Comments on the BC Ferry Commissioner Discussion Papers

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Key Points

The following are the key points we wish to bring to the attention of the Commissioner as he develops his positions as part of the review of the *Coastal Ferry Act*:

- Maintaining financial sustainability and a commercial approach are fundamental to the on-going provision of the ferry system that serves the needs of British Columbia passenger, shippers and the tourism industry. Financial sustainability is of paramount interest to users and should not be removed as the primary regulatory guiding principle.
- Cross-subsidy is undesirable. It will necessarily lead to passengers and shippers paying more on the major routes, reducing volumes on these routes, impeding tourism, and adding to the cost of goods and services for island residents reliant on the ferries. It undermines the economics of both the major routes who will have to pay higher fares and the other routes.
- The inflexibility of the Coastal Ferry Services Contract needs to be revised. Most of the costs faced by BCFS are locked in by this contract (which specifies routes, frequencies, vessel capacity, home porting and other service attributes) and by other government regulation, removing the ability of BCFS to reduce costs.
- With one exception, the existing duties of the regulator are valid and should be continued. The regulator's role in ensuring financial sustainability and the elimination of cross-subsidization, and encouraging a commercial approach and minimization of costs (without compromising safety).
- The one exception is that the roles of the Commissioner also include moving to greater reliance on a user pay. Here, user interest differs from a government policy objective, reducing taxation. We suggest that moving toward user pay be removed from the Commissioner's roles, and instead be included in the overall statement of government policy toward ferry services.
- The Government of BC needs to provide BCFS with a long term plan for the type of ferry services British Columbians will need. A long term plan is needed if BCFS is to meet its mandate to adopt a commercial orientation and to seek long term cost reduction.
- The existing provisions with respect to Alternative Service Providers (ASPs) seems confused and creates conflict. It undermines economies of scale and scope in the provision of ferry services. The current implementation of the policy compels BCFS to seek ASPs but leaves it responsible for any service failure as well as for safety and security. Legislation should not require/compel BCFS to seek ASPs. BCFS can and has used ASPs without legislation when there are good justifications. The current legislative provisions seem to be a solution for which there is no problem.

BC Ferries plays a key role in the economic and social well-being of many BC residents. Its financial sustainability should be a key provincial priority.

1. Introduction

Background

On 28 September 2011, the BC Ferry Commission released the first of nine discussion papers on issues regarding B.C.'s *Coastal Ferry Act.* The Commission indicated it was seeking public comments on the issues raised in the Act. This paper provides our comments on the issues raised in all nine discussion papers.

In reviewing the *Coastal Ferry Act*, the Commissioner has raised a number of important questions for British Columbians to address in shaping the future direction of coastal ferry services in British Columbia and the way that the service provider, BC Ferry Services Inc., is guided and regulated. One of the fundamental questions is in regards to what changes should be made to the principles governing the regulation of ferry services to balance financial sustainability of the operator with the interests of ferry users. This issue is raised in several of the Commissioner's Discussion Papers.

When the *Coastal Ferry Act* was enacted, the number one priority for the Commissioner in regulating ferry operations was the financial sustainability of the operator. The other roles for the Commissioner were generally complementary to the primary role of financial sustainability:

- Encouragement of adoption of a commercial approach;
- Encouragement of minimization of expenses without adversely affecting safety;
- Minimization and subsequent elimination of cross-subsidization;
- Move to greater reliance on a user pay system on designated routes so as to reduce the amount of government subsidization; and
- Encouragement of seeking of additional or alternative service providers on designated routes through fair and open competitive processes.

The Commissioner's priority, financial sustainability, stemmed from a recognition of the role BC Ferries played and the risks to that role that were posed by financial uncertainties which historically had plagued ferry operation and fleet renewal.

In the current review of the *Act*, we believe it is important for the Commissioner, the Government of British Columbia, and ultimately the citizens of British Columbia, to consider the possible outcomes of changes to the Act that could lead to a diminishing of the financial sustainability of the BC Ferry system and inadvertently affect the level and reliability of service which British Columbians receive, and the price they pay for ferry services.

Who we are

The authors of these comments are employed by Inter*VISTAS* Consulting Inc. (IVC), a member of the DHV Group of companies. IVC, headquartered in Vancouver, British

Columbia, is an internationally experienced team of recognized experts in transportation and tourism. IVC assists governments, airports, airlines, ports, transit operators, ferry service providers, tourism organizations, rail carriers, shippers, and other clients with regulatory and economic analysis, strategic services in facility and operational planning, and service marketing.

