British Columbia Ferry Services Inc.

Response to

British Columbia Ferries Commissioner

Discussion Papers

December, 2011

BCFerries

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EXECUTIVE SUMMARY

British Columbia Ferry Services Inc. ("BC Ferries" or the "Company") submits this document in response to the invitation of the British Columbia Ferries Commissioner ("Commissioner") to interested parties to make submissions and comments to inform his current review of the *Coastal Ferry Act* ("CFA").

In this submission, BC Ferries first lays out the experiences of the corporation which led to the creation of the new model for coastal ferry services as set out in the CFA. This is considered important context to consider the regulatory model now in place. Prior to 2003, as a provincial crown corporation, BC Ferries had been encumbered by years of government interference concerning everything from tariff setting to vessel construction and spending priorities. Poor planning and decision making over the prior decade had wasted over $0.5 billion in taxpayers' dollars, including the $463.0 million for the fast ferries. In fiscal year 2000, the Province rescinded (forgave) debt totalling $1.08 billion that was owed to it by the Company. This effectively made the taxpayers responsible for this debt.

A new model for coastal ferry services, as reflected in CFA, was established by government in 2003 on the basis that BC Ferries needed to be restructured to create a strong, financially viable, sustainable, customer focused transportation provider that could meet the growing needs of coastal communities without further burden on taxpayers. The restructuring included a systematic mechanism though which government would focus on setting policy and guidelines that are in the public interest, while the corporation would build a successful marine transportation operation, based on sound business decisions, without government or political intervention.

The Auditor General in his report Changing Course – A New Direction for British Columbia's Coastal Ferry System (December 2006) concluded that government's overall objective in establishing the new governance structure for the coastal ferry system has been achieved:

> *"The changes made to the governance structure, brought about by the Coastal Ferry Act, have achieved their immediate purpose: the separation of government policy decisions and BC Ferries' business decisions."*

> *"We believe that, with the transformation of BC Ferries, government has created a structure that has achieved its immediate objective and has the potential to achieve more. Already, it appears to have achieved separation of public policy and business decisions, opening the way for a new capital program to replace aging ferries and other infrastructure."*

The new governance and regulatory structure has enabled BC Ferries to make advances in all areas of its business as it has pursued its vision of providing a continuously improving west coast travel experience. Recognizing these advancements, the Comptroller General, in the Report on Review of Transportation Governance Models, deemed BC Ferries to be well functioning stating, *"Overall we found the operations of [BC Ferries] to be reasonably well run within its legislated and contractual context. Aside from compensation issues discussed in section 4, appropriate financial and management controls and processes are established including planning, budgeting, monitoring, reporting, internal controls, a capital asset management framework, procurement policies, and an active internal audit function. The company demonstrated that cost containment strategies, revenue generating efforts and customer service quality systems are in place…."*

It is important to remember that by nature of the business model all earnings are either retained in the Company and invested in needed capital expenditures, or returned to the government in the form of dividends on the preferred shares owned by them.

Since 2003, BC Ferries has raised $1.378 billion in the capital markets and has paid $503.5 million in cash to the Province. Of this latter amount, $453.6 million was principal and interest on the original debenture issued to the Province by the Company in 2003. This loan was repaid from proceeds raised in the markets. The remainder of the payments to the Province includes dividends paid of $6.0 million per annum.

While the Company has made significant strides in terms of capital investments, revenue generation, operational efficiencies and improvements (see below for examples), various factors have constrained the financial results of BC Ferries and caused upward pressure on the levels of fares that its customers have and are expected to experience in the successive performance terms.

	Fiscal Year 2004 Results	Fiscal Year 2011 Results	Improvement Since 2004
Passenger Safety *(claims per million passengers)*	12.82	7.23	43.6%
Employee Safety *(employee time loss injuries)*	365	214	41.4%
Fleet Reliability *(% of all scheduled sailings delivered)*	99.14%	99.83%	0.7%
Fleet On Time Performance *(% of sailings within ten minutes of the scheduled sailing time)*	84.1%	89.6%	6.5%
Overall Customer Satisfaction* *(rating out of 5 where 5 is very satisfied and 1 is very unsatisfied)*	3.99	4.22	5.8%
Employee Absenteeism *(hours for illness and other paid leave)*	408,619	304,678	25.4%
Fuel Consumption *(total litres consumed)*	122,550,507	119,502,828	2.5%

** Calendar year 2003 and 2010 results*

Together, these outcomes have served to generate concerns amongst some about the long term sustainability of the model. The Company asserts that the model is effective in that it makes transparent the cost of government policy decisions. It is not correct to assume that because increases in ferry fares have been greater than inflation that the model has not been successful. BC Ferries submits that a significant contributing factor to the higher ferry fares is the policy decision of government, as reflected in the CFA, to move to a higher portion of user pay, while provincial service fees decrease on an inflation adjusted basis.

Under normal world economic conditions, and given the extraordinary level of capital investment required to reverse years of under-investment, this policy approach would have led to fare increases higher than inflation. This has been exacerbated by the extraordinary circumstances experienced of late (i.e. a world recession and its impact on traffic, together with significant increases in the cost of fuel). Accordingly, with no increase in service fees or ability to adjust service levels from those prescribed in the Coastal Ferry Services Contract ("CFSC"), large increases in fares must be expected for a ferry operator, such as BC Ferries, with a very high proportion of fixed operating costs.

It is within the context of affordability of fares that the current review of the CFA was initiated. The stated focus of the review is to identify improvements to the CFA which would better enable the Commissioner to balance the interests of ferry users and the financial sustainability of the ferry operator. BC Ferries contends that the CFA cannot 'balance' financial sustainability with the interests of ferry users as this implies that they are at odds with each other. In fact, financial sustainability is the foremost regulatory principle directly aligned with the interests of ferry users as surely it cannot be in the interest of any user, no matter how broadly defined, for the system to deteriorate and fail over time. At odds with the interest of ferry users is the principle of a move toward user pay. BC Ferries contends that it is the regulatory principle of user pay, and only this principle, that needs to be balanced against the interests of users.

BC Ferries submits that the financial sustainability of the ferry operator is a primacy, as anything less will lead to declining service quality and reliability, and eventual service disruption. It is therefore imperative to the interests of ferry users that financial sustainability be retained as a regulatory priority.

While BC Ferries sets out in this document certain areas where the regulatory framework could be adjusted for greater efficacy, the Company is of the general view that, with the exception of the principle of user pay, the model as set out in the CFA is well-founded and does not require a fundamental overhaul.

BC Ferries submits, however, that a key missing element of the model to date has been a long term ferry service strategy and a defined and transparent ferry policy. Government's current service strategy for BC Ferries is defined by the CFSC, which is based on scheduled service in 2002, which in turn is rooted in the service levels of the 1980s and 1990s. The CFSC is highly prescriptive and inflexible in terms of the service BC Ferries must provide. This affords BC Ferries minimal opportunity to profile or shape its service in response to declines in or changes to traffic demand. The CFSC is short-term (four years) with respect to service levels. BC Ferries, therefore, must make capital decisions without the benefit of knowing government's future service expectations. BC Ferries submits that a more flexible long-term service policy, overseen by the Commissioner, would enable the Company to realize efficiencies that could help keep fares affordable over the long term.

Summary of Responses to the Commissioner's Discussion Papers

In summary, BC Ferries' responses to the key issues in the Commissioner's discussion papers are as follows:

- All of the regulatory principles in the CFA, except that of the requirement to move towards user pay, are generally aligned with the interests of ferry users, and the principle of ensuring the financial sustainability of the operator is directly aligned. The financial sustainability of the operator should remain the regulatory priority. BC Ferries submits that user pay as a regulatory principle should be seriously reconsidered.

- To be applicable to the coastal ferry system, the definition of financial sustainability provided in Discussion Paper #3 (based on fare increases of no more than inflation) requires the use of replacement cost for asset valuation, plus other adjustments unique to the coastal ferry system.

- Limitations on debt levels is inappropriate; a 'deemed' equity approach is better.

- The current provisions of the CFA regarding return on equity are appropriate.

- Regulation of ancillary revenues is not required to protect the consumer, and is inherently in conflict with the principle of encouraging the ferry operator to take a commercial approach.

- Improvements to the existing methodology for the establishment of the price caps can be made.

- BC Ferries is indifferent to the allowing of cross-subsidization, provided that differing price elasticity between route groups is properly taken into account.

- The sections of the CFA dealing with alternative service providers ("ASP") are unnecessary (and costly) as it is in the Company's interest, and ultimately that of the fare payers, to pursue safe and reliable ASP opportunities, where it believes it makes sense to do so.

- A forward looking long term service policy from the Province is required. This is essential to the development of a service plan and a long term capital plan, both of which are significant factors in the determination of ferry fares.

- Section 45.1 of the CFA, which deals with unfair competitive advantage, should be reconsidered, as federal protection legislation already exists in this area.

1.0 PURPOSE

On May 19, 2011, the Province and the Commissioner announced a review of the CFA to identify improvements to the statute which would better enable the Commissioner to balance the interests of ferry users and the financial sustainability of the ferry operator. BC Ferries submits this document in response to the invitation of the Commissioner to interested parties to make submissions and comments to inform the review.

2.0 BACKGROUND

2.1 Context

BC Ferries currently operates as an independent company providing coastal ferry services on the west coast of British Columbia. On June 15, 2010, the Company celebrated 50 years of service. The service started with two vessels operating between Swartz Bay and Tsawwassen. Over the years, the Company has grown to be one of the largest and most complex ferry systems in the world, providing frequent year-round transportation service on 25 regulated routes, supported by 35 vessels and 47 terminals. BC Ferries provides a wide and varied service for its customers. In fiscal year 2011, the Company provided more than 185,000 sailings, carrying 20.7 million passengers and 8.1 million vehicles.

BC Ferries' service is an integral part of British Columbia's coastal transportation system and has been designated by the Province as an essential service for purposes of the Labour Relations Code. This designation means that the Company's services are considered necessary for the health, safety and welfare of the residents of British Columbia.

The imperative for a coastal ferry system that is efficient, reliable and sustainable underlies the rationale for government's decision in 2003 to establish the current model for coastal ferry services, as reflected in the CFA.

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Prior to 2003, as a provincial crown corporation, BC Ferries had been encumbered by years of government interference concerning everything from tariff setting to vessel construction and spending priorities. An inability to operate in a business-like manner had been well chronicled in several reports and inquiries, including the Gordon Report (February 1999), the Morfitt Report (October 1999) and the Wright Report (December 2001).

The *Ferry Corporation Act* (1977) resulted in confused governance with no clear separation between policy and operational considerations. Cabinet, not the board of directors of BC Ferries, made key business decisions such as approving route additions or deletions, tariffs, capital program, operating budget setting, borrowings and final outcomes of collective bargaining. Results included:

- Route and Rate Design
  - Rigidity in route structures and schedules that in many cases weren't supportable by capital assets employed;
  - Establishment of Discovery Coast ferry route (Route 40); which was intended as a commercial fare-supported route but with no properly researched supporting business case;
  - Over 5,000 individual tariffs (including specialty tariffs such as a group rate for motorcycles with sidecars);
  - Government social discount programs introduced with no offsetting compensation to the Company;
  - Irrational discount structure;
  - Major fare increase announced in November, 1997 took the Company by surprise and resulted in irate Gulf Islanders marching on the legislature.

- Capital Program
  - Disastrous fast ferry program imposed on the Company;
  - Under-investment in conventional assets creating pent-up demand for major capital expenditure.

- Operating Budget
  - Inconsistent approach, such as approving a capital expenditure but disallowing resulting amortization costs;
  - Systematic subsidy reductions without ability to reduce operating costs, resulting in multiyear and growing operating deficits;
  - Starved maintenance programs, resulting in under maintained aging assets.

- Borrowing
  - Between operating deficits and fast ferry write-offs, liabilities exceeded assets by approximately $500 million;
  - Debt service costs added to debt (and death) spiral;
  - Company was nearing a condition where it would be borrowing to meet day-to-day expenses, such as fuel and labour.

- Collective Bargaining
  - Final results were always negotiated with the Minister;
  - Rigid and inconsistent work rules and hours of work provisions;
  - A complicated and non-commercially oriented collective agreement;
  - Heavy penetration into management – over 90% of employees were in the bargaining unit and there was no management presence onboard vessels or in terminals most of the time;
  - A poisoned and dysfunctional union/management relationship;
  - Low employee morale.

- The Company had completely lost its way
  - Dated financial systems did not even report bottom line results as there was no commercial focus;
  - No asset ledger existed resulting in estimates of asset values and amortization being reported in annual financial statements;
  - Administration was dysfunctional and reactive to political demands - business ethics were questionable;

- Internal control systems were all but non-existent;
- Maintenance systems were eclectic and largely paper-based;
- Service standards, to the extent they existed, were unacceptable;
    - on time performance, service disruptions, inefficiencies, long line-ups, unsafe vehicle queues,
    - mediocre retail/concession services; lack of choice, quality, competition;
- Customer and employee safety increasingly at risk.

Poor planning and decision making over the prior decade had wasted over $0.5 billion in taxpayers' dollars, including the $463.0 million for the fast ferries. (The fast ferries were subsequently sold at auction in 2003 for less than 5% of their acquisition cost.) In fiscal year 2000, the provincial government rescinded (forgave) $1.076 billion agency debt then owing by the Company. (This effectively made the taxpayers responsible for this debt.) In spite of these actions, BC Ferries, fleet and infrastructure continued to age as a result of inadequate capital re-investment.

It was realized that over the next 15 years more than $2.0 billion would be required to replace vessels and upgrade terminal facilities and that significant changes to the current corporate structure would be required if these investments were to be realized effectively and without significantly increasing the financial burden on the taxpayer. At the same time, ferry users had grown increasingly concerned about service disruptions, inefficiencies, late sailings and a lack of service and amenity choices within the ferry system.

These challenges were summarized in the Wright report, which noted that as a crown corporation, BC Ferries was vulnerable to events beyond its control, which could severely impact its future financial sustainability "*…political interference is not limited to such a high profile example [as fast ferries]. It pervades every*

> " … political interference is not limited to such a high profile example [as fast ferries]. It pervades every important decision whether it involves services levels, tariffs, labour negotiations or the purchase of new vessels."
> - Wright

important decision whether it involves services levels, tariffs, labour negotiations or the purchase of new vessels."[1]

As a crown corporation, with limited scope to its decision making authority, BC Ferries was not in a position to make the necessary operational choices to increase revenue and reduce costs to achieve greater efficiency and effectiveness. Without change, it was felt by government that stress on the system would worsen, economic growth would be at risk and taxpayer exposure would increase.

2.2 New Model For Coastal Ferry Services

A new model for coastal ferry services, as reflected in CFA, was pursued by government on the basis that:

> The restructuring was intended to allow the corporation to build a successful marine transportation operation, based on sound business decisions on how best to service the millions of customers who buy ferry services every year.

> *"the provincial government needs to restructure BC Ferries to create a strong, sustainable, customer focused transportation provider that can meet the growing needs of coastal communities without further burden on taxpayers. The restructuring must include a systematic mechanism though which government clearly focuses on setting policy and guidelines that are in the public interest. In addition, the corporation must be allowed to build a successful marine transportation operation, based on sound business decisions on how best to service the millions of customers who buy ferry services every year…"*[2]

Government determined that within any new governance model, the *"most appropriate role for the provincial government would be to focus on the public interest, make provisions for consumer protection, encourage competition and limit financial exposure and risk to taxpayers."*[3]

[1] Review of BC Ferry Corporation and Alternative Uses for the Fast Ferries, Fred Wright, December 2001

[2] Restructuring the British Columbia Ferry Corporation Context Paper, Crown Agencies Secretariat, November 19, 2002

[3] Ibid

In developing the new model, government *"considered the full spectrum of business model options for improving the delivery of ferry services, including the continuation of the [crown corporation] status quo to full privatization of the coastal ferry services. Both of these extremes were rejected on the basis of risk at [the] time. The status quo [was] considered too risky as it [left] substantial business and financial risk to government while doing little to improve customer services. Full privatization [was] considered too risky as it has proven in many other jurisdictions to require a lengthy period of adjustment with some negative service and price consequences for customers during transition. As a result, the Authority model [was] recommended. It is neither the status quo nor full privatization but provides the following:*

- *an ability to run the business as a commercial enterprise;*
- *an opportunity to innovate for purpose of enhancing service to the customer;*
- *the transfer of significant financial risk from government to external bond holders;*
- *service and price protection for customers; and*
- *the ability to develop the business using best practices, some of which flow from the Authority model used successfully at the Vancouver International Airport."*[4]

The model for coastal ferry services established by government in 2003 encompassed the following principal pillars to protect the interests of the public and ferry users.

