiencies in build approach as well as vessel design. The standardization objective is intended to reduce the number of classes of vessels and achieve maximum flexibility as practicable.

A reduction in the number of classes of vessels offers several advantages:

- opportunities for standardization of vessel design;
- scalability of vessel size, stemming from a common hull platform and similar propulsion systems;
- standardization of safety, bridge and navigation equipment; and
- interoperability and flexible deployment of standardized vessels between routes.

This move to enhanced vessel standardization in turn allows for reduced:

- capital acquisition cost through multiple vessel procurement;
- costs of parts and equipment;
- repair and maintenance life cycle costs; and
- crew training and familiarization costs.

BC Ferries currently has 17 classes of ships. The intermediate class ferry program is the first step to reduce the number of classes of ships. These three identical vessels are being built through a program build that offers economies of production. Future vessels with varying capacities will also be built off this common hull design.  In addition, the intermediate class ferries will offer the ability to accommodate live aboard crews, which may result in operating cost savings.

When these ferries are introduced into service on the Northern Sunshine Coast and Southern Gulf Islands, they will offer greater flexibility and efficiency in service delivery.

The combination of these advantages will contribute to reducing the total life cycle costs of these vessels, thus helping to reduce pressure on fares.

Customer Facing Information Technology

In their report, the Commissioners observed that the ability of a ferry operator to manage travel demand by having a robust and dynamic yield management system in place has particular benefits to the ferry user in a price cap situation.  A true yield management system consists of a range of fares reflecting demand levels, thereby giving the ferry user a choice between fare level and service convenience. Yield management can also be used as a capacity utilization tool by 'flattening' demand levels at peak sailing times.

BC Ferries currently has little ability to use yield management to full advantage because its point of sale system is out of date and does not have a system wide reservation system in place. Differential pricing on a limited scale with a resident fare on the northern routes and with Experience Cards on the minor routes and the route connecting Langdale and Horseshoe Bay, already exist. The Commissioners felt that the objective for BC Ferries should be to develop a more comprehensive pricing structure which could deal with the daily, weekly and monthly variations in ferry demand to optimize system performance.

BC Ferries has moved towards this objective through the development of its Fare Flexibility and Digital Experience Initiative, which through demand management tools and processes, is expected to increase traffic and related revenues and reduce service delivery costs, thus helping to reduce pressure on fares in PT4 and beyond.

BC Ferries is developing a multi-channel website platform as an enabling component for deploying this Initiative and pursuing opportunities to increase ancillary revenue. Given the role this website plays as the electronic storefront for customers, this Initiative is expected to deliver the following benefits:

- Increased revenue from bookings made through online self-service channels of sailings, vacations/packaged offerings and other onboard amenities;
- Operational cost savings through improved capacity utilization, as the advance purchase model and revenue management techniques envisaged in this Initiative will enable BC Ferries to better match capacity to demand.

**Under-Utilized Capacity**

The Commissioners' review of 2012 found that the level of capacity utilization was inefficient on some routes and needed to be improved in order to drive cost out of the system. The Commissioners recognized that BC Ferries is mandated by the CFSC to deliver the sailings as prescribed by the contract, and that improved capacity utilization in the immediate term would require amendments to that contract.

The Province and BC Ferries made amendments to the CFSC for PT3 which had as their objective, the realization of service level adjustments to achieve $30 million (later modified to $23 million) in net savings over the performance term. Most of these service level adjustments were directed at sailings with low utilization.

Service level adjustments for the major routes (targeted savings of $4.0 million to the end of PT3) were implemented in the first year of PT3. Round trips were reduced on three of the major routes where the traffic levels no longer warranted extra service or where service was significantly under-utilized, resulting in net savings of $4 million. These savings result from fuel savings and reduced requirements for casual employees during the off-season. $1 million of these net savings will continue annually through PT4.

Following a public consultation and engagement process led by the Province, service level adjustments for the minor and northern routes (targeted savings of $14.0 million) were implemented in year three of PT3 (April 28, 2014). The net savings of $14 million from these reductions result from fuel savings and reduced overall labour or overtime requirements depending on the route. $7 million of these net savings will continue annually through PT4. The remaining service level adjustments (targeted savings of $4.9 million) are intended to be focused on the major routes.

Overall, average capacity utilization has increased from 52.7 percent to 54.5 percent for all routes combined, and from 44.4 percent to 47.5 percent for routes impacted by service level reductions in the May-December time period.

**Fuel Deferral Accounts: Performance**

Fuel procurement costs for BC Ferries represent the second largest expenditure after labour, and were approximately $125 million or 18 percent of BC Ferries' direct operating costs in fiscal 2014. The pricing for these elements is volatile and beyond the control of BC Ferries. Further, because of the volatile nature of this commodity, it is not possible for BC Ferries or the Commissioners to accurately forecast the cost of fuel over the four years of a performance term, and the potential variance between the forecast and actual cost can be material. Fuel price volatility would be a significant risk to the financial sustainability of BC Ferries if BC Ferries were not able to fully recover these costs.

Fuel cost deferral accounts address this volatility. Deferral mechanisms are a commonly used regulatory tool. They act to "true up" forecast prices to actual prices and ensure that both BC Ferries and the ferry users pay the actual cost of the commodity. With the authorization of the Commissioners, BC Ferries has had fuel deferral accounts in place since 2004. Bill 47 amended the Act to make this jurisdiction express and embodied in a separate, stand-alone provision.

The conditions set out in Commissioners' Order 12-03 for the management of the non-northern account were intended to ensure the balance of the account never exceeded 2 percent of the annual pre-surcharge tariff revenue, and that the balance would not persist beyond a two-year period without passing through the zero dollar point. The purpose of these parameters is to ensure that the deferral account balance is addressed in a timely fashion and does not build up to an unreasonable level.

Fuel price volatility has been reflected in both fuel surcharges and rebates being applied on the non-northern routes since inception of the fuel deferral accounts.

**Performance Reviews**

Bill 47 gave the Commissioners explicit authorization to conduct reviews of the performance of BC Ferries. In PT3, the Commissioners conducted five such reviews to examine fuel management, general efficiency, home-porting practices, BC Ferries Vacations business line, and the Automated Customer Experience IT system.

**Summary**

The Act requires the Commissioners to balance the interests of the operator, the taxpayer and the ferry user. The Commissioners' review invited all stakeholders to the ferry system to play a part in making the system financially viable for the operator and affordable for both the taxpayer and the ferry user. The point was made that all three key stakeholder groups would need to be part of the solution. At this point stakeholder contributions include:

- The Province initiated the review of the Act and accepted its recommendations. It enunciated a vision, changed the legislation, created a new framework for governing the system, and expanded the powers for oversight by the regulator. The Province provided $86 million in new funding, adjusted key policies, took steps to remove underutilized capacity, and is funding an examination of different means for providing critical transportation infrastructure.

- BC Ferries made the shift to a new financial model, the bond rating agencies supported that change with improved ratings, efficiency targets were exceeded, administration costs were reduced, and executive compensation terms were changed. The innovation challenge has been addressed through fleet standardization, multi-vessel procurements, a cable ferry, LNG powered engines and new technology to support time of day pricing, expanded reservation systems and yield management. Ancillary revenues have continued to grow, bringing in revenue which would otherwise need to come from fares.

- Ferry users have done their part as well. Ridership is stabilizing, revenue from ancillary business lines are growing, the drop trailer business is being utilized, customers are buying BC Ferries vacations, and changes to the service levels  are being accommodated.

Change is always challenging, and it's a credit to all concerned that so much change has been absorbed in a relatively short period of time.