A more detailed description of our individual background and qualifications is included in Appendix A.

We note that Inter*VISTAS* has been a consultant on ferry pricing, forecasting, planning and regulatory issues at various times to the Province of British Columbia, the BC Ferry Commission, to BC Ferry Services, as well as to other ferry operators. We are currently providing services to BC Ferry Services with respect to its submissions to the BC Ferry Commission regarding establishing the price cap for FY2013 – FY2017. BC Ferries requested that we review the Discussion Papers produced by the Commissioner, and respond to the Commissioner's questions, and we are compensated for this. Nevertheless, our engagement was to express our own views on the issues raised by the Commission. Thus this paper reflects the views of the authors and does not necessarily reflect the views of BC Ferries.

Outline of these comments

Rather than responding to each of the Commission's 9 discussion papers individually, we provide a consolidated perspective on issues related to the review of the *Coastal Ferry Act.*

- First we deal with the key points we believe need guide upcoming policy decisions.
- Second, we address issues related to financing the system.
- Third, we consider the recent decision on the drop-trailer service under the provisions related to unfair competitive advantage.
- Fourth, we address the issue of Alternative Service Providers.
- Finally we discuss the need for a long term service plan from the government to guide planning and investment decisions.

2. Recommended Guiding Principles

Context for our recommendations

BC Ferry Services Inc. (BCFS) plays a critical role in transportation within British Columbia. The connectivity it provides for passengers, tourists and shippers of goods is integral to the economic and social well-being of many British Columbia residents. This critical transportation and supply chain role lies behind the priority objective of the *Coastal Ferry Act* – to ensure the on-going financial sustainability of the services required by users of the system now and in the future. While BC may be able to weather the service disruptions from the failure of an air carrier, a trucking company or a railway, the cessation of ferry services for more than a short period of time is not sustainable to either the provincial economy or the connectivity of its residents.

The guiding principles for the pending policy decisions regarding the *Coastal Ferry Act* thus need to reflect the need for a sustainable ferry service that meets the evolving needs of its users.

In order to ensure the continuation of critical ferry services, the following recommendations are offered to guide the policy decisions that will be made concerning potential amendments to the *Coastal Ferry Act*.

Maintain the financial sustainability of BCFS as the key priority for the Commissioner.

There is strong North American evidence that **a focus on financial sustainability is critical to successful transportation systems**. At a time when U.S. railways were failing, the *Staggers Act* deregulated the railways and adopted financial stability as a primary purpose of rail transportation policy. Since then, the U.S. railways have made significant investment in plant, increased capacity, improved productivity and have passed on that productivity increase through reduced real rail rates, and have become financially sound. In contrast, the *Canada Transportation Act* does not focus on carrier financial sustainability, but rather on competition to achieve the lowest total cost. In Canada, to achieve cost reductions and achieve improved financial viability, the railways discontinued service on thousands of miles of track, forcing shippers to use alternative means of transport (i.e. truck). Rail was not the only mode with adverse impacts due to a lack of legislative focus on financial viability – many Canadian air carriers failed or merged, including major carriers such as CP Air, Wardair and Canadian Airlines International. Air Canada and Jazz also entered

> A legislative focus on financial sustainability of BCFS is key for ferry service in BC, just as it was for the revival of the U.S. railway industry.

bankruptcy protection. These types of market disruptions are endurable in rail, aviation and trucking because there are alternatives, but this is not the case for coastal ferry services in BC.

This suggests that a legislative and regulatory move away from having financial sustainability as the priority could put at risk continuity of ferry service in BC, or lead to a period of declines in service reliability or scope, if there is sub-par financial performance of BCFS. Any decrease in financial sustainability of BC Ferries will inevitably lead to one or more of a number of adverse outcomes:

- an increasing reliance on government subsidization;
- reinstitution of user cross-subsidization, with detrimental impacts on users of major routes who would have to pay higher fares to cross subsidise users of other routes;
- a reduction in spending on core areas such as maintenance;
- an inability to upgrade equipment and facilities;
- reduction or even cancellation of service(s); and
- an inability to replace vessels as they approach the end of their useful life.

All of these outcomes are undesirable from economic, social and environmental perspectives, and could have negative impacts on user safety.

Do not reintroduce cross-subsidy as a means to cover unviable routes.