2.2.1 Independent Corporate Governance

To remove BC Ferries from political intervention, government created the B.C. Ferry Authority ("Authority") and converted BC Ferries from a crown corporation to an independent operating company.

- **B.C. Ferry Authority**

Creation of the Authority as a no-share capital (holding) corporation with the sole purposes of holding the single issued voting share of the operating company (BC Ferries) and appointing

[4] Financial Framework for British Columbia's Coastal Ferry System (Cabinet Submission prepared for Minister of Transportation November 19, 2002)

> The stated rationale for the structure was "independence from the Province".

the Company's directors. (Through amendments to the CFA arising from Bill 20, the Authority also became responsible for approving the compensation plans for directors and certain executives of BC Ferries.) The stated rationale for the structure was "*independence from the Province*". Specifically, by "*placing the power to appoint directors of the operating company in the hands of an Authority not controlled by the Province… a greater level of independence and… improved operating decision making*"[5] by the Company was expected to result.

- **British Columbia Ferry Services**

> The new model was introduced "so that the new BC Ferries can operate in a commercial manner…. Political mismanagement and bad business decisions in the past have meant a waste of taxpayers' money."

The CFA recognized the conversion of the former crown corporation to a company under the *Business Corporations Act* (then the *Company Act)*, fully independent from government and able to operate in a commercial manner, with the ability to attract capital to finance necessary investments, while ensuring no additional debt burden is placed on taxpayers. The stated objective of the conversion of the crown corporation was a "*corporatization, whereby the Crown would create a new governance structure more resembling a private sector corporation"*[6]*.* The then Minister of Transportation further emphasized this point in 2nd reading of Bill 18 (*Coastal Ferry Act*) when she stated that the new model was introduced *"so that the new B.C. Ferry Services can operate in a commercial manner. The new B.C. Ferry Services is designed to attract private sector investment, establish innovative partnerships and, for the first time in more than 40 years, be able to respond to the marketplace and offer services that people are seeking…We are taking action to restructure B.C. Ferries because of the problems with its governance and structure which have inhibited the corporation's ability to operate in a sound, businesslike manner. Political mismanagement and bad business decisions in the past have meant a waste of taxpayers' money."*

> The Coastal Ferry Services Contract is the vehicle through which the provincial government exercises its public policy role of determining service levels and ensuring affordability of fares through the service fees it establishes.

2.2.2 Coastal Ferry Services Contract

Long term fee for service contract between the Province and BC Ferries, which specifies routes, service levels and service fees. This is a commercial contract and is the vehicle through which it was

[5] Restructuring the British Columbia Ferry Corporation Context Paper, Crown Agencies Secretariat, November 19, 2002

[6] Ibid

intended that the provincial government would exercise its public policy role of determining service levels and ensuring affordability of fares through the service fees it established.

2.2.3 Regulatory Framework

A regulator, independent from government, was established to regulate tariffs through a "light-handed" incentive based price cap regulatory model and monitor BC Ferries' compliance with service levels under the CFSC.

2.3 Overall Business Model Objectives

The new business model was developed in order to achieve key *"strategic shifts"* or objectives. These objectives, together with the means by which government addressed them in the new model, are set out below.

2.3.1 Focused Public Policy Role for Government

Government determined that its role should only be one of setting public policy regarding coastal ferry services, principally with respect to routes, service levels and taxpayer support.

Government determined that its role should only be one of setting public policy regarding coastal ferry services, principally with respect to routes, service levels and taxpayer support, but that all decisions with respect to how BC Ferries operates should be made by the Company, which would operate on a commercial basis.

The government exercises its public policy role through the CFSC. Through this contract, the government sets the routes, the frequency of ferry service and the level of service fee per route. The Company then determines how best to structure its operation in order to deliver those services. The government, by setting the level of taxpayer financing (service fee) that it is prepared to provide for each route, influences the level (and affordability) of the fares charged by BC Ferries for ferry services. Routes, service levels and service fees are subject to renegotiation for each 4 year performance term. The provincial government also meets other policy goals through the social programs it funds through the CFSC. Through these programs the government subsidizes fares for seniors, students and disabled persons, and for medical transportation.

2.3.2 Empowered Commercial Service Delivery Role for the Company

BC Ferries provides ferry services under a commercial fee-for-service contract with the Province. Under the contract, the Province and the Company agree to the level of services to be provided, and the Company then determines how best to structure its operation in order to deliver those services. The Company is also able to pursue other commercial/ancillary revenues outside the CFSC in an effort to improve its profitability and generate earnings that can be reinvested in the coastal ferry system.

Government envisaged a 'corporatization' of BC Ferries, which meant a Board and a senior management team with a private sector approach.

The model recognized that in order to realize the significant commercial potential enabled by the new structure, a significant shift in the management and culture of BC Ferries would be required. Government envisaged a *'corporatization'* of BC Ferries, which meant a Board and a senior management team with a private sector approach.

2.3.3 Increased Transparency and Accountability

The disclosure requirements for the Company and the Authority were intended to (and in fact do) exceed that which was in place under the former crown corporation model.

BC Ferries operates under considerable public scrutiny, both through the media and through the disclosure required under the CFA, CFSC, as well as securities regulations. The disclosure requirements for the Company and the Authority were intended to (and in fact do) exceed that which was in place under the former crown corporation model.

Through the model, government ensured transparency of cost of ferry operations. In the past, revenues from the profitable major routes went to support services on other routes. The CFA requires that such "cross subsidization" be eliminated. This required that BC Ferries make public the revenues and costs of each route. The CFSC, also a public document, discloses the service fee payable for each sailing on each route. The total of service fees is disclosed and debated in the annual Estimates tabled in the Legislature. Social program fees paid by government are also now publicly reported.

The CFSC requires BC Ferries to hold an annual public meeting, and make public its audited financial statements, its annual report to the Commissioner, which includes financial statistics, traffic levels and other operating statistics, and annual business plan.

Similarly, the CFA requires that the Authority hold an annual general meeting open to the public, make public its bylaws, changes to bylaws, records with respect to director nominations, outcomes of Board meetings, the compensation plans for directors and certain executives of BC Ferries, annual reports, and audited financial statements. As well, the CFA requires BC Ferries to make public its quarterly reports to the Commissioner, which includes traffic levels and other operating statistics.

As an issuer of public debt, BC Ferries must meet stringent reporting requirements of securities regulators, which require ongoing public disclosure of comprehensive financial, governance and executive and director compensation information.

In keeping with the objective of enabling BC Ferries to operate as a commercial enterprise, it was initially deemed inconsistent to apply legislation applicable to public sector organizations, such as *Freedom of Information and Protection of Privacy Act* ("FOIPPA"). The government subsequently changed its position on this matter and, arising from the *Miscellaneous Statutes Amendment Act (No.3) – 2010* ("Bill 20"), BC Ferries and the Authority became subject to FOIPPA effective October 1, 2010.

2.3.4 Independence from Government

Legal ownership of the operating company, BC Ferries, was transferred to the Authority, which was structured to be an independent entity outside the control of government or any other entity. As noted above, it was established as a holding company, for the purpose of owning the only common (or voting) share issued by BC Ferries and appointing BC Ferries' board of directors. Subsequently, through amendments to the CFA arising from Bill 20, the Authority also assumed responsibility for approving compensation plans for the directors and certain executives of BC Ferries. The Authority has no direct reporting obligations to government. To protect the public interest in the operating company, government obtained (non-voting) preferred shares of BC Ferries, which are fully convertible to common shares in the event the Authority were to sell its common share. This feature gives the government the ultimate approval of any potential sale of BC Ferries. By virtue of it being the holder of the preferred shares of BC Ferries, the government has authority to approve any amendments to the Articles of BC Ferries. This includes the amendments required under the CFA to set out the maximum remuneration levels that the directors and certain executives will receive under the compensation plans approved by the Authority

A regulator, independent from government, was also established to regulate tariffs and service, and protect consumers. The regulator once appointed, can be removed by the Lieutenant Governor in Council for only a very narrow set of reasons.

2.3.5 Reduced Service Fees and Improved Financial Performance

The minimization of costs to the provincial taxpayer was an underlying objective of the model.

The minimization of costs to the provincial taxpayer was an underlying objective of the model. This was envisaged to be achieved through the improved financial performance of the Company which would arise from the model, and reductions in the service fees paid by government. Specific mechanisms in the CFA included: the principle of moving towards user pay by reducing service fees relative to fares; expanding ancillary and commercial services and potentially using the surpluses from those services to reduce the need for service fees; and, fostering economic efficiency through productivity factors set by the Commissioner in establishing price caps.

2.3.6 Flexible Labour Contract

The concept of moving towards a commercial collective agreement is one which the Company has and continues to embrace. Independence from government has enabled the Company to continue to make positive steps towards this objective. Between 2004 and 2006, the Company achieved a nine year collective agreement (expiring October 2012) along with a new ‘bargaining process’ for future agreements that provided for ‘binding arbitration' and hence ensures uninterrupted service to the travelling public.

2.3.7 Self Financing

The intent of the model was for BC Ferries to operate on a financially sustainable basis, thus enabling the Company to access the capital debt markets at favourable rates.

The intent of the model was for BC Ferries to operate on a financially sustainable basis, thus enabling the Company to access the capital debt markets at favourable rates in order to return to the Province a significant portion of its investment in the Company, and to allow BC Ferries to make the large capital investments necessary to properly rebuild the fleet and infrastructure of the ferry system.

Since 2003, BC Ferries has raised $1.378 billion in the capital markets and has paid $503.5 million in cash to the Province. Of this latter amount, $453.6 million was principal and interest on the original debenture issued to the Province by the Company in 2003. This loan was repaid from proceeds raised in the markets. The remainder of the payments to the Province includes dividends paid of $6.0 million per year.

During this same period, the Company has invested $1.728 billion[7] in its capital asset base. A portion of this investment was financed with the remainder of the proceeds from the issued debt, and the balance was from cash generated from operations.

Since 2003, the Company has grown its equity from $75.5 million to a high of $313.6 million at the end of fiscal year 2009. During the last two fiscal years, equity has eroded to $308.7 million, primarily due to the economic downturn and the resulting impact on ridership.

Key features of the model, which have enabled BC Ferries to achieve cost effective access to capital debt markets include: independence from government, long term commercial fee-for-service contract, long term terminal leases, as well as the legislated principle requiring the regulator to place priority on the

[7] This capital investment is prior to the receipt of the $119.4 million in duty remission subsequently granted for the *Northern Expedition* and the three Coastal class vessels. The remission funds were received subsequent to the debt issued to purchase these vessels. In addition to a 2% system-wide reduction in fares in fall, 2010, the remission funds are being used for current capital expenditures and other short term investments.

financial sustainability of the Company, and the requirement that price caps be set at a level sufficient to provide the Company with an appropriate return on equity.

2.3.8 Increased Competition and Commercialization

- **Increased revenue from commercial sources**
- **Improved efficiency**
- **Competition for route and other outsourcing contracts**
- **More effective ferry and non-ferry service to customers**

The model reflected government's belief that a more commercial approach, with an emphasis on profitability, would work to decrease costs and maximize revenues for BC Ferries, which would ultimately ensure the long term sustainability of the ferry system.

The model established in the CFA reflected government's belief that a more commercial approach, with an emphasis on profitability, would work to decrease costs and maximize revenues for BC Ferries, which would ultimately ensure the long term sustainability of the ferry system. The price cap model provides incentives to the Company to pursue new opportunities to generate incremental fare and ancillary revenue. There are numerous examples of the Company taking a more commercial approach, such as building new retail outlets (Tsawwassen and Departure Bay Quays), expanding the reservation system, and entering the drop trailer market. Ancillary revenue has grown from $76.8 million in fiscal year 2003 to $109.9 million in fiscal year 2008 before falling off to $102.0 million in fiscal year 2009 due to the recession. Subsequently, ancillary revenue has grown to $103.3 million in fiscal year 2011. Even taking the recession into account, this represents a compounded annual growth rate of 3.77%. The regulatory model ensures that sustained enhancements in performance from commercial / ancillary activities will ultimately benefit the fare payer through lower price caps and/or the taxpayer through lower service fees than would otherwise be the case.

The regulatory model has elements that explicitly encourage BC Ferries to be efficient and minimize expenses. The CFA includes a provision that requires the regulator to encourage the Company to minimize expenses, as long as it does not affect the safety of ferry services. If the Commissioner considers that costs are excessive, he can set the price caps at levels that will act as an incentive for the Company to reduce these costs. As an additional incentive to be efficient, the Commissioner may also set a productivity factor as part of the establishment of the price caps.

The model includes a legislated requirement for BC Ferries to seek ASPs to provide ferry service at a lower cost, when so ordered to do so by the Commissioner. This mechanism does not generate competition over time, as BC Ferries retains overall responsibility for the service provided by an ASP under the CFSC. Various structural impediments exist to securing successful alternative service delivery initiatives and make it unlikely that any significant cost savings will result from this legislated requirement (see part 3.3.7).

An underlying priority of restructuring was to foster improved service to customers. Consistent with the intended increased commercial focus of the Company, the specifics of what constitutes improved service is not defined in the model. Rather, it is envisaged that the marketplace will dictate what improvements are made, reflecting the preferences of the ferry users. To ensure public accountability for BC Ferries in regard to service quality, the CFSC requires that BC Ferries undertake customer satisfaction surveys each year and report publicly and to the provincial government and the Commissioner on the results. The survey is conducted by an independent firm. Since the introduction of the new model, BC Ferries has consistently achieved very high customer satisfaction ratings.

3.0 REGULATORY REVIEW

3.1 Progress Toward Restructuring Objectives

The Auditor General concluded that government's overall objective in establishing the new governance structure for the coastal ferry system has been achieved.

The Auditor General in his report Changing Course – A New Direction for British Columbia's Coastal Ferry System (December 2006) concluded that government's overall objective in establishing the new governance structure for the coastal ferry system has been achieved:

"The changes made to the governance structure, brought about by the Coastal Ferry Act, have achieved their immediate purpose: the separation of government policy decisions and BC Ferries' business decisions."

"We believe that, with the transformation of BC Ferries, government has created a structure that has achieved its immediate objective and has the potential to achieve more. Already, it appears to have achieved separation of public policy and business decisions, opening the way for a new capital program to replace aging ferries and other infrastructure."

The Comptroller General deemed BC Ferries to be well functioning.

The new governance and regulatory structure has enabled BC Ferries to make advances in all areas of its business as it has pursued its vision of providing a continuously improving west coast travel experience. Recognizing these advancements, the Comptroller General, in the Report on Review of Transportation Governance Models, deemed BC Ferries to be well functioning stating, *"Overall we found the operations of [BC Ferries] to be reasonably well run within its legislated and contractual context. Aside from compensation issues discussed in section 4, appropriate financial and management controls and processes are established including planning, budgeting, monitoring, reporting, internal controls, a capital asset management framework, procurement policies, and an active internal audit function. The company demonstrated that cost containment strategies, revenue generating efforts and customer service quality systems are in place...."*

BC Ferries has made significant advances in passenger and employee safety (see Figures A and B), service reliability (see Figures C), on-time performance (see Figure D) and customer satisfaction (see Figure E), as independently measured by the Mustel Group, an independent research firm. After years of labour turmoil, the establishment of a long term collective agreement with an arbitration process replacing work stoppage options has provided labour stability. This has supported improved labour/management relations and employee morale, which in turn has led to improved productivity (see Figure F). The Company has acquired seven new vessels (six of which were on schedule and all were within budget) and has significantly upgraded many others. This, along with improved operational procedures, has led to increased fuel efficiency (see Figure G). Significant upgrades and improvements have also been made by the Company at its terminals and to other infrastructure.

Notwithstanding the significant progress made to date in renewing the fleet and infrastructure, much work remains to be done. For example, the average age of the Minor route group fleet today is 36 years. BC Ferries anticipates replacing 10 vessels during the next 10 years.