Reintroduction of cross-subsidy will necessarily raise fares on the major routes for passengers, truckers, and buses. Increased fares on these routes will further reduce traffic volumes. This will require even higher fares among the remaining users, which in turn will reduce volumes even more, setting up a vicious spiral. Reduced ability to travel will have negative economic and social impacts on travellers. Higher shipping costs will raise total logistics costs for BC's coastal communities, which will in turn lead to higher retail prices for goods shipped to communities reliant on ferry services. Finally, higher fares will have an adverse effect on tourism volumes, causing financial hardship to tourism attractions, entertainment sites, hotels, restaurants, gas stations, retail outlets etc.

> Cross-subsidization is bad economics and will lead to traffic declines on the major routes, higher costs for goods moved by ferry and reduced tourism.

Cross-subsidization is simply bad economics. Artificially keeping fares low on one route by raising fares on another route above their economic cost distorts **both** markets. It is economically inefficient, wasting scarce economic resources. We would also suggest that cross-subsidization is bad policy. It puts the interests of one set of users in conflict with those of another. If one group is expected to pay for services delivered to others, should they get a say in the level and scope of those services?

Provide more flexible service specification in the Coastal Ferry Services Contract

The services provided by BCFS are specified in the Coastal Ferry Services Contract, which prescribes routes to be operated, frequency of service, vessel capacity and other service elements. Because the current contract locks in almost every aspect of service, BCFS costs effectively are locked in by the highly detailed prescriptive nature of the contract. Routes that must be operated are specified, as are frequencies, vessel capacity and where vessels must be home ported. The size of vessel to be operated in turn locks in staffing requirements, which are set by federal regulation. No prescribed sailings can be cancelled by BCFS (without previous permission), except for a narrow set of reasons (e.g., due to weather, safety concerns and vessel mechanical issues), and no service rationalization is allowed, even where alternatives exist (e.g. road alternative to the Mill Bay service, or three service points on Salt Spring Island). Service rationalisation is not allowed even when sailings have considerable excess capacity. If fuel prices go up, BCFS simply has to pay them, as it is unable to adapt the schedule to deal with this increased cost. In our view, the Coastal Ferry Services Contract has almost an absurd level of detail and is an impediment to more efficient and cost effective ferry operation.

BCFS costs are effectively locked in by the highly detailed prescriptive nature of the Coastal Ferry Services Contract.
... it effectively removes the ability of BCFS to achieve major cost reductions in order to reduce fares.

The highly prescriptive nature of the Service Contract is part of the problem as it effectively limits the ability of BCFS to lower costs. It effectively removes the ability of BCFS to achieve major cost reductions in order to reduce fares. More flexible service terms would allow BCFS to identify and implement means to reduce costs, improving its viability and helping it to hold the line on fares.

More flexible service terms would allow BCFS to reduce costs, improving its viability and helping it to hold the line on fares.

We have observed that in other jurisdictions, the provision of ferry services often has a more flexible aspect. In Europe, for example, some coastal ferry services are subsidised (as are some services in BC) and minimum service levels are specified, but with some flexibility. For example, a recent specification by the Government of Scotland states:

> *"5.1.3 In setting the outputs required, the Executive has sought to achieve a balance between giving a comprehensive specification of the service required, while also leaving scope for the contractor to use its expertise to provide innovative solutions and responses within the overall requirement."*

The Government provides a specification in terms of a minimum essential level of daily service frequency as well as a broader requirement for total annual or seasonal capacity; but it allows the operator flexibility in terms of actual schedules, which can vary by day of the week or season, the capacity to be operated on specific sailings, etc. The Government provides guidance on the minimum level of service and a higher overall level of service, but with some degree of flexibility as to how the service requirements can best be met day by day. The government is willing to consider solutions which lead to a more cost efficient and effective level of service for passenger and trucking users, and that achieves the most effective use of subsidy from the taxpayer, provided that the core requirements and outputs of the service are supplied.

Do not return ferry services to Government operation

One option that some might advocate, but we do not, is to return BCFS to government operation. Such a change will inevitably bring the political process into the rate setting exercise, as well as capital investment decision-making. This historically has led to operational decisions that, in turn, led to stagnation, financial difficulties, deferred maintenance, and underinvestment in the right type of capacity. Our comments are not based only on the history of ferry services in BC. Elements of these outcomes can be seen in the history of CN Rail and Air Canada when they were Crown Corporations, Canada's ports and airports when they were operated by Transport Canada, and in VIA Rail today.