Figure A: Passenger Safety

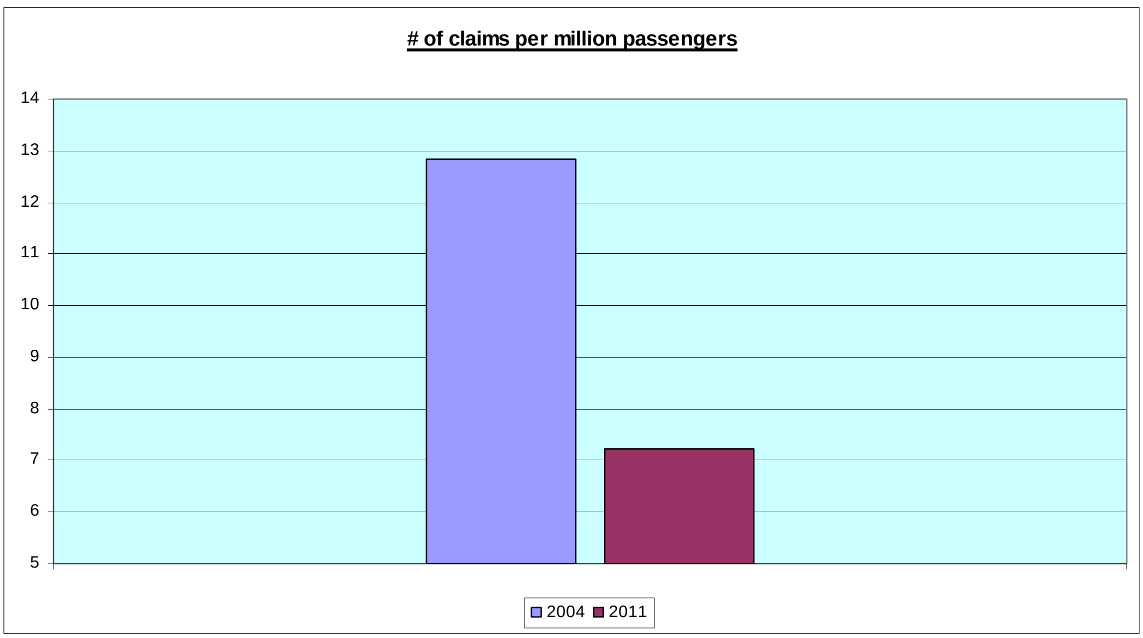


Figure B: Employee Safety

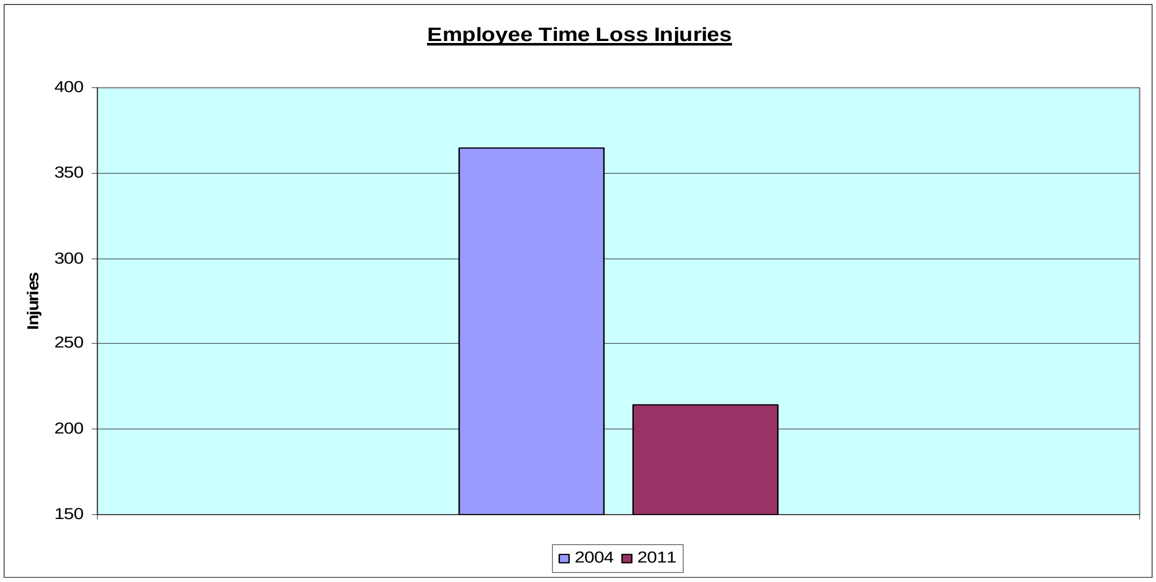


Figure C: Fleet Reliability

(% of all scheduled sailings delivered)

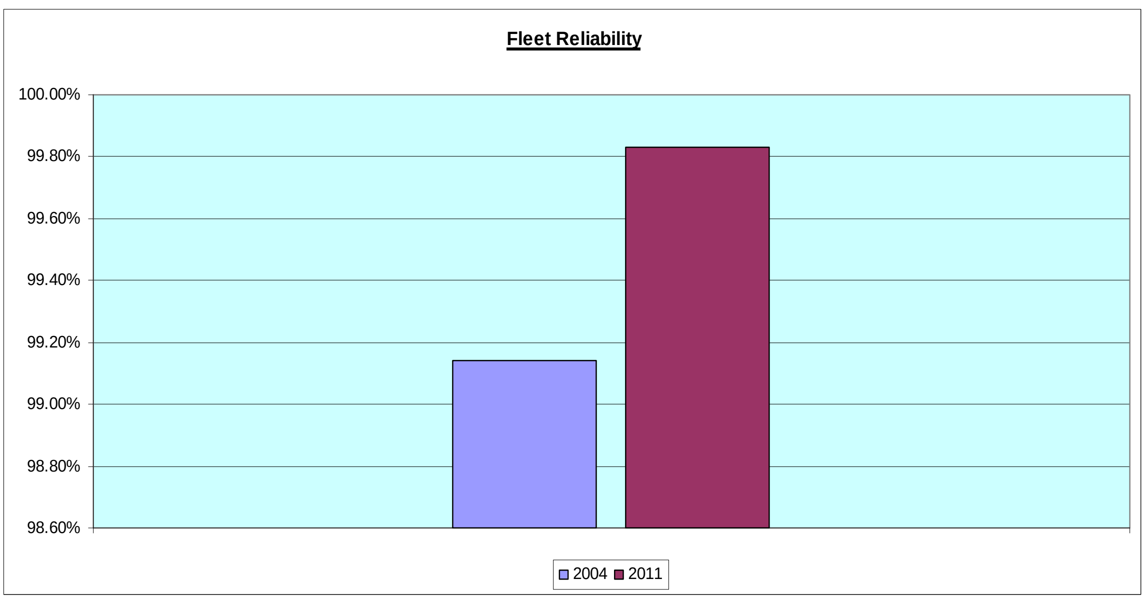


Figure D: Fleet On-time Performance

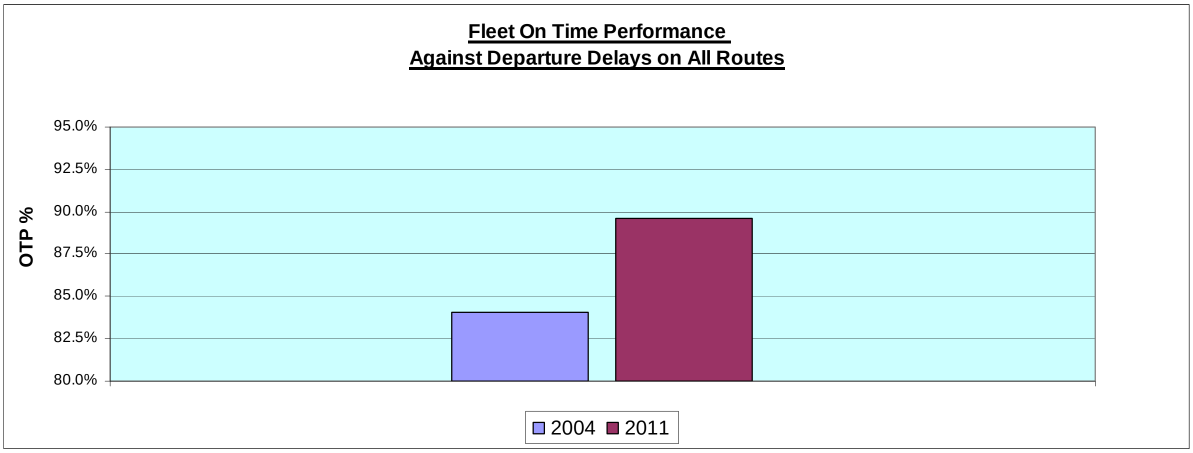


Figure E: Customer Satisfaction Ratings

(On a five-point scale where '1' means very dissatisfied, '2' means dissatisfied,'3' means neither satisfied or dissatisfied, '4' means satisfied and '5' means very satisfied)

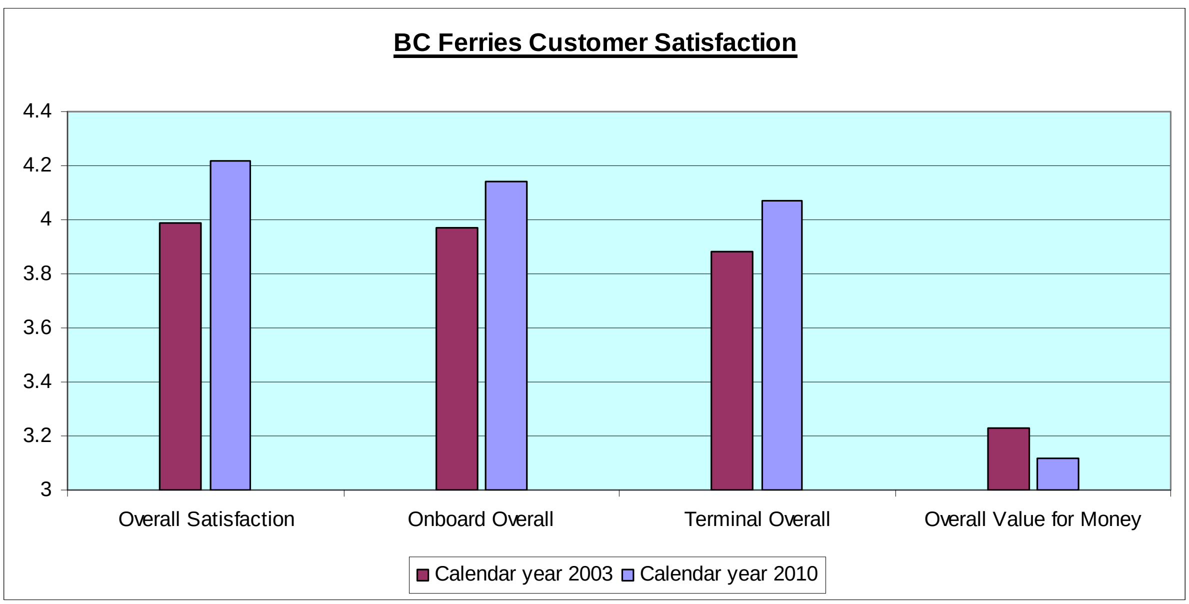


Figure F: Absenteeism

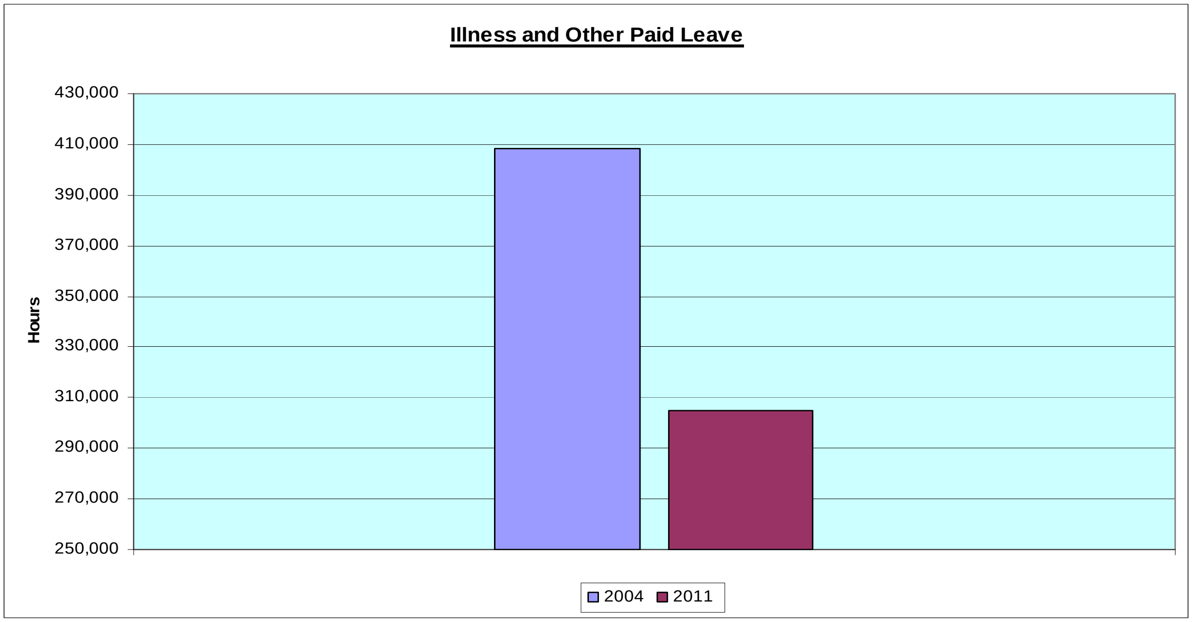
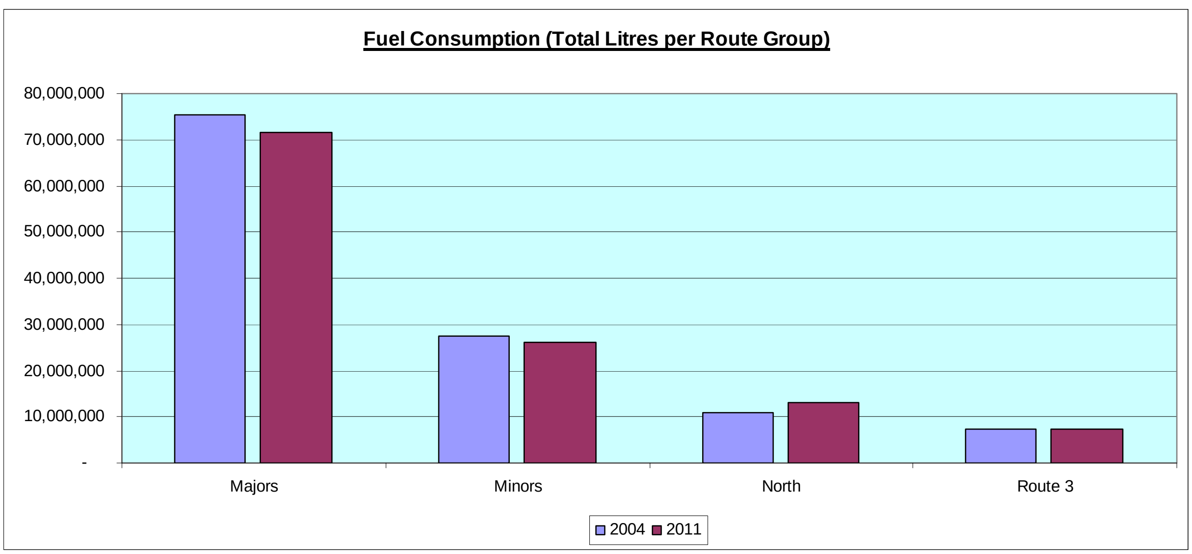


Figure G: Fuel Consumption



3.2 Challenges to the Framework

The fundamental framework of the coastal ferry model is sound, and has enabled the Company to make significant strides in terms of the capital investments, revenue generation, operational efficiencies and improvements necessary to ensure the long term viability of the ferry service. However, the functioning of the model has been strained by a number of factors which together have contributed to declines in BC Ferries' financial performance and the requirement for greater than inflation level increases in price caps in order to ensure the financial sustainability of the Company. These factors include the following.

3.2.1 Government Ferry Transportation Policy

The Coastal Ferry Services Contract is highly prescriptive and inflexible.

Coastal ferry service policy is outlined in the CFSC and is based on scheduled service in 2002, which in turn is rooted in the 1980's and 1990's. The contract is highly prescriptive and inflexible. As such, BC Ferries has minimal ability to realize efficiencies through reshaping its service in response to declines in or changes to traffic demand.