This is not intended as an indictment of the capabilities of legislators and civil servants, but simply a reflection of the realities of operating, maintaining and renewing the infrastructure of modern transportation services in an environment of financial and service level uncertainty.

Do not move to rate-base rate-of-return regulation

We are aware of no government that has recently set up a new, or revised an existing, regulatory system that has gone in the direction of returning to rate-base rate-of-return regulation. This regulatory system, which originated in the 1930s, is subject to lengthy delays, high regulatory costs, disincentives to carriers to innovate their operations and capital decisions, and ultimately to higher costs for consumers. Instead, governments around the world are moving to more flexible forms of regulation, including options such as trigger

> A move to rate-based rate-of-return regulation would be a step in the wrong direction, and would paradoxically lead to higher fares and an overbuilt system.

regulation, revenue caps and price caps. The current regulatory design for B.C.'s coastal ferry services uses the revenue cap approach (although it is implemented via a price cap, that cap is set on the basis of a cap on BCFS revenues) and it is consistent with regulatory state of the art practice.

There are less costly regulatory approaches that would provide more incentive for innovative service redesign to reduce costs.

Rate-based rate-of-return regulation is costly to implement, both for the regulator and the regulated, and offers no real gain in return. It has historically introduced years of delay in making necessary rate changes. Not only does this lead to lower service levels, it paradoxically creates incentives to overbuild the system in order to inflate the capital base which increases the amount of revenues required and hence the returns. In the case of BCFS, which is currently not recovering its full costs (including an allowed cost of capital), a move to rate-based rate-of-return regulation will result in higher fares than those that currently exist.

We would also like to suggest that regulating BCFS via benchmarking to ferry service providers elsewhere would be bad regulatory design. Such an approach was tried in Ireland in the 1990s for aviation regulation and was quickly abandoned. Each ferry operation has its unique attributes, operating conditions and governance models. Benchmarking methods would fail to fully recognize the unique operating conditions faced by BCFS, the unique demographics of the people it serves, and the unique geography and climate of coastal B.C. B.C.'s coast is not the same as Alaska's, nor is it the same as Puget Sound and other services in Washington State, the Newfoundland to New Brunswick services, services in Scotland, Australia, New Zealand, etc. Benchmarking coastal ferry services would be expensive and in the end may provide little insight.

Consider revisiting the existing implementation of the price cap.

In his first price cap review, the previous Commissioner developed a detailed financial model of BCFS with which to implement and adjust the price cap. This process is expensive for both the Commission and BCFS, which had to make major investments in financial systems only for purposes of regulatory review. It also effectively locks in BCFS to a specific plan and removes some incentives for BCFS to lower costs. As an example, during the 2008/2009 economic recession, BCFS deferred some non-critical and non-safety related training expenditures, expecting to catch up in 2010, only to see the Commission deny some of these costs in its setting of the preliminary third price cap. This removes any future incentive to make temporary adjustments to its costs to deal with traffic fluctuations, and instead creates an old style environment of "spend all your budget every year or you will never get it back". This is bad economics, bad regulation and creates incentives for what could become bad management.

While the *legislative design* of B.C.'s ferry regulation is consistent with regulatory best practices, in setting its first price cap the Commission implemented the price cap via a complicated and rigid financial model. We suggest considering alternative implementation approaches for the existing revenue/price cap regulation model that are less costly and provide more incentive to reduce costs by service redesign and other innovative approaches. One such approach is to change to a price cap based on inflation (retaining the current fuel price adjustment), less a productivity factor, and with an allowance, as needed, for capital expenditures. Such an approach was envisioned in the *Coastal Ferry Act*, but wording of the *Act* guided the Commissioner, incorrectly in our view, to the more constrained type of revenue cap that dis-incents management. The cap would be reset every four years if the actual rate of return achieved by the company is found to have exceeded the cost of capital, even if the company stayed within its allowed price cap. If the company is unable to achieve a rate of return to cover its allowed cost of capital, then it would have the opportunity to apply to the Commissioner to adjust the cap, provided it can make a convincing justification to support such an action.

3. Financing Issues

Because financial sustainability is such a critical element of the long term provision of coastal ferry services in BC, we provide a few additional comments.