Government's policy of moving to user pay for the coastal ferry service is inconsistent with its free fare policy for its inland ferry service. This is a significant issue for many coastal ferry users.

3.2.2 Economic Downturn and Cost Pressures

A principal factor in government's decision to restructure the coastal ferry model in 2003 was the recognition that BC Ferries faced a significant challenge in terms of the need to replace and upgrade aged vessels and terminals over the next 15 years, and that a private sector approach would help mitigate risks associated with such an undertaking. The capital replacement and upgrading program was estimated at $2.0 billion at the time and reflected the many years of under-investment in assets that had been characteristic of the years BC Ferries operated as a crown corporation. It was understood by government at the time that the potential for lower traffic demand and rising fuel costs posed significant risks for the Company's financial plan. These risks have materialized and, together with other exogenous factors, have put pressure on the Company's financial performance and the need for greater than anticipated price cap increases.

- **Traffic**

While BC Ferries' traffic levels have historically been relatively stable, vehicle and passenger traffic declined significantly in fiscal year 2009 (5.2% and 4.9%, respectively from the prior year). That year, the Canadian and world economies experienced turbulence in the financial markets and a recessionary period. British Columbia experienced fewer housing starts, reduced tourism, plant closures in the forest product industry, falling auto sales, dramatically higher vehicle fuel costs (occasioned by higher fuel prices and/or taxation, such as the carbon tax introduced in 2008 and raised in each subsequent year), rising unemployment and generally reduced consumer confidence. These and other declining economic conditions all negatively impacted the Company's commercial and discretionary travel markets.

The down turn in traffic in fiscal year 2009 was at least partly due to the factors described above. In fiscal year 2010 vehicle and passenger traffic increased 1.5%, as economic conditions improved and vehicle fuel prices declined compared to the previous year. The Winter Olympics in Vancouver also had a positive impact on traffic in the latter part of the year. Since then, however, traffic levels have continued to decline as the Company's passengers faced increasing vehicle fuel prices (see Figure H) and tourism has remained soft.

It is likely that changing demographics, particularly on the southern and northern Gulf Islands and the Sunshine Coast, is having a negative impact on ridership. Improving communications technologies, such as video conferencing and web-ex, are also potentially influencing commercial travel. As well, population growth, particularly on Vancouver Island, is bringing more access to goods and services locally. This has the potential to inhibit traffic growth.

This year, vehicle traffic levels are the lowest the Company has experienced in 11 years, while passenger traffic levels are the lowest experienced in 20 years.

This year, vehicle traffic levels are the lowest the Company has experienced in 11 years, while passenger traffic levels are the lowest experienced in 20 years (see Figure I).

Figure H: Retail Gasoline Prices

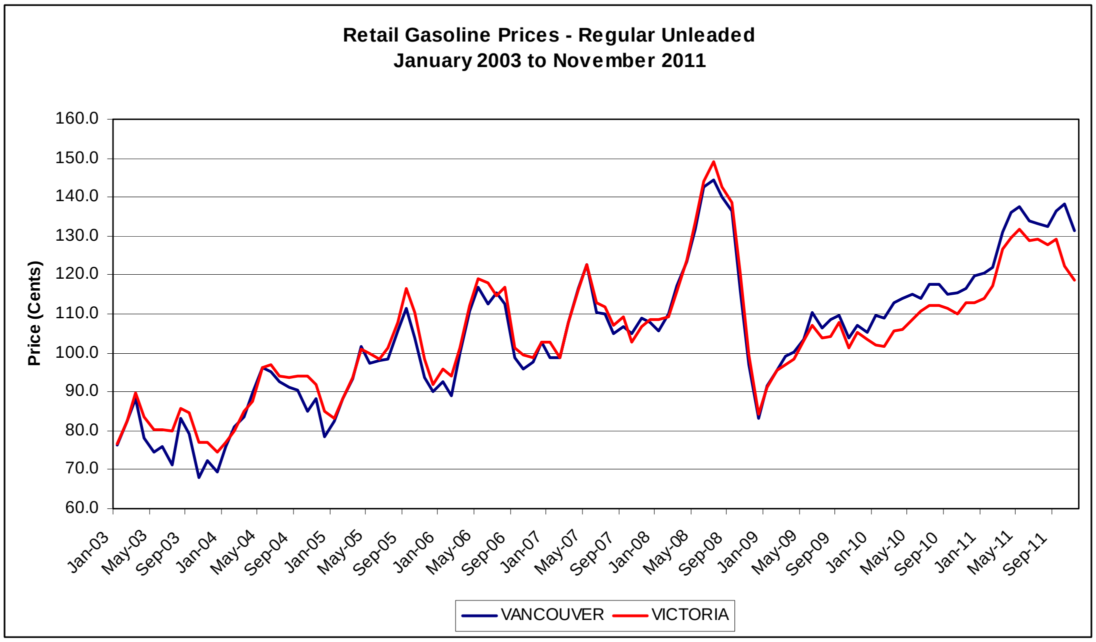
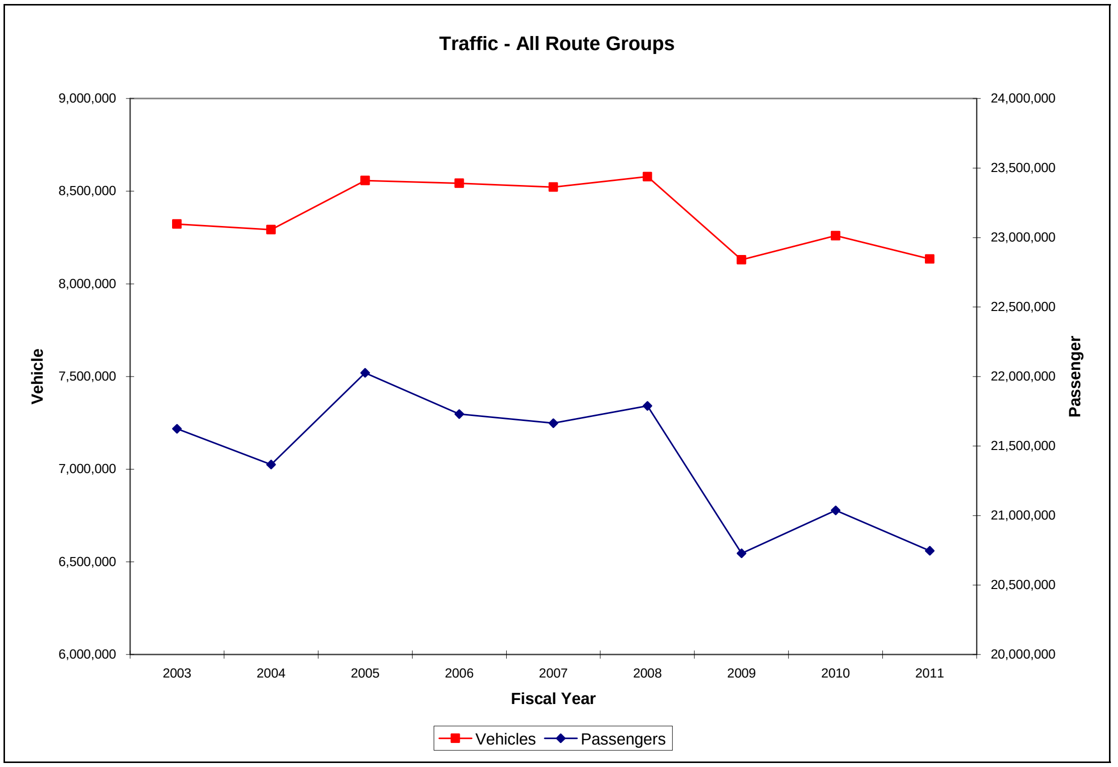


Figure I: Traffic



At the same time that traffic has declined, the Company has experienced significant increases in costs outside its direct control.

This sustained loss in traffic has put considerable pressure on the Company's earnings. Contributing to this pressure is the fact that the amount of the service fees provided by government under the CFSC are an annual fixed amount, subject to the service being provided, which does not vary with traffic on the route and does not increase should BC Ferries suffer a financial deficit on the route. Also, the price caps provide a maximum annual rate of increase in the weighted average fare per unit of traffic in a route group. By tying price increases to a weighted average individual traffic unit fare, tariff revenues contract when traffic declines.

- **Cost Pressures**

At the same time that traffic has declined, the Company has experienced significant increases in costs outside its direct control. Table 1 shows the major categories of operating costs and the associated increases experienced since fiscal year 2004.

– While the Company has been successful in keeping administration costs stable through the period through aggressive cost containment programs, cost pressures outside its control have resulted in an overall increase of 29% in annual operating costs. This includes costs arising from Bill 20, such as those associated with the application of FOIPPA to BC Ferries and the Authority.

- Amortization costs have predictably increased dramatically reflecting the implementation of the planned capital investment program. Major capital investments totalling in the order of $2.0 billion are still needed in vessels, terminals, information technology systems and other infrastructure over the next 10 years.
- Transport Canada has imposed significant changes to regulations which are beyond the control of the Company:
    - Minimum safe manning has added pressure on crew levels, particularly affecting the Minor route group. This has been somewhat mitigated by capital investments in life saving equipment upgrades and through negotiated licence reductions;
    - Port security regulations have added pressure on staff levels at Major and some Northern terminals, as well as requiring significant capital expenditures;
    - New sewage emission regulations require a significant response in capital expenditure and will increase ongoing operating costs.
- While the Company has reduced its fuel consumption by 4.5%, the significant increases in the price of diesel fuel has caused a 156% increase in fuel price since fiscal year 2003. The price of diesel has risen from an average of $0.394/litre when the coastal ferry services model was created to the current year-to-date average cost of $1.011/litre. An increase in fuel prices of this magnitude could not have been anticipated at the time the model was created, and it has had a significant impact on the Company's financial results.
- Labour costs have increased by 28% driven by many factors; including new Transport Canada minimum safe manning and port security regulations, and the outcome of an arbitrated collective agreement.

– Tax policy changes have also had a negative impact on costs. BC Ferries is exempt from the *Income Tax Act*, but is subject to the federal *Excise Tax Act*. It is also subject to provincial taxes.

- o The implementation of the HST replaced PST rules with GST rules. This has driven sales tax costs upwards, particularly in respect to contract services and parts and materials for vessels of more than 500 GRT. While the provincial government is returning to the PST, new rules/rates are uncertain.
- o The provincial carbon tax has added significantly to fuel costs. Also, the competing objective of incenting lower vehicle use may have had a negative effect on ferry ridership.

Cost pressures from the implementation of the new provincial taxes - HST and carbon tax – added $9.1 million in additional annual costs in fiscal year 2011.

Table 1: Major Cost Drivers Affecting Fares ($ millions)

	Fiscal 2004 Actual	Fiscal 2011 Actual
Labour	202	258
Fuel (at procurement price)	50	97
Materials, Supplies, Contracted Services and Other	33	37
Insurance, Property Tax, Utilities and Credit Card Fees	10	21
Maintenance Expenses	84	86
Administration Expenses	32	31
Net Financing and Amortization	68	185

3.2.3 Performance Term Two ("PT2") Price Cap Methodology

In setting the PT2 price caps, the Commissioner employed certain methodologies that BC Ferries submits were contrary to the CFA. These had negative consequences for the financial performance of the Company and were not in the interests of ferry users.

- **Productivity Challenge**

The magnitude of the productivity challenge set by the Commissioner in the PT2 price caps was not reflective of the Company's situation.

The PT2 price caps set by the Commissioner included a productivity challenge of $76 million or about 1% of costs (including the approved return on equity) over the performance term. The magnitude of the challenge was determined without reference to past experience and exceeded significantly, the productivity advancements the Company had been successful in achieving to date.

The establishment of a productivity challenge of this nature was conceptually inconsistent with the methodology used by the Commissioner to establish the price caps. That methodology required detailed information on forward projections of costs and capital requirements. With such information, the establishment of an incremental productivity challenge could only be justified if it was viewed that the detailed cost forecasts were in error. The Commissioner conveyed no such view to BC Ferries. In fact, the Commissioner's independent expert advisors, retained to review BC Ferries' forecasts, found them to be reasonable.

BC Ferries has made significant gains in efficiency and innovation since its transition from a crown corporation in 2003. Unlike other operators in the transport sector, the Company is, however, significantly challenged by regulatory and structural constraints in realizing further gains. These constraints include:

– Rigidity in the core service levels the Company must provide through the CFSC. For example, daily number of round trips and hours of operation, home ports, and vessel capacity are specified in the contract and reflect public policy decisions of government. These contract requirements were based on service schedules which had been in place for many years, and there has been no substantive change in them since 2003. The prescriptive nature of the service requirements prevents the Company from achieving productivity from economies of vessel size or other traffic consolidation or from efficiencies from certain operational practices, such as reducing speed.

– A largely fixed cost base. Labour and benefits, and fuel comprising 58% and 18% of total operating, maintenance and administrative expenses, respectively, of which all of fuel and a substantial portion of labour is driven by the service requirements of the CFSC;
– A restrictive collective agreement with respect to such things as hours of work and job description flexibility;
– Crew levels set by Transport Canada with limited opportunity for reductions through traditional means, such as capital investments;
– New and expanded regulatory requirements, the compliance with which is mandatory and adds significant additional costs – for example, federal government security and sewage treatment regulations, and provincial government FOIPPA; and
– Point of assembly and familiarization clearance restrictions for various vessels.

BC Ferries' productivity is also affected by traffic levels. The traffic losses described above arising from events outside BC Ferries' control, such as the economic downturn, higher fuel costs (paid by ferry users) occasioned by fuel price increases and new taxes such as the carbon tax, have caused overall negative productivity growth in PT2.

The Company's inability to achieve productivity savings in the order of magnitude reflected in the PT2 price caps has resulted in lower earnings for the Company than required to ensure long term financial sustainability.

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- **Constant PT2 Price Cap Increase**

Price cap increases were set by the Commissioner using an approach that led to a back loading of revenues and net earnings for BC Ferries over PT2. (The same approach was used by the Commissioner for setting the preliminary price caps for PT3.) The approach guaranteed that BC Ferries would earn less than required to meet its target return on equity in the first two years with the expectation that, to compensate, BC Ferries would earn more than required in the last two years. The decline in traffic commencing year two of PT2 constrained earnings even further than that projected to be experienced as a result of the Commissioner's rate approach. With the continued downturn in traffic and cost pressures outside the Company's control, the higher earnings expected to be available to compensate the Company for the under earning in the early years, have not materialized in the last two years of the term.

The Commissioner's rate approach has negatively affected the Company's return on equity in PT2. Over the first three years of PT2, the Company has earned a return on equity of 2.9%, 1.1% and 1.2%, respectively (as compared to the target return on equity for those years in the order of 9.0%, 10.0% and 14.3% respectively). In the latter two years, the return on equity was not sufficient to cover the dividend paid to the Province. The expectation for the current year (the final year of PT2) is that the Company will have a negative return on equity. The Company's financial integrity is undermined by its inability to achieve its corporate earnings and return on equity targets. Should it not meet its targets, investors will demand higher returns or choose not to invest in the Company at all. The Company's ability to fund future capital expenditures will be jeopardized by its lower operating cash flow and its constrained ability to raise cost effective financing. The achievement of the return on equity target is an important factor for the continued financial sustainability of the Company.

Furthermore, under normal circumstances, had there not been a profound economic recession in 2008 and 2009, and ensuing declines in traffic, this approach would have meant that price caps would have ended PT2 at higher levels than if alternative approaches had been used. That is to say, ferry users would have to pay higher fares by the end of PT2 than they otherwise would have if an alternative methodology had been used. Effectively, ferry users at the end of the performance term are paying higher fares so those ferry users traveling at the beginning of the performance term can pay less. This outcome is not in the best interests of ferry users.

- **Differential Weighted Average Cost of Capital (“WACC”)**

In setting the PT2 price caps, the Commissioner used a lower WACC for the Northern and Minor route groups than for the Major route group. BC Ferries understands the rationale for adopting the lower WACC for the Northern and Minor route groups was the perception that these route groups face less financial risk than the Major route group because BC Ferries receives contract service fees (including the federal subsidy) for operating these routes. Therefore, it was suggested that the Northern and Minor route groups should pay a lower equity risk premium. BC Ferries' experience to date in PT2 is that the Minor and Northern route groups continue to fail to cover their own costs and this strongly suggests that BC Ferries faces more financial risk in operating the Northern and Minor route groups. These route groups have historically, significantly underachieved financially as opposed to the Major route group which has until recently provided strong earnings. Over the first three years of PT2, BC Ferries reported net earnings of $16.2 million. Over this period, the Major route group contributed net earnings of $29.8 million and Route 3 contributed $2.0 million, while the Northern and Minor route groups incurred net losses of $15.6 million. BC Ferries submits that the lower cost of capital used in setting PT2 price caps for the Northern and Minor route groups was a factor contributing to the erosion in BC Ferries' equity. It resulted in higher fares on the Major routes and, due to price elasticity, contributed to the decline in traffic experienced on those routes.

> The lower cost of capital used in setting PT2 price caps for the Northern and Minor route groups was a factor contributing to the erosion in BC Ferries' equity.

- **Failure to Allow for Full Costs**

In setting the price caps for PT2, not all future costs were accounted for by the Commissioner. For example, costs for compliance with federal security regulations arose subsequent to BC Ferries' filing of its PT2 submission to the Commissioner and while brought to the attention of the Commissioner prior to the finalization of the PT2 price caps, were not included. The

The failure to include all of BC Ferries' costs in the price caps and to set an unrealistic productivity target put the Company in the position at the very outset of the performance term, of not being able to realize its required return on equity.

implication is that effectively BC Ferries is required to cover these costs without any incremental revenue. This is in addition to the aggressive productivity target imposed by the Commissioner discussed above. Taken together, the failure to include all of BC Ferries' costs in the price caps and to set an unrealistic productivity target put the Company in the position at the very outset of the performance term, of not being able to realize its required return on equity.

3.2.4 Status Quo Service Fees

The original CFSC established service fees (Ferry Transportation Fees) at $91.8 million. Consistent with the original financial plan established with government, these base service fees have not changed in nominal terms. This has resulted in a reduction in real terms (i.e. inflation adjusted) of $9.4 million (10.2%). See Table 2.

The original CFSC also tasked BC Ferries with developing a Northern Service Strategy to address the impending need to make substantial capital investments. The result of that work and subsequent negotiations resulted in a special Northern supplemental fee of $34.5 million. These supplemental fees have reduced in both nominal and real terms.

Without any inflationary increase in the amount of the service fees, fares have had to increase by an annual amount which is higher than the rate of inflation.

Without any inflationary increase in the amount of the service fees, fares have had to increase by an annual amount which is higher than the rate of inflation. For example, fares paid by Minor route group ferry users provided 34% of revenues at the beginning of performance term one ("PT1"), and service fees provided 50%. (Of the remainder, the federal/provincial contract provided 13% and ancillary activities 3%.) Currently, fares provide 44% of revenues and service fees provide 42%. The disproportionate increase in revenues from fares reflects the fact that the fares have had to cover the inflationary impact that is not being covered by the service fees. This is referred to as 'gearing up' the price cap. Figures J and K graphically display this effect.

Figure J: Minor Route Group Total Revenue

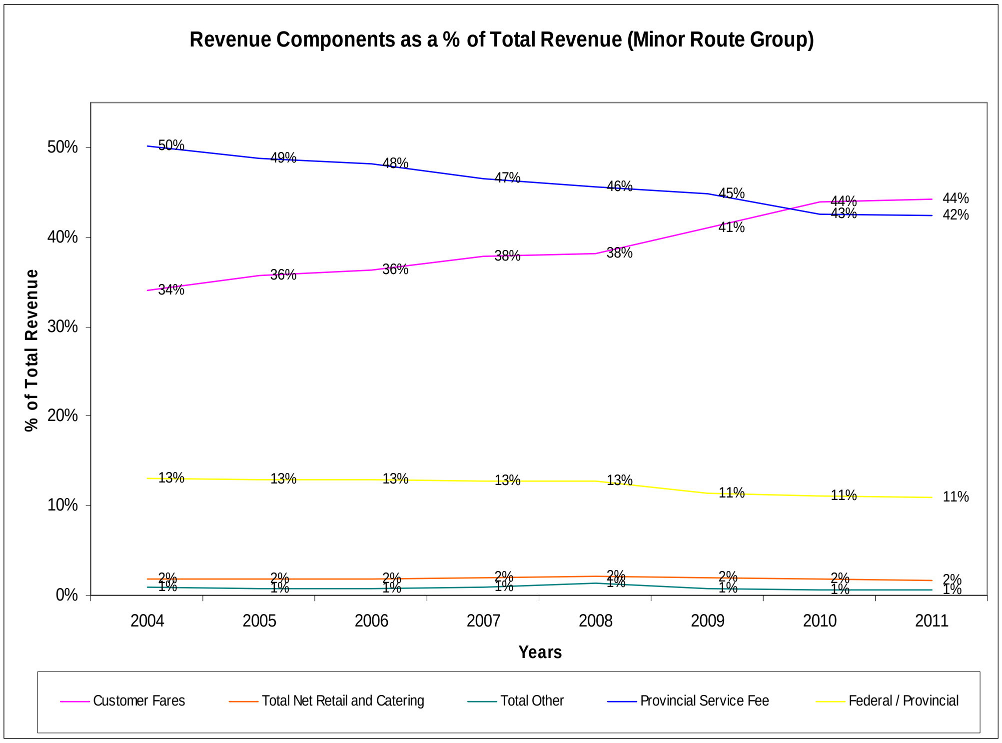
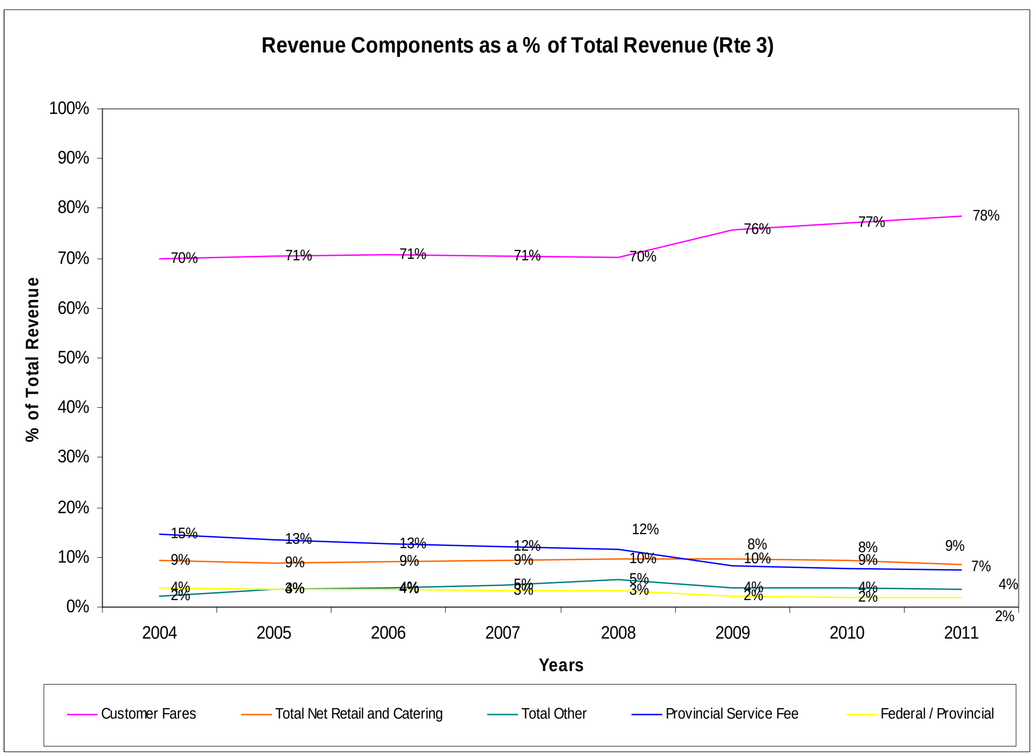


Figure K: Route 3 Total Revenue



If service fees also increase by cost inflation, there would be no need for gearing. For BC Ferries, however, the service fees it receives do not increase with inflation each year. This has meant higher fares for ferry users. In the order of 86% of the cost increases have been covered by fares.

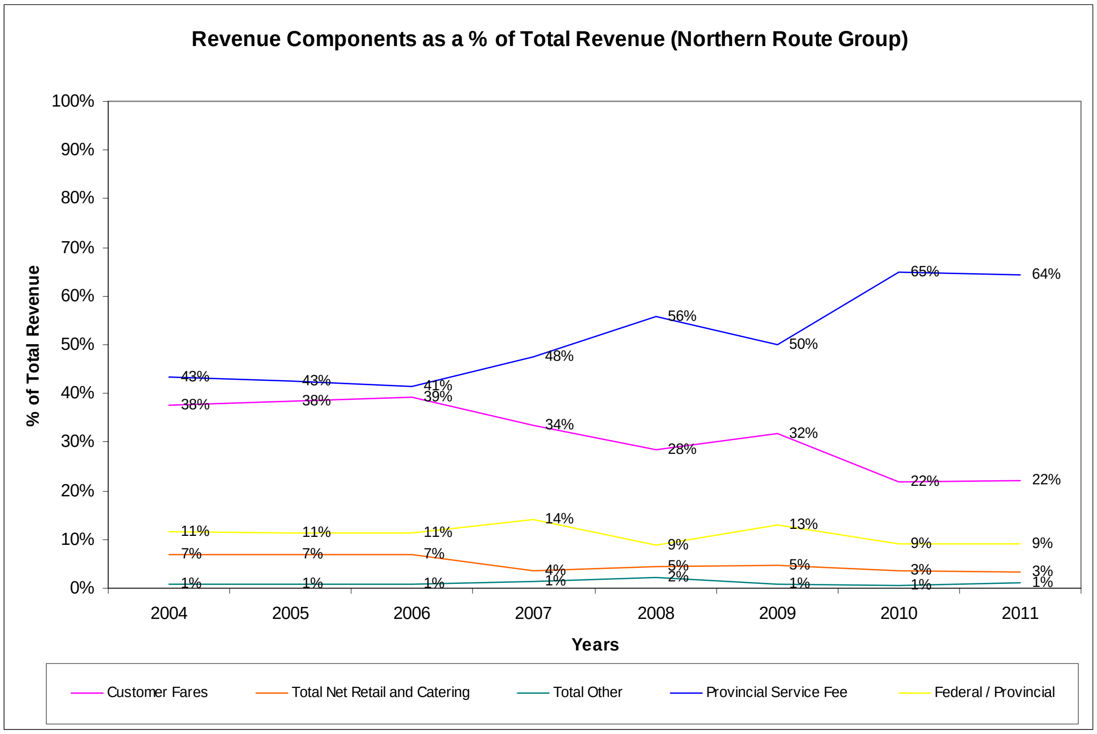
Table 2 shows the impact of inflation on the real (inflation adjusted) value of service fee levels since fiscal year 2004.

Table 2: Provincial Service Fees – Nominal and Real ($ Millions)

($ Millions)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**Total**
Base Fees									
Nominal Base Fees	91.8	91.8	91.8	91.0	91.6	91.7	91.1	91.6	732.4
Real Base Fees (2004 $)	91.8	90.0	88.3	86.0	85.1	83.4	82.8	82.2	689.6
Variance (Real less Nominal)	-	-1.8	-3.6	-5.0	-6.6	-8.3	-8.3	-9.4	-42.9
Northern Fee Adjustment									
Nominal Northern Fee Adjustment	-	-	-	-	12.2	11.5	34.5	33.6	91.9
Real Northern Fee Adjustment (2008 $)	-	-	-	-	12.2	11.3	33.8	32.5	89.8
Variance (Real less Nominal)	-	-	-	-	-	-0.2	-0.7	-1.1	-2.1

There has been a different result for the Northern route group (see Figure L).

Figure L: Northern Route Group Total Revenue



In 2003, when the model was created, it was acknowledged that service fees would increase in order to offset the capital cost of new northern vessels. Because of this incremental service fee paid to offset the capital cost of new northern vessels, the percentage of total revenues paid by users in the North has declined. However, the total cost of the service has increased significantly to cover the amortization and cost of capital of these new additions. Actual fares have increased at the same rate as the Minor route group and Route 3, reflecting the decision of the government to consolidate all fees supported groups.

3.2.5 Summary

In summary, various factors have constrained the financial results of BC Ferries and caused upward pressure on the levels of fares that its customers have and are expected to experience in the successive performance terms. Together, these outcomes have served to generate concerns about the long term sustainability of the model. The Company asserts that the model is effective in that it makes transparent the cost of government policy decisions. It is not correct to assume that because increases in ferry fares have been greater than inflation that the model has not been successful. Rather the higher ferry fares reflect the policy decision of government, as reflected in the CFA, to move to a higher portion of user pay while provincial service fees decrease on an inflation adjusted basis. Under normal world economic conditions and given the extraordinary level of capital investment required to reverse years of under-investment, this policy approach would have led to fare increases higher than inflation. This has been exacerbated by the extraordinary circumstances experienced of late (i.e. a world recession and its impact on traffic, together with significant increases in the cost of fuel). Accordingly, with no increase in service fees or ability to adjust service levels from those prescribed in the CFSC, large increases in fares must be expected for a ferry operator, such as BC Ferries, with a high proportion of fixed operating costs.

In the following section, BC Ferries identifies certain suggestions for the refinement of the regulatory model which offer the potential to help mitigate these outcomes. Fundamentally, however, the Company is of the view that the coastal ferry model, as currently structured, provides the appropriate mechanisms within which the principal issues of financial sustainability and affordability of fares can be effectively addressed, provided that the prescriptive nature of the service requirements in the CFSC are replaced with a longer range forward-looking policy approach that would allow the Company to more appropriately adjust its service offering to respond to customer demand, and the principle of user pay is revisited. The model achieves the primary business objectives, enabling the Company to operate on a commercial basis, leaving policy decisions to the provincial government and making transparent the costs of the service.

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3.3 Regulatory Construct

The Commissioner has issued nine discussion papers on issues regarding the regulatory framework. In this section BC Ferries comments on these and other issues respecting the regulatory framework.

The regulatory model as set out in the CFA is well-founded and does not require a fundamental overhaul.

3.3.1 Overview

In summary, BC Ferries is of the view that the regulatory model as set out in the CFA is well-founded and does not require a fundamental overhaul. Changes are needed, however, in the construct of the required service levels, in order that BC Ferries can realize efficiencies in its operations to help keep fares affordable.

3.3.2 Form of Regulation

Regulation is intervention by administrative agencies through the imposition of rules and actions, which either directly or indirectly affect market outcomes by imposing constraints on the behaviour of market participants. Because BC Ferries was considered to have near-monopoly status in its core vehicle and passenger transportation services, regulation was considered necessary to protect consumers.

There are two primary forms of regulation – intrusive and incentive.

- Intrusive regulation (e.g. rate base rate of return, cost-plus) involves the regulator in all decisions of the firm being regulated, including pre-approval of tariffs of every service offering, all capital investment decisions, service standards etc. This regulatory model is costly to administer and may result in long-term negative impacts including: a lack of incentives for the firm to be become more productive or introduce cost efficiency, rising costs, efforts to seek above normal returns by organized labour and suppliers, a lack of innovation, declining service standards, infrequent but large tariff adjustments, and over-investment in capital.

- Incentive regulation is intended to reduce the role of the regulator to the minimum required to ensure the service objectives (set by government) are met. This model sees the overall average of tariffs being subject to regulation, with the firm being provided the latitude to set individual tariffs. Instead of costly day-to-day regulatory oversight, incentive regulation involves only periodic reviews (e.g. every four years). The firm has the ability to introduce new innovative services without the need for seeking regulatory permission to deviate from the status quo. Incentives exist for the firm to become more efficient, through setting of price caps which require appropriate levels of productivity improvement. This regulatory model is observed to significantly reduce the negative long-term consequences of intrusive forms of regulation.