Defining financial sustainability

The Commissioner’s consultation papers raised the issue of defining financial sustainability. Financial sustainability is the ability to cover all costs, including the cost of capital. The cost of capital is the return that *the market* requires in order to justify investment.

While the regulator can set a cost of capital for a regulated operator at any level he/she sees fit, the correct measure is what the market requires. If the cost of capital set by the regulator is below the level the market requires, the operator will either be starved for capital, or will have to pay an interest premium to attract the needed capital that the regulated firm cannot recoup through the regulatory process. This situation does not depict financial sustainability. Setting the right level for the cost of capital is a critical aspect of price regulation.

In his third discussion paper, the Commissioner proposed a definition of what constitutes financial sustainability for a regulated firm. We caution that his proposed definition has ambiguity in a number of areas, and that ambiguity could lead to incorrect implementation of price cap regulation. We discuss two of these below.

Defining financial sustainability: the role of replacement cost

A critical issue for regulated firm is how to measure the costs associated with capital assets (e.g., vessels and terminals). If the regulated firm is only allowed to recover the historical costs paid for capital assets, the firm will earn an inadequate amount to allow it to cover the costs of replacing ageing capital assets. Consider a vessel with a forty year life. In its last ten years, accounting depreciation of its historical costs will be a fraction of what would need to be charged to allow BCFS to renew the vessel at the upcoming end of its life. While it may be tempting to confine the price cap to only consider historical costs of aged vessels, it will produce a rate of return which the market will consider inadequate. The consequences will be that a) BCFS will pay higher rates on debt used to finance vessel replacement, and b) users will face a sudden and potentially dramatic increase in fares when the depreciation and financing costs of a new vessel come onto the accounting books. We point out that the *Coastal Ferry Act* provided guidance on this issue, specifically that the Commissioner is to consider replacement cost when setting price caps. It is our opinion that this is good guidance and should remain a part of the price cap guiding principles in the *Act*.

Defining financial sustainability: Gearing of cost inflation

BCFS faces a unique issue in financial sustainability due to what the Commissioner refers to as "gearing". The costs of BCFS increase each year due to inflation, and the price cap is intended to provide BCFS with the ability to recover these costs. However, the revenue it receives comes from two major sources: fares paid by users and payments received from governments. The payments from the provincial government under the Coastal Ferry Services Contract are set each performance term for a fixed amount per year and these amounts are not indexed for inflation. This means that the price cap must make allowance for fares to cover cost inflation not only on the portion of BCFS revenues from fares, but also on the portion due to the fixed nature of the provincial payments under the Contract. The Commissioner refers to this as gearing the fare price cap. This unique nature of BCFS financial sustainability needs to be kept in mind when considering what constitutes financial sustainability of BCFS.

Consequences of a lack of financial sustainability

If financial sustainability is not achieved, there are several serious consequences to BCFS, and hence to the scope and reliability of BC's coastal ferry services. These include:

- A higher debt cost, limits to the amount of debt the company can carry and/or more onerous conditions by bond issuers on financial metrics (e.g. quick ratio) that have to be met or the quality of the debt is degraded. This raises BCFS costs and ultimately raises fares;

- The need for a government guarantee of BCFS debt, which extends financial risk to government, and which results as BCFS debt appearing as Provincial government debt;

- The need for government debt to finance BCFS, which increases the provincial debt load;

> Without financial sustainability, there are many negative impacts on BCFS, its users, and the provincial government.

- The need for government subsidy, which adds to the budget pressures government faces and places ferry services in competition for funding with other priorities such as health and education;

- The need for cross-subsidization from one set of ferry routes to other ferry routes. This necessarily raises the rates on major routes which in turn has negative implications for passengers, shippers and tourism;

- The deferral of maintenance, with potential negative implications for service reliability and possibly for safety;

- The deferral of training, with negative implications for service;

- The deferral of vessel upgrades and/or replacement, with negative implications for service; and

- An overall decrease in service and performance as cost cutting increases, with negative implications for connectivity of people and goods and the quality of life in communities reliant on ferry services. Cost cutting that increases efficiency is desirable. Cost cutting that results in deferral of maintenance, training and needed investment is detrimental to the ferry services received by British Columbians.

Cost cutting that results in deferral of maintenance, training and needed investment is detrimental to the ferry services received by British Columbians.

BCFS invests in long-lived assets and needs long life funds. Inadequate revenues to support this financing will have negative consequences for British Columbia.