The regulatory model established in the CFA was a price cap model, envisaged to be "light handed" or incentive regulation. It was envisaged that the regulation would utilize the price cap approach commonly used for monopolies in United States, the United Kingdom, Australia and New Zealand. The approach would allow BC Ferries to automatically raise its weighted average tariff for a route group each year by the Consumer Price Index ("CPI") less an offset for expected productivity improvements. The productivity adjustment could be negative, resulting in an above CPI increase, particularly where a large program of capital renewal is required. The price cap increase formula is referred to as 'CPI minus X', where 'X' represents the percentage change in productivity. Once every four years the regulator would conduct a review of the performance of BC Ferries and establish the value of 'X' for the following four year period. The price cap would be reset every four years if the actual rate of return achieved by the Company was found to have exceeded the cost of capital, even if the Company had stayed within its allowed price caps. In the event of a failure to meet its cost of capital, the Company would have the opportunity to make its case to the Commissioner to have the price caps adjusted upwards.

By using the established price cap formula as the basis for adjusting price caps in PT2 and subsequent performance terms, the amount, extent and cost of the regulatory process was expected to be minimized, while providing appropriate protections for taxpayers and ferry users.

Price caps for PT1 (April 2, 2003 – March 31, 2008) were set out in the CFA. The price cap increases for PT2 (April 1, 2008 – March 31, 2012) were determined by the Commissioner on the basis of a rate-of-return, as opposed to the 'light handed' price cap approach envisaged in the CFA. The Commissioner justified this approach as resetting base rates for BC Ferries' route groups based on an estimate of the revenue that would be required in each year of PT2 to allow BC Ferries to earn a normal rate of return on its capital but not to exceed that target rate of return as determined by the Commissioner. In setting the base rates, the Commissioner considered the following:

- Expected traffic levels and traffic mix in each quarter of PT2;
- Estimated operating costs for each quarter of PT2;
- Amount of existing capital assigned to deliver services for the route group and also required/allowed investment in new capital;
- Financial capital required for each route group, including provisions for allowed new investments;
- Determination of the appropriate rate of return on financial capital for BC Ferries;
- An allowance for ancillary revenues;
- An allowance for productivity improvement;
- The use of replacement cost for purposes of determining the rate of return on assets to be incorporated into the price caps, but ultimately chose to use net book value.

The approach taken by the Commissioner in setting the price caps for PT2 was a hybrid of the 'incentive' and 'intrusive' regulatory models. It added significant cost to the regulatory process and impaired the Company's ability to earn its required return.

The approach taken by the Commissioner in setting the price caps for PT2 was a hybrid of the 'incentive' and 'intrusive' regulatory models. It added significant cost to the regulatory process, including approximately $500,000 for a financial model developed for the sole purpose of meeting the Commissioner's needs for a detailed four year cost forecast at a route group level. Further, by failing to allow for the Company's full costs as projected by this model to be recovered, despite the confirmation of their reasonableness by the Commissioner's independent expert advisors (see part 3.2.3), the Company's ability to earn its required return on equity in PT2 was impaired. This outcome was contrary to the regulatory principle of ensuring the financial sustainability of the operator and not in the interests of ferry users.

Adherence to the light handed price cap model originally envisaged in the CFA best ensures the financial sustainability of the Company and provides the protections taxpayers and ferry users require.

BC Ferries is of the view that adherence to the light handed price cap model originally envisaged in the CFA best ensures the financial sustainability of the Company and provides the protections taxpayers and ferry users require. To be effective, the model must necessarily continue to include provisions allowing BC Ferries to address fuel price volatility through fuel rebate and surcharge mechanisms during the performance term. It must also take into account needed capital expenditures either through the use of replacement cost-based regulation or through an adjustment factor if the net book value approach is used.

3.3.3 Regulatory Principles

The impetus for the establishment of the coastal ferry model, as set out in the CFA, was the recognition that a restructuring of BC Ferries was needed to "*create a strong, sustainable, customer focused transportation provider that can meet the growing needs of coastal communities without further burden on taxpayers.*"[8] With this as its focus, government originally determined six principles that would guide the Commissioner in his regulatory role. These are as follows:

- Priority is to be placed on the financial sustainability of the ferry operators;
- Ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;
- Ferry operators are to be encouraged to seek additional or alternate service providers on designated ferry routes through fair and open competitive processes;
- Ferry operators are to be encouraged to minimize expenses without adversely affecting their safe compliance with core ferry services;
- Cross subsidization from major routes to other designated routes is to be eliminated; and

[8] Restructuring the British Columbia Ferry Corporation Context Paper, Crown Agencies Secretariat, November 19, 2002

- The designated ferry routes are to move towards a greater reliance on a user pay system so as to reduce, over time, the service fee contributions by the government.

Subsequently, through Bill 20, the legislators added a requirement in the CFA that the Commissioner consider the interests of ferry users. The intent of this addition to the CFA is difficult to determine, as the coastal ferry model as set out in the CFA generally, and many of the regulatory principles, in particular, are aimed at ensuring that the interests of ferry users are considered.

- **Financial Sustainability as the Priority**

The objectives of efficiency and reliability of ferry service underlay the first of the regulatory principles set out in the CFA. British Columbia's economy requires an efficient transportation system to ensure the effective movement of people and goods. An integral component of an efficient transportation system in the province is a reliable ferry system. If efficiency and reliability within the transportation system cannot be achieved, the economic costs to moving people and goods and of services will increase, private sector investment will move to more favourable environments and economic opportunities will be lost. A decline in the competitive position of the region would result from a lack of private sector investment. British Columbia's coastal ferry network needs to be efficient and reliable to ensure that the continued strength of the provincial economy and the connectivity of its residents.

British Columbia's coastal ferry network needs to be efficient and reliable to ensure that the continued strength of the provincial economy and the connectivity of its residents.

An efficient and reliable ferry system is in the interests of taxpayers and ferry users. Service reliability requires a ferry system that is financially healthy and sustainable.

BC Ferries is of the view that the CFA cannot 'balance' financial sustainability with the interests of ferry users as this implies that they are at odds with each other. In fact, financial sustainability is likely the foremost regulatory principle directly aligned with the interests of ferry users as surely it cannot be in the interest of any user, no matter how broadly defined, for the system to deteriorate and fail over time. Operator financial sustainability is a primacy, as

Operator financial sustainability is a primacy, as anything less will lead to declining service quality and reliability, and eventual service disruption.

anything less will lead to declining service quality and reliability, and eventual service disruption.

- **Commercial and Cost Minimizing Approach and Alternative Service Delivery**

Principles encouraging the ferry operator to adopt a commercial approach, minimize expenses and pursue ASPs, where it makes business sense to do so, are appropriate.

Principles encouraging the ferry operator to adopt a commercial approach, minimize expenses and pursue ASPs, where it makes business sense to do so, are appropriate. Through their focus on encouraging the ferry operator to deliver service more effectively and efficiently, they help ensure continued access to external financing without guarantee from the taxpayers and help ensure tariffs remain lower than they would otherwise have been. These outcomes are clearly in the interests of taxpayers and ferry users. These principles should be retained. However, with respect to ASPs, BC Ferries submits that the provisions of the CFA which require BC Ferries to seek ASPs are unnecessary and costly, and should be reconsidered (see part 3.3.7).

- **Cross Subsidization and User Pay**

The regulatory principles requiring the elimination of cross subsidization from the Major to other routes and greater reliance on a user pay system are matters of public policy. Both directly affect the level and affordability of fares.

Cross Subsidization

BC Ferries is indifferent to the allowing of cross-subsidization, provided that differing price elasticity between route groups is properly taken into account.

The allowance of cross subsidization would result in users on the Major routes paying higher fares to cover costs that are associated with the provision of service on the Northern and Minor routes. As the ferry operator, BC Ferries is indifferent on this point, with the following caveat: any decision to allow cross subsidization would need to be made with careful consideration to the price elasticity impacts of the resulting higher fares on the Major routes. The Major routes have price elasticity of approximately twice that of the Minor routes and any lost revenue on the Major routes arising from the higher fares occasioned by the allowance of cross subsidization would need to be realized elsewhere (through, for example, higher service fees from the government) in order for BC Ferries to earn its required return.

> It is the principle of user pay, and only this principle, that needs to be balanced against the interests of ferry users.

User Pay

- The move to a user pay system for ferry fares, with less reliance on government funding, necessarily stands in opposition to the principal issue that underlies the stated concerns of many ferry users, namely affordability of fares. It is the principle of user pay, and only this principle, that needs to be balanced against the interests of ferry users. A move to a user pay system for coastal ferries may be in the interests of the broader taxpayers of the province, but is not necessarily in the interests of ferry users. BC Ferries submits that user pay as a regulatory principle should be seriously reconsidered.

As discussed in part 3.2.4, and shown in Table 2, service fees from government have largely remained at the levels set in 2003 (with the exception of the Northern route group where fees increased as originally planned to offset the cost of new vessels brought into service), with no offsetting upward adjustment for inflation or for significant increases in the cost of fuel and other factors outside BC Ferries' control. In the presence of status quo service fees, price caps and, therefore, fares have had to increase more than they otherwise would to ensure BC Ferries has the ability to generate sufficient revenue to cover its cost. A policy decision to stabilize the user pay portion of revenue could lead to higher service fees from the government. Effectively there must be a determination of the appropriate level of taxpayer support for the coastal ferry system. Once that is determined, enabling the fees to increase by inflation will stabilize the portion of taxpayer support and eliminate the gearing effect.

> The inland ferries are fully funded by taxpayers and service is provided free to the users.
>
> The Northern route group is 64% taxpayer supported.
>
> The Minor route group is 42% taxpayer supported.
>
> Route 3 is 7% taxpayer supported.
>
> The Major route group receives no taxpayer support.

The government's current policy of taxpayer support of ferry services varies across the province. There are the inland ferries that are fully funded by taxpayers where the services are provided free to the users; the Northern route group, where 64% is taxpayer supported; the Minor route group that is 42% taxpayer supported; Route 3 that is 7% taxpayer supported; and the Major route group that receives no taxpayer support. Policy decisions which set the appropriate level of taxpayer support for these services may or may not address these differences, but should address inflation escalation in order to eliminate gearing.

3.3.4 Financial Sustainability

- **Definition of Financial Sustainability**

Financial sustainability for BC Ferries can and should be defined as the ability to deliver core ferry services over the long-term. In order for BC Ferries to maintain financial sustainability it must be able to meet its current obligations and provide for the replacement and refurbishment of its capital assets. Price cap determinations, which provide for cost recovery and a return on equity, are key components of financial sustainability.

To be applicable to the coastal ferry system, the definition of financial sustainability provided in Discussion Paper #3 (based on fare increases of no more than inflation) requires the use of replacement cost for asset valuation, plus other adjustments unique to the coastal ferry system.

In the Commissioner's discussion paper #3, a definition of financial sustainability is provided whereby it is suggested that a ferry operation can be sustained by fares adjusted by inflation. While this may provide a high level starting point, it is predicated on the use of replacement cost for asset valuation. In BC Ferries' case there are two other considerations:

– In the case of the tax supported route groups, the service fees are fixed and, therefore, fares must increase sufficiently to cover their own inflation plus that of the service fees;

– The second largest operating cost is fuel, which is commodity priced and does not conform to the consumer price index per se. Accordingly, the current fuel deferral account mechanisms should be retained.

BC Ferries submits that to be consistent with the paramount principle of financial sustainability in the CFA, the level of price caps must be adequate to enable the Company to:

– meet its contractual obligations with current investors (e.g. bond holders) by ensuring that it can meet existing financial covenants;

– earn adequate levels of net earnings as an important source of funding for future needed capital expenditures; and

– increase equity in order to access financing as a second source of funding for future capital expenditure.

The CFA provides for BC Ferries to earn a pre-tax return on equity. This coupled with exemption of BC Ferries from paying income taxes was intended by the legislators to enable BC Ferries to build equity to facilitate financing for its asset renewal program.

Pre-tax Return on Equity

The current provisions of the CFA regarding return on equity are appropriate.

The provision in the CFA for a pre-tax return on equity is appropriate for the following reasons.

– Firstly, it supports financial sustainability by enabling BC Ferries to build equity via retained earnings. BC Ferries is not able to issue more equity shares to raise capital. Instead, the Company must finance all capital through a combination of debt and cash flow from operations. A pre-tax rate of return facilitates net earnings which increases equity via retained earnings. A higher level of equity allows BC Ferries to access cost effective financing via the capital markets. Thus, the approved pre-tax return on equity is an integral part of a capital renewal and replacement plan that provides ferry users with continued safe and reliable service. If the regulatory structure were to shift to after-tax return on equity, the Company's cash flow would be constrained, driving the need for additional debt.

– Secondly, it promotes the cost effective delivery of coastal ferry services. Establishing price caps on the basis of a pre-tax return on equity treats BC Ferries as though it were taxable at prevailing income tax rates. As a consequence, the fares BC Ferries can charge are unaffected by whether the Company is a taxable entity or not. This effectively eliminates any pricing advantage and allows ASPs to compete with BC Ferries. The nature of this competition is to drive efficiencies that are to the benefit of the fare payers. Although BC Ferries is currently income tax exempt, it does not hinder competition as the pricing for BC Ferries and for its competitors are both based on pre-tax return on equity.

Exemption from Income Tax

BC Ferries' exemption from income tax provides a benefit to fare payers as it increases the speed at which the Company builds retained earnings and equity. Even if BC Ferries were to become taxable it would continue to benefit from the high cash flow afforded to it by a pre-tax return on equity because it would not pay taxes for some time due to the pent up capital cost allowance ("CCA") arising from its significant capital program. In addition, the tax exemption for BC Ferries helps to offset the constraint imposed on BC Ferries by its ownership structure. Namely, the shareholder (the Authority) cannot provide any new capital, nor can BC Ferries issue any new shares of equity. Higher earnings and cash flow because of a pre-tax return on equity and no payment of income tax (either due to the exemption or pent up CCA) is to the benefit of fare payers as BC Ferries builds equity and with this finances the replacement of assets. It should be noted that although BC Ferries' fare payers benefit from an exemption to income tax, the Company does pay HST and other excise taxes, PST, and carbon tax.

Any change in the CFA that would have price caps based on a post-tax return on equity would be to the detriment of fare payers. It would constrain the growth of retained earnings and lower cash flow increasing the requirement for financing in order to maintain delivery of the capital plan. Effectively it would slow the Company's ability to access capital markets. This would either lead to a deferral of the renewal and replacement of some assets while still requiring the same level of service which would hinder the Company's ability to continue to provide safe and reliable service, or increase the cost of borrowing which would put upward pressure on fares and/or service fees. It is important to remember that by nature of the business model all earnings are either retained in the Company and invested in needed capital expenditures, or returned to the government in the form of dividends on the preferred shares owned by them.

Run Away Equity

A criticism of the current regulatory model is that it could lead to runaway equity. This could theoretically occur because the CFA defines equity to mean share capital and retained earnings. In order for BC Ferries to achieve its target return on equity it must have positive net earning after dividend payments. This increases retained earnings which increases equity thereby increasing the amount of net earnings required to achieve the target return on equity. In turn, this leads to higher equity. This spiralling increase in equity is referred to as "run away equity". It has yet to materialize for BC Ferries but theoretically it could.

Limitations on debt levels is inappropriate; a 'deemed' equity approach is better.

The potential issue of runaway equity could be easily eliminated by a change in the definition of equity in the CFA such that it becomes "deemed" equity, an amount to be determined by the Commissioner at a level equivalent to that of other regulated businesses with reasonably similar risk characteristics. This change, would lead to fares based on a fixed WACC calculated using the deemed equity/debt weighting. There would be no theoretical requirement to increase fares as the proportion of equity to capital increases in order to ensure that the target return on equity is attainable. "Deemed" equity is commonly used for regulated companies in Canada and the USA and, in 2010, the deemed equity for most Canadian regulated utilities ranged from 35% to 40%. A change in the definition of equity to "deemed" equity would undoubtedly lead to a higher WACC than what was used in the preliminary PT3 price cap decision due to the higher equity portion. This would result in higher fares in the near term, but lower, more stable fares over the long run.

The "deemed" BC Ferries' capital structure ratios for rate-setting purposes, in conjunction with the allowed return on equity and total capital needs to be sufficient to enable a prudently managed BC Ferries to attract new debt capital on reasonable terms under normal financial market conditions without impairing the financial integrity of BC Ferries. That is, that BC Ferries is able to meet its earnings expectations and return on equity targets without breach of financial covenants.

It should be noted that a change in the CFA is not required to unwind runaway equity, if it did occur. Equity could be reduced via alternative methods such as an extraordinary dividend payment to the preferred share holder (the Province).