Balancing user interest and financial sustainability

The Discussion Paper raises the issue of whether financial sustainability of the operator is an interest of the users. We are strongly of the view that it is the primary interest of users to have a sustainable operation that can continue on an on-going basis. This is not a moot point. Historically, ferry operators have failed in B.C., and elsewhere in the world we continue to observe financial failures of ferry operations. BCFS plays a key role in the BC transportation and logistics networks and in the social connectivity of our province. It is in the best interests of all users for this role to be financially sustainable for the long term. If it is not sustainable, service levels and reliability would first fail and ultimate the company could fail, at which point all other user interests become moot. Thus one cannot speak of "financial sustainability" and "user interests" as being mutually exclusive and requiring one to be balanced against the other: without the achievement of financial sustainability, all other interests cannot be met.

Balancing user interest and user pay

The roles of the Commissioner also include moving to greater reliance on a user pay system on designated routes so as to reduce the amount of government subsidization. This is one area where user interest differs from a government policy objective. Users obviously have an interest in lower prices for the services they use, but taxpayers have an interest in reducing the taxes they must pay. We would suggest that a move toward greater user pay is not a role for the Commissioner, but rather a role that should be addressed by the government. The mechanism for doing so is the amount of subsidy paid to BCFS in the four year Coast Ferry Services Contract. We suggest that the user pay objective be removed from the roles of the Commissioner, and instead be included in the overall statement of government policy toward coastal ferry services.

4. Does BCFS Have an Unfair Competitive Advantage?

In a recent change to the *Coast Ferry Act*, the Government of British Columbia decided to empower the Commissioner to determine whether BCFS was pricing its drop-trailer service fairly (covering direct costs and an appropriate share of indirect costs) or whether it was benefiting from an unfair advantage. In doing so, we believe the government moved in the wrong direction.

The existing federal *Competition Act* has provisions to deal with abuse of dominant position, such as was the concern regarding drop trailer services. The Competition Bureau has resources and expertise such that these kinds of abuses can be constrained. However, in introducing provincial law in this area, the Government of British Columbia effectively removed federal *Competition Act* jurisdiction over the matter. This is because investigations of alleged abuse of dominance generally begin with a determination as to whether conduct is elsewhere regulated. If it is, the Commissioner is unlikely to investigate pricing abuse of dominance.

> The decision to have the Commissioner examine potential abuse of market power when federal regulatory processes already exist to deal with this adds a layer of regulation, redundancy, cost and complication.

In our view, this adds a needless layer of regulation, adds redundancy and adds cost and complexity to the regulatory process. It even muddies the waters regarding prevention of abuse of market dominance with potentially clashing federal and provincial jurisdiction.

Aside from this, there are other important aspects. First, in our view, the entry of BCFS into the drop trailer services market was adding competition to a market that was dominated by, at best, very few other firms. The regulatory provisions on BCFS prices needlessly constrain its ability to compete, to the detriment of shippers (including shippers who export BC products) and consumers on the islands served by BCFS. We note that a BCFS price that is lower than that of the competitor(s) could readily stem from the economies of scale and scope enjoyed by BCFS, rather than reflecting a form of unfair pricing. The new provisions in the *Coastal Ferry Act* do not provide guidance to the Commissioner regarding pricing in the presence of economies of scale, or what economists call economies of scope (whereby it is cheaper to provide one service if the carrier is utilising infrastructure that provides other services). If BCFS were to set prices below its costs, the *Competition Act* can and should be used, rather than create another layer of regulation at the provincial level.

Second, constraining the ability of BCFS to compete in the drop trailer market, by forcing it to charge higher prices on drop trailer services, results in higher fares to passengers. The price cap regulation to which BCFS is subject means that incremental revenues from drop trailer services would *necessarily* lower fares paid by passengers. By limiting BCFS' ability to compete, by forcing higher drop trailer fares, the opportunity to grow incremental revenues from this market is to the detriment of passengers

> Constraining the ability of BCFS to compete in the drop-trailer market prevents a decrease in passenger fares.

Third, the *Act* guides BCFS to adopt a commercial approach and instructs the Commissioner to regulate the company with this objective as a guiding principle. An innovative decision to enter the drop trailer market, thereby offsetting passenger fares, seems to be precisely the type of commercial approach intended by the *Act*. The new provisions in the *Act* are in conflict with the objective of a commercial orientation for BCFS and in conflict with application of the *Competition Act*. Developing an additional source of revenue, such as revenues from drop trailer services, can also reduce BCFS reliance on government subsidization.

5. Alternative Service Providers

The *Coast Ferry Act* requires that BCFS seek alternative service providers (ASP) when ordered to do so by the Commissioner, and specifies powers for the Commissioner to monitor this process. Yet the Coastal Ferry Services Contract places responsibility for fulfilling the service requirements of the contract on BCFS, even when an ASP is engaged, as well as responsibility for adherence to the price cap. (ASP routes will necessarily be part of one of the route groups to which a price is enforced.)

In our view, this is a confused policy and creates a serious corporate responsibility dilemma for BCFS. If BCFS engages an ASP, and if the provider fails, BCFS is held responsible. Its responsibilities are not trivial, as in addition to the provision of required ferry services to British Columbians, BCFS bears major responsibilities for safety and security. Utilising an ASP is a high risk proposition for BCFS.

> In our view, the ASP provisions are a confused policy ... To the extent that there are economies of scale or scope in the provision of ferry services, the requirement to actively seek ASPs seems uneconomic and creates the potential for higher cost.

The current legislation is unclear as to why BCFS must actively seek ASPs and why it faces potential penalties imposed by the Commission if it fails. To the extent that there are economies of scale or scope in the provision of ferry services, the requirement to actively seek ASPs seems uneconomic and creates the potential for higher cost. Of course, there can be some routes which require a specialised vessel and which could be operated separate from the rest of the ferry system where an ASP may be a sensible choice. However, even before passage of the Coastal Ferry Act, BCFS was able to do so, and did/does, engage ASPs. Legislation was not required to enable use of ASPs.

Given a) the enormous responsibilities BCFS continues to bear for safety and security for ASP operations, b) the ultimate responsibility BCFS has for the provision of service on ASP routes, c) the economies of scale and scope in the provision of services on many routes and route groups, and d) the unknown nature of service requirements beyond the four years of the Coast Ferry Services Contract, it is difficult to understand why BCFS faces a *legislative requirement, enforced by the Commissioner,* to actively seek alternative providers for services it is ultimately responsible. Acting rationally in fulfilling its corporate, service and safety/security responsibilities, BCFS should only engage an ASP when there is a very strong commercial justification to do so.

In our view:

- Legislation is not needed to enable BCFS to engage an ASP. Before the passage of the *Act*, it could and did engage ASPs where there were strong reasons to do so.

- Legislation is also not needed to require/compel BCFS to seek ASPs.

- If the Government is truly of the view that BCFS must be compelled to seek ASPs, it needs to clearly provide in the legislation a policy statement that gives the rationale for this. To the extent that there are economies of scale or scope in the provision of ferry services, the requirement to actively seek ASPs seems uneconomic and creates the potential for higher cost. The reasons for such an onerous requirement, guiding principles for what circumstances compel this need and guidance to the Commissioner for assessment any BCFS decision to not engage an ASP, are needed.

Legislation is not needed to require/compel BCFS to seek ASPs.

No clear justification for such a requirement has been provided.

We also question why BCFS is to retain responsibility for all service, safety and security responsibility for the performance of the ASPs. It would seem more appropriate for the ASP to be directly contracted with the Government and to be monitored by the Commission, rather than impose a confusing indirect relationship through BCFS. This prospect is envisioned in the Act through its specification that there can be more than one ferry operator with a Coastal Ferry Services Contract with the government.

6. The Need for a Long Term Service Plan *from the Government*

A key gap of the current coastal ferry services policy is that the Coastal Ferry Services Contract is only a short to medium term contract (four years), and there is no long-term plan or guidance provided *by the government* to BCFS.

The provision of coastal ferry services in B.C. is defined by the Coastal Ferry Services Contract, which specifies which routes are to be operated, along with frequencies, vessel capacity, home port and other service aspects. It is the government, and not BCFS who determines the minimum required level of service on routes.

The contract, however, only specifies services for a four year period. There is no long term vision or plan by the government as to which routes will be operated in the long term, nor what service levels on those routes will be.

BCFS, however, must engage in long term planning, especially with regard to its capital requirements. Ferry vessels are long lived assets, with lifetimes of 40 years or more. BCFS has a legislative requirement to have (and keep to date) a ten year capital plan. However, because it has no long term service plan from the government, it must develop this capital plan and undertake corporate strategic planning in a policy vacuum.