- **Oversight of Major Capital Expenditures**

The CFA empowers the Commissioner to determine whether new capital assets deployed on a route by BC Ferries are reasonably required and appropriate, or whether the Commissioner views that an excessive (or inadequate) level of capital has been deployed or a level of capital is being deployed which provides a service level which is either too high or too low. To reduce uncertainty for its capital decisions, BC Ferries may apply to the Commissioner for an advanced ruling on proposed capital investments. BC Ferries exercised this option in respect of its acquisition of vessels in PT2. BC Ferries is of the view that these regulatory provisions in respect of pre-approval of major capital expenditures are appropriate.

> The regulatory provisions in respect of pre-approval of major capital expenditures are appropriate.

Bill 20 introduced a new requirement in the CFA for the ferry operator to file with the Commissioner a 10 year capital plan to support the Commissioner's development and determination on price caps for the subsequent performance term. As the CFSC includes service levels for only a single four year performance term, BCFS must develop and submit its 10 year plan in isolation of knowing what service profile the government will require in the next and subsequent terms. In this circumstance, the only option is for BC Ferries to prepare and implement a plan to meet status quo service levels. As the major capital assets (primarily vessels and terminals) have economic lives greatly exceeding 10 years – up to 40 years for vessels – this will restrict the Company in realizing efficiencies arising from any future change in the service profile as determined by the government (and included in the CFSC) to reflect, for example, changes in demographics and traffic levels. A longer planning horizon by government for the service levels to be set out in the CFSC would mitigate this issue and would be in the interests of ferry users.

> A longer planning horizon by government for the service levels to be set out in the CFSC is required.

> The requirement arising from Bill 20 to make public capital plans and budgets before (or in the midst) of tendering such projects is clearly contrary to the regulatory principles of operating in a commercial manner and minimizing expenses.

It is important to note that the 10 year capital plan required to be submitted by BC Ferries to the Commissioner, which must include for every major capital expenditure, the amount, proposed timing, type of proposed capital acquisition or expenditure and the options considered and the rationale for the proposed capital acquisition, must be posted by the Commissioner on his website. Given the conceptual nature of the projects over the medium to long term portions of the plan, it is unlikely that this level of detail will exist with any degree of accuracy. But, more importantly, the requirement that such information be made public before (or in the midst) of tendering such projects is clearly contrary to the regulatory principles of operating in a commercial manner and minimizing expenses. With project budgets available to potential bidders, it can be assured that BC Ferries will realize little benefit in terms of cost savings arising through a tendering process and may actually pay more. BC Ferries believes that it is appropriate for the Company to provide information on its capital plans to the Commissioner as part of his determination of future price caps, but that detailed information on the specific projects in those plans should be held in confidence by the Commissioner, as its release would be harmful to the financial and economic interests of the Company. Ultimately, if the price BC Ferries must pay to undertake capital projects is higher, ferry fares will be higher, all else being equal. This is not in the interests of ferry users.

- **Revaluation of Assets**

> Use of replacement cost may be an appropriate approach for setting future price caps once the major capital investments on a route group have been made.

The CFA indicates that in setting a price cap, the Commissioner must determine, based on current replacement costs, the appropriate value of capital assets deployed within, or in support of, the route group. In the setting of PT2 price caps, replacement cost was considered but not used for purposes of determining the rate of return on assets to be incorporated into the price caps. Use of replacement cost may be an appropriate approach for setting future price caps once the major capital investments on a route group have been made.

Revaluation of capital assets for price cap purposes reflects the need for the firm to earn an adequate return on the actual market value of a capital asset. The use of historical costs in markets where asset values have changed significantly can lead to inefficient use of capital. This motivates the consideration of replacement cost as alternative.

There are other reasons for using replacement values for regulated process. The use of historical costs keeps fares low as long as the existing assets are used. As soon as the assets reach the end of their lives and are replaced, asset prices increase and the corresponding regulated fares increase. This causes several problems:

- The sudden increase in asset values may cause transitional difficulty for users. In contrast, the use of replacement values results in much less volatile changes in fares over the years, making it easier for users to adjust.

- Users may not want to purchase services at the higher fares, or may reduce the amount of service they use. This will not be known until the new asset is deployed and the users are challenged with higher fares. In contrast, with periodic replacement revaluation of assets, users are faced with higher prices earlier, and their response signals to the operator whether they will be willing /able to pay the higher fares needed to replace the assets at the end of their lives. If users signal they are unwilling to pay the higher prices for the existing level of service, then the operator can decide whether to invest in a smaller capacity replacement.

One caveat must be stated regarding users gradually adjusting to higher fares when replacement costs are used. If fares have been based on historical costs, then moving to replacement values of older assets will induce a one-time large increase in fares. This impact is mitigated if the move to replacement values occurs when new capital assets are deployed. With the completion in PT2 of the vessel replacement program for a significant portion of the Major route group, an opportunity to move to replacement value for that route group exists commencing PT3. The move to replacement value for the Northern and Minor route groups could occur in subsequent performance terms once the vessel replacement program for these routes groups is substantially complete.

- **Extraordinary Price Cap Increases**

The CFA provides that during the period between price cap reviews, BC Ferries may apply to the Commissioner for one or more increases above the prevailing price cap. The Commissioner may grant such requests only for extraordinary conditions, including a) the deployment of a new capital asset, such as a vessel, during the period between price cap reviews, b) an extraordinary and uncontrollable increase in the prices of certain non-controllable inputs, such as an unanticipated and dramatic increase in fuel prices, c) an unanticipated and extraordinary change in traffic levels, d) the introduction of new safety or other regulations. Changes in labour costs or terms of employment during the period between price cap reviews (other than by the impact of new regulations) are viewed as controllable and are not eligible for extraordinary adjustments.

The provisions for extraordinary price cap increases are intended to ensure that the Company can continue to earn a satisfactory return in the face of extraordinary and/or unforeseen events outside its control. These provisions are critical in the credit assessments of the Company. A significant change in or the elimination of the extraordinary price cap provisions would result in a change in the Company's credit profile and would negatively affect its financial integrity. Through the likelihood of resulting increases in the costs of borrowing, such action would negatively impact the continued financial sustainability of the Company which is not in the interest of the ferry user.

A significant change in or the elimination of the extraordinary price cap provisions would result in a change in the Company's credit profile and would negatively affect its financial integrity.

3.3.5 Productivity and Efficiency

In setting the price caps, the Commissioner must, among other things, ensure that the Company is afforded sufficient revenue to ensure its continued financial sustainability. In simple terms, BC Ferries generates revenue from three sources: fares; ancillary services such as parking, catering and travel packages; and, service fees paid by the provincial government for the delivery of service on all but the Major routes. The more efficient the service provided by BC Ferries, the lower the revenue the Company requires to be sustainable. The efficiencies that BC Ferries achieves during a performance term help the Company build equity, which is re-invested in vessels, terminals and other initiatives to improve customer service, that benefits ferry users. In the subsequent performance term, those efficiencies are "captured" by either or both of the ferry users through lower price caps, and/or the provincial government through lower service fees.

One way the CFA encourages the ferry operator to pursue efficiencies is by requiring the Commissioner to include a productivity factor in the establishment of the price caps. That factor can be either positive or negative, the latter reflecting the case, for example, where a ferry operator needs to generate sufficient cash flow to undertake previously delayed capital programs. BC Ferries supports the concept of including a productivity factor in the price caps where the level of such a factor reflects the circumstances of the Company. As has been addressed previously in this submission, BC Ferries submits that the productivity challenge set by the Commissioner for PT2 was not achievable given that the methodology followed to set the price caps already took fully into account prospective productivity enhancements (see part 3.2.3). This 'double counting' of prospective productivity enhancements for PT2 has been a significant contributing factor to the Company's lower that forecast earnings in PT2.

To assist the Commissioner in setting the productivity factor for future performance terms, Bill 20 created a new requirement for the Company to submit a plan to the Commissioner in advance of an upcoming performance term identifying how it intends to provide services more efficiently in that term. A plan for performance term four (April 1, 2016 – March 31, 2020) was the first that was statutorily required to be prepared. However, BC Ferries continuously seeks opportunities to pursue efficiencies and, with that as its continued objective, submitted a report - *Opportunities for Enhancing Efficiency in Performance Term Three* - to the Commissioner in October 2010. This plan is posted on the Commissioner's website.

> By far, the greatest opportunities to realize cost reductions and efficiency gains arise from a restructuring of the service levels as set out in the Coastal Ferry Services Contract.

There are three two broad categories of options to consider in regard to enhancing efficiency. The first relates to initiatives that BC Ferries can pursue within the constraints of the status quo or existing CFSC service levels. The second relates to opportunities for cost savings and efficiency gains that can be brought about through modest changes to existing service profile as set out in the CFSC to allow for efficiencies through, for example, elimination of poorly utilized sailings. The third involves a longer term rationalization of the CFSC service levels. By far, the greatest opportunities to realize cost reductions and efficiency gains arise from a restructuring of the service levels as set out in the CFSC. This matter is further discussed in part 3.3.10 of this submission.

BC Ferries supports the Bill 20 concept of putting forward its vision for efficiency and productivity enhancements in the subsequent performance term by way of a report to the Commissioner that is made available for public view. Such a report will presumably be input into the Commissioner's determination of the productivity factor to be included in the price caps for the subsequent performance term. Once those price caps are set, the Company is incented to pursue all viable initiatives to enhance productivity and efficiency, as the benefits realized through such initiatives help build equity which is available for investment in needed capital expenditures. (Ultimately these benefits are captured by the ferry user through lower fares and/or the provincial government through lower service fees.) BC Ferries submits that given this incentive mechanism, it is unnecessary for oversight by the Commissioner of the Company's implementation of its efficiency plan and/or the specific initiatives addressed therein, unless it is to oversee the implementation of a flexible government service policy. Further, it is important that the BC Ferries remain fully responsible for all operational decisions of the Company. Any role for the Commissioner with respect to the implementation of the efficiency plan and/or the individual initiatives contained therein, could potentially conflict with the fulfilment by the Company's directors and officers of their corporate responsibilities.

3.3.6 Ancillary Revenue Maximization

Retained earnings from increased commercial / ancillary revenues are used to offset the costs of providing core services or go towards fleet replacements and other infrastructure improvements. The regulatory model ensures that sustained enhancements in performance from commercial / ancillary activities will ultimately benefit the fare payer through lower price caps and/or the taxpayer through lower service fees. The model should continue to provide opportunities for BC Ferries to pursue such initiatives. It is appropriate that the Commissioner regulate fares as these must be paid by the user. However, ancillary services are optional to the user, and accordingly, need not be regulated as they are self regulated by the marketplace. For these reasons, BC Ferries is opposed to regulation by the Commissioner of ancillary services as that is inherently in conflict with the principle of a commercial approach by the operator. This is not in the interest of the ferry user.

Regulation of ancillary revenues is not required to protect the consumer, and is inherently in conflict with the principle of encouraging the ferry operator to take a commercial approach.

3.3.7 Alternative Service Delivery

The model includes a legislated requirement for BC Ferries to seek ASPs to provide ferry service at a lower cost when so ordered by the Commissioner. Various structural impediments exist to securing successful alternative service delivery initiatives and make it unlikely that any significant cost savings will result from such action. That being said, like any commercial company, BC Ferries has an interest in pursuing all possible avenues for cost savings that do not compromise safety and is motivated to pursue ASPs where it believes savings may be realized without jeopardizing the continued provision of safe, reliable service. With this as its objective, BC Ferries has successfully outsourced a number of business areas, including new retail outlets (Tsawwassen and Departure Bay Quays) and parking. As well, the Company's passenger only route, Gambier Island - Langdale-Keats Island has been successfully delivered by an ASP since 2003. While its efforts to secure costs savings through an ASP on the Mill Bay-Brentwood Bay route and the northern Gulf Islands routes were not successful, the Company did identify potential costs savings through the provision of service by an ASP on its mid-coast route. In that case, however, the government was not in a position to approve the modest changes in the core service level requirements that would have been required by an ASP and it was necessary, therefore, to cancel the initiative. The Company is currently seeking an ASP for cable ferry service on its Denman Island to Buckley Bay route.

It is important to note that competition is not generated through the ASP process. For this reason, there is no conflict in BC Ferries itself conducting the procurement process, including evaluating the proposals received from an ASP. The exercise is one of potentially out-sourcing some or all of a route, the responsibility for which under the CFSC remains with BC Ferries if the service is delivered by the ASP. Accordingly, BC Ferries is of the view that the procurement process for seeking an ASP need not be any different than other procurement processes undertaken by the Company to identify cost savings through sub-contracting arrangements and need not involve external validators and their cost.

> The sections of the CFA dealing with ASPs are unnecessary as it is in the Company's interest, and ultimately that of the fare payers, to pursue safe and reliable ASP opportunities, where it believes it makes sense to do so.

BC Ferries is of the view that the Company is in the best position to determine opportunities for seeking ASPs or other outsourcing ventures and that the regulatory provisions in the CFA are unnecessary and costly. It is in the Company's interest, and ultimately that of the fare payers, to pursue safe and reliable ASP opportunities, where it believes it makes sense to do so as any savings realized are available to the Company to offset the costs of providing core services or to build equity for fleet replacements and other infrastructure improvements.

3.3.8 Regulation of Unfair Competitive Advantage

Bill 20 introduced the requirement for the Commissioner to regulate BC Ferries in respect of any competitive transportation ferry service it may operate. The Commissioner must determine whether in providing a competitive ferry transportation service, BC Ferries has an unfair competitive advantage (because of, for example, having vessels or terminals previously owned by government, being tax exempt or being provided a government subsidy) or is pricing its service below the direct costs and an appropriate portion of indirect costs associated with that service. If the Commissioner finds that either of these exists he must make an Order either requiring BC Ferries to seek an ASP to deliver the service or setting a floor price for the service.

Section 45.1 of the CFA, which deals with unfair competitive advantage, should be reconsidered, as federal protection legislation already exists in this area.

The addition of this new regulatory requirement is inconsistent with the regulatory principles of the CFA and the overall objectives of the coastal ferry services model. Further, as the federal Competition Bureau exists to deal with matters respecting commercial competition, and specifically to address situations where a company prices its services below its costs, these regulatory provisions in the CFA are unnecessary and result in duplication and add costs and complexity to the regulatory process.

- **Drop Trailer Service**

In accordance with the new regulatory provisions of the CFA, the Commissioner reviewed and determined that BC Ferries has an unfair competitive advantage in the provision of drop trailer service on the Major routes and set a floor price for the service. The ruling is currently under appeal by one of BC Ferries' competitors, who is the dominant service provider in the drop trailer market.[9] The process to conclude the regulatory process on drop trailer has been lengthy (over 17 months to date) and has involved a very significant expenditure of time and financial resources by BC Ferries and the Commissioner. It has also created continued uncertainty in the drop trailer market which has had negative consequences for BC Ferries.

The drop trailer service allows BC Ferries to maximize the utilization of existing assets without driving increased vessel capacity requirements. This produces benefits for all ferry users in that it leads to fares for core ferry services being lower than they otherwise would be.

The drop trailer service allows BC Ferries to maximize the utilization of existing assets without driving increased vessel capacity requirements. This produces benefits for all ferry users in that it leads to fares for core ferry services being lower than they otherwise would be. This outcome is not achieved through unfair competition. Rather, efficiency is the source of BC Ferries' competitive advantage. There are two aspects to this efficiency. First, the multimodal business model of BC Ferries (i.e. offering both passenger vehicle and commercial vehicle service) delivers

[9] On December 9, 2011 it was announced that the dominate provider of drop trailer service, Seaspan Ferries Corporation, has acquired Vancouver Island Barge Service. In the absence of BC Ferries, Seaspan would have an unregulated monopoly in this service area.

highly efficient marine transportation service. Second, as indicated above, drop trailer service enhances the efficient use of existing assets.

The drop trailer service is in the interests of core ferry users because drop trailer prices are higher than the cost of providing the drop trailer service, and that positive difference will reduce the prices to users of core ferry services without affecting their access to service. The drop trailer service provides greater capacity in the market for existing drop trailer customers and greater value for the service. The greater BC Ferries' revenues compared to the costs of the drop trailer service, the greater the benefits for the users of core ferry services. As noted earlier, the regulatory principles of the CFA encourage BC Ferries to take a commercial approach to the delivery of ferry service. Therefore, BC Ferries should compete for all markets where the additional cost of providing a service is lower than the existing average costs of providing service.

In summary, BC Ferries submits that the regulatory provisions of the CFA as they relate to unfair competitive advantage are contrary to the regulatory principle of acting in a commercial manner and add unnecessary cost and complexity to the regulatory process. They constrain BC Ferries' ability to pursue efficiencies in a fair manner and ultimately, result in higher fares for the users of core ferry services. The provisions are not in the interests of ferry users and should be eliminated from the CFA. The Competition Bureau, with its mandate and significant powers should remain the principal agency by which concerns of anti-competitive behaviour are investigated and addressed.

3.3.9 Traffic and Demand Forecasting Methodology

Using the Commissioner's revenue cap approach, a forecast of traffic (or demand) is required to set the price caps. Recent econometric efforts by BC Ferries and its independent consultants to forecast traffic has revealed that, at present, meaningful statistical relationships for a forecast model are difficult to ascertain. This may arise because of such factors as the global economic recession, volatile fuel prices, flat traffic growth, among others. In the circumstance where a reliable traffic forecast cannot be developed, other approaches must be considered for addressing traffic in the price cap setting process.

- **PT2 Traffic Forecast**

BCFS provided a traffic forecast for PT2 (and the remaining years of PT1). In hindsight, this forecast was overly optimistic. There were several reasons for the over forecast. First, the forecast was based on previous methodology which linked BC Ferries' traffic to population. Recent analysis indicates that such a population-to-traffic link may no longer exist. Thus, while British Columbia population has continued to grow, BC Ferries traffic has not grown to the degree forecast, likely due to changing demographics of that population. Second, PT2 has experienced the deepest global recession of the postwar (post World War II) period which has contributed to unprecedented declines in traffic in the transportation sector.

In the methodology for setting the PT2 price caps, the traffic forecast played several roles. As described previously, the Commissioner used a revenue cap approach to set the price caps and, in so doing, a total revenue requirement was established based on the forecast of costs (less allowance for ancillary revenues earned in PT1) and an allowance for a return on equity. To derive the price cap, the revenue cap was divided by an index of the forecast traffic. The traffic forecast was also used in the determination of productivity challenge set by the Commissioner for PT2. Analysis of historical productivity data for BC Ferries revealed a relationship between traffic and productivity. The Commissioner considered this historic relationship between traffic and productivity, but ultimately set a productivity challenge for the Company significantly greater than that which the Company had in the past and could in the near term realistically expect to achieve. The effect of the Commissioner including a portion of the increase in the traffic forecast in the determination of the price caps was to set lower price caps from where they otherwise would have been. As this traffic did not materialize, this assumption contributed significantly to the depressed earnings of the Company in PT2. BC Ferries contends that, as a result of these factors, the Company's equity by the end of PT2 will be $225 million lower than anticipated by the Commissioner by his ruling.

- **PT3 Traffic Forecast**

BC Ferries engaged an independent consulting firm to develop a traffic forecast for PT3. This engagement was in response to the Commissioner's requirement in Order 11-02 setting out the preliminary price caps for PT3 for a traffic forecast to be produced by BC Ferries and provided to the Commissioner.

The report is available on the Commissioner's website. The general observations and findings of the consultants were as follows:

> *First, there have been some dramatic changes in the 2003-2011 period in traffic drivers, such as severe global recession and high fuel prices, BCFS traffic was largely flat during this period, with a small net decline. It is difficult to uncover meaningful statistical relationships for a forecast model when traffic is flat, especially when driver variables have considerable variation.*
>
> *Second, our investigation suggests that BCFS traffic may be in the middle of a major transition. In the 1990s there appeared to be stable relationships with key drivers such as population and gasoline prices. Today, however, there are major changes underway. For example, while population may still be a driver of BCFS traffic, demographic changes are also underway. Many residents who had commuted regularly in the past, are reaching retirement age and travelling less frequently and for different purposes. In some areas of the BCFS service territory, there has been an increase in non-resident property ownership, which may also be changing traffic patterns, such as replacing a former commuter with less frequent, leisure oriented travel. Statistically, what our investigation has found is more ambiguous relationships between traditional traffic drivers and actual BCFS traffic, than were found in the past. These findings are consistent with a major change being underway in the demand for BCFS services. This is compounded by the severe effects of past few years of general economic crisis. Despite continuing population growth and*

recovery from the 2008 crisis, BCFS traffic has largely been flat during the PT2 period and declining on some routes or for some periods of time.

Third, the forecast methodology used in this report reveals that there is considerable uncertainty for BCFS future traffic levels. Some forecast methodologies produce a single "base case" or "central" forecast, and create the illusion that future traffic is reasonably certain. This, of course, is an illusion. There is considerable uncertainty in drivers such as GDP, with the possibility that a recession (or two) could occur between now and 2016. Other factors could act upon BCFS traffic. Some are positive, such as unexpected high tourism growth, but others are negative, such the impact of a terrorism event such as 9/11. Our methodology reveals that while BCFS traffic may grow slightly in PT3, there is almost an equal probability that it will not grow or decline. [10]

At this point in time ferry traffic appears to have no trend. In such a circumstance, it is prudent to assume status quo traffic levels in the development of price caps for the subsequent performance term.

In summary, the consultants found that at this point in time ferry traffic appears to have no trend. In such a circumstance, BC Ferries submits that it is prudent to assume status quo traffic levels in the development of price caps for the subsequent performance term. There are several options to address the situation where the actual level of traffic experienced in the upcoming performance term varies significantly from the status quo.

One such option is to have a mechanism that automatically adjusts the price cap for actual changes in traffic during the performance term. In concept, the mechanism could be similar to the way price caps are now adjusted annually in response to changes in the CPI. While such an approach would address the specific issue at hand, it would be contrary to the intent of the price cap model, and may not be necessary.

[10] *Performance Tern 3 Forecast & Measurement of Demand Elasticity for British Columbia Ferry Services Inc.* (InterVISTAS Consulting Inc.)

With fixed service levels, capacity requirements and crew levels, BC Ferries' principal lever to enhance earnings is to grow traffic (and augment ancillary revenue). The intent of a price cap model is to incent the Company to take risk in pursuing initiatives during the performance term that might increase traffic or otherwise drive efficiencies as this will directly benefit ferry users through lower fares in the future and/or enable the government to reduce its ferry service fees. The model does this by allowing the Company to retain the benefits derived from such initiatives for the current performance term and then capturing them for the benefits of the ferry users in subsequent performance terms through price caps being lower than they otherwise would have been. The risk/reward is symmetrical in the circumstance where traffic levels fall. In that case, the Company bears the resulting lower revenues during the performance term, but price caps in subsequent terms must then be increased to ensure the Company remains financially viable. A necessary underpinning of this structure is the existing mechanism in the CFA that allows for the Company to apply to the Commissioner for price caps to be upward adjusted within a performance term if the decline in traffic is unanticipated and extraordinary.

The price cap model, as currently reflected in the CFA, is appropriate in respect of the manner in which changes in traffic levels are addressed.

BC Ferries believes that the price cap model, as currently reflected in the CFA, is appropriate in respect of the manner in which changes in traffic levels are addressed. The Company is of the view that adding specificity in the CFA around the requirement for a traffic forecast and/or the methodology to be used to prepare such a forecast is not necessary and, given the current lack of statistical relationships upon which to base a forecast, may simply add costs for which no meaningful output is achieved.

3.3.10 Long Term Service Policy from Government

As noted previously, government's current service strategy for BC Ferries is defined by the CFSC, which is based on scheduled service in 2002 which in turn is rooted in the 1980s and 1990s. The service levels are highly prescriptive and afford BC Ferries minimal opportunity to respond to declines in or changes to traffic demand in order to realize efficiencies that could help keep fares affordable.

> A forward looking long term service policy from the Province is required. This is essential to the development of a service plan and a long term capital plan, both of which are significant factors in the determination of ferry fares.

- **Capital Planning Challenges**

The CFSC is short-term (four years) with respect to service levels. BC Ferries makes capital decisions without the benefit of knowing government's future service expectations. BC Ferries submits that a more flexible long-term service policy, overseen by the Commissioner, would be appropriate.

- **Service Efficiency**

There are opportunities to improve service efficiency. For example, on most of the routes in the Minor route group, the vessels are appropriately sized based on the commuter demand in the mornings and early evenings. However, at other times of the day, and particularly in the later evening hours, demand is particularly low. On many of these sailings, there are more crew than there are passengers, and in some instances, there are no passengers at all. Figures M and N below are intended to illustrate this point. They are a composite of seven Minor routes with higher round trip frequencies. The two figures illustrate peak (August) and off-peak (February) seasons.

Overall, the vehicle capacity utilization on the Minor routes in total averages 41.7%. If the number of round trip sailings was reduced by 11.0%, focussed primarily on routes with higher trip frequency levels, the overall capacity provided within the route group would be reduced by 9.7%.[11] If all traffic displaced from these sailings moved to other sailings during the day, average utilization would increase to 46.2%. If the reductions were focussed on those times of the day with minimal capacity utilization, then while such a service reduction would have negative implications for some Islanders, clearly the majority would be unaffected most of the time and service efficiency would be improved. There are similar opportunities in all route groups.

[11] The percentage reduction in capacity is less than the percentage reduction in round trips because vessel size on the routes with higher trip frequencies are typically smaller than the average vessel size in the route group overall.

Figure M: Capacity Utilization – Seven Minor Routes (August, 2010)

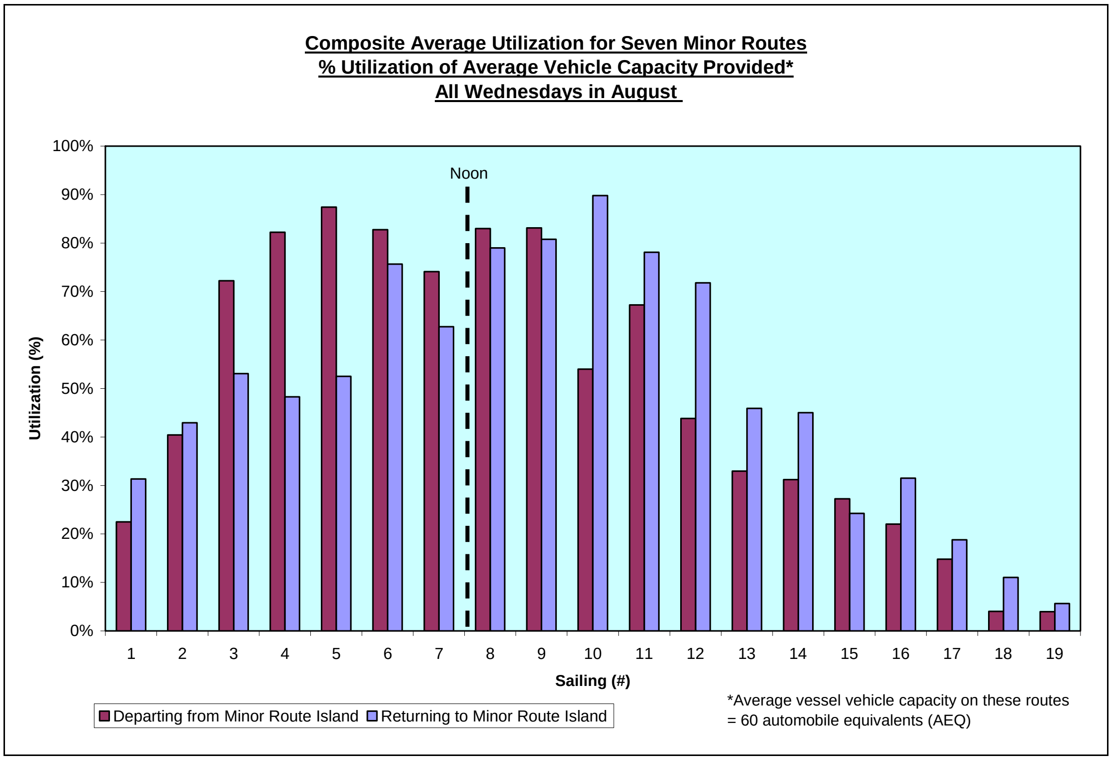
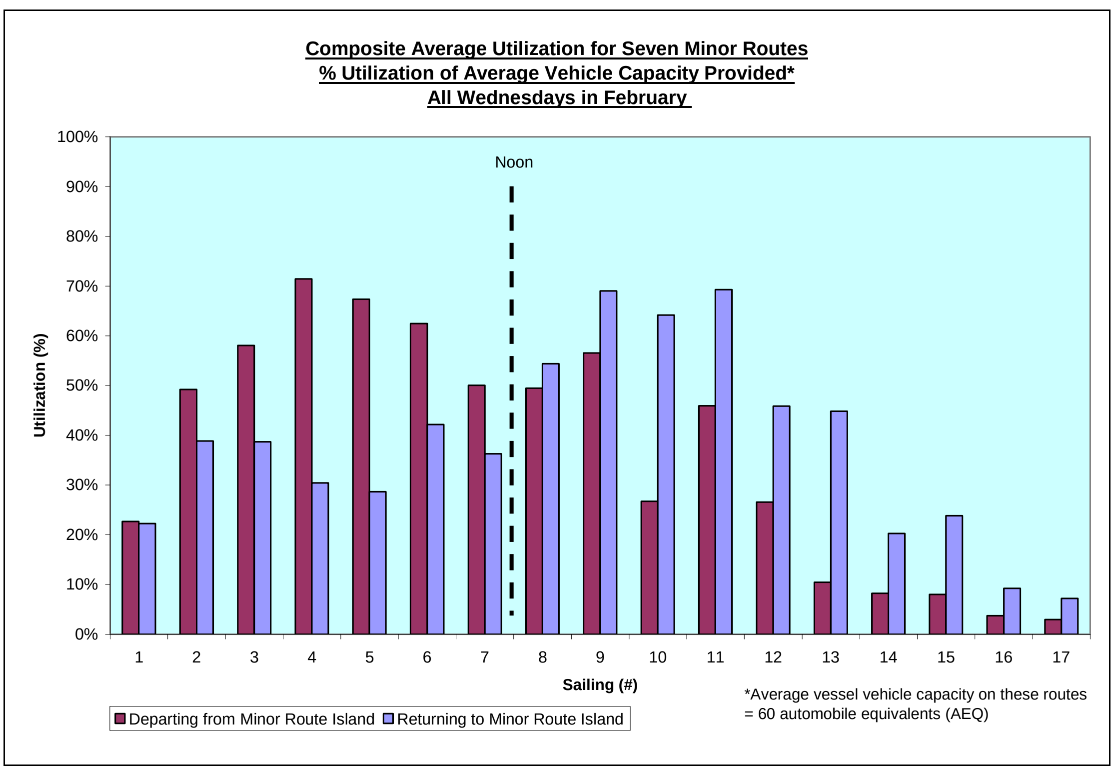


Figure N: Capacity Utilization – Seven Minor Routes (February, 2011)



4.0 CONCLUSION

In summary, BC Ferries' responses to the key issues in the Commissioner's discussion papers are as follows:

- All of the regulatory principles in the CFA, except that of the requirement to move towards user pay, are generally aligned with the interests of ferry users, and the principle of ensuring the financial sustainability of the operator is directly aligned. The financial sustainability of the operator should remain the regulatory priority. BC Ferries submits that user pay as a regulatory principle should be seriously reconsidered.

- To be applicable to the coastal ferry system, the definition of financial sustainability provided in Discussion Paper #3 (based on fare increases of no more than inflation) requires the use of replacement cost for asset valuation, plus other adjustments unique to the coastal ferry system.

- Limitations on debt levels is inappropriate; a 'deemed' equity approach is better.

- The current provisions of the CFA regarding return on equity are appropriate.

- Regulation of ancillary revenues is not required to protect the consumer, and is inherently in conflict with the principle of encouraging the ferry operator to take a commercial approach.

- Improvements to the existing methodology for the establishment of the price caps can be made.

- BC Ferries is indifferent to the allowing of cross-subsidization, provided that differing price elasticity between route groups is properly taken into account.

- The sections of the CFA dealing with ASPs are unnecessary (and costly) as it is in the Company's interest, and ultimately that of the fare payers, to pursue safe and reliable ASP opportunities, where it believes it makes sense to do so.

- A forward looking long term service policy from the Province is required. This is essential to the development of a service plan and a long term capital plan, both of which are significant factors in the determination of ferry fares.

- Section 45.1 of the CFA, which deals with unfair competitive advantage, should be reconsidered, as Federal protection legislation already exists in this area.