In effect, BCFS is left with no guidance beyond the four-year service requirements in the CFSC as to what level of service it will have to provide in the medium to long term. The level of service on routes is dictated by government and is not a choice matter for BCFS. The issue for BCFS when it does its ten year capital plan is whether it should extrapolate the current four-year service plan out to 40 years, the approximate life of its vessels? Extrapolating anything out that far into the future seems a suboptimal exercise for any endeavour. The Commissioner's Discussion Paper #3 recognizes this need when it links financial sustainability to the ability to deliver and maintain service and infrastructure according to a long-term plan.

In the case of BCFS, it may be that British Columbians could be better served by utilisation of vessels of different capacities than are presently in the fleet, and possibly with different frequencies of service. As well, should BCFS have greater flexibility for the timing of its services during the day and week? Greater service flexibility could lead to different capital decisions.

> The lack of a long-term service plan by government is a significant problem. … BCFS is forced to make long-run capital decisions without knowing what future government service expectations will be.

The short term nature of the CFSC, in the absence of any well thought out long term guidance from government, leaves BCFS guessing, and given the lack of long term service level guidance from government it may be locking in existing, potentially suboptimal service levels as well as high service costs due to the short term and highly specified (i.e., inflexible) service plan.

As well, there are long term changes in island demographics and economic activity, and these may mean that in the longer term different service levels and patterns are appropriate. BCFS capital decisions should be guided, in part, by a longer term service plan from government that considers evolution of the coastal economy, demographics, as well as the fundamental trade-offs of ferry economics.

Some may be of the view that the requirement that the company have a 10 year capital plan is *all* that is needed, but this is a mistaken perspective. The capital plan is produced by the company, showing how it will meet its service obligations. But at present it must guess at what service obligations the government will require of it beyond the immediate term of the contract. This approach lacks vision for how the long term needs of British Columbians will be met.

> Merely renewing the same service levels from one four year Coastal Ferry Services Contract to another lacks vision and may be locking in higher costs.

In our view, the lack of this longer term vision or plan from government is a critical shortcoming in the regulatory model. BCFS needs to make fleet decisions that will have extremely long-term (around 40 years) consequences for the type and cost/price of ferry services British Columbians enjoy

We suggest that government should provide a longer term service vision, developed with input from BCFS and with consultation from stakeholders, which becomes a formal part of the CFSC process. This will provide BCFS with better guidance on how and when it should invest in capital assets as well as other operational aspects such as training programs.

We make one additional observation. The 10 year capital plan that the legislation currently requires must provide specific dollar amounts for capital investments. While an overall capital budget is a sensible approach, too much specificity in capital budget estimates removes bargaining power from the company when it goes to market for bids. It is not in the interest of ferry users that BCFS's bargaining power with its suppliers is constrained by too much specificity.

Appendix A: Our Qualifications

Dr. Michael W. Tretheway

Dr. Michael W. Tretheway is a resident of Richmond, British Columbia, Canada. He is employed by Inter*VISTAS* Consulting Inc. (IVC), a member of the DHV Group of companies. IVC, headquartered in Vancouver, British Columbia, is an internationally experienced team of recognized experts in transportation and tourism. IVC assists governments, airports, airlines, ports, transit operators, ferry service providers, tourism organizations, rail carriers, shippers, and other clients with regulatory and economic analysis, strategic services in planning, and marketing.

Dr. Tretheway is President of Inter*VISTAS* Consulting Inc. (the Canadian division of the Group) and is the Chief Economist for the Inter*VISTAS* group of companies. He holds a Ph.D. in Economics from the University of Wisconsin.

From 1983-1996 he was an Associate Professor in the Faculty of Commerce and Business Administration, University of British Columbia and continued as an Adjunct Professor from 1997 to 2011 when he co-founded InterVISTAS. He has taught courses in transportation economics, managerial economics, business statistics, air transportation management, urban transportation management, project evaluation, the role of transportation in the economy, government and business, and business logistics. He is the author of over 40 scholarly papers and his research has been published in journals such as *The Rand Journal of Economics, The Review of Economics and Statistics, The Logistics and Transportation Review, Transportation, Transportation Research, The Journal of Transport Economics and Policy, The Journal of Air Transport Management, Annals of Aviation and Space Law,* and the *Transportation Practitioner's Journal.* He is the author of several books on transportation.

Dr. Tretheway has served as an advisor or consultant to government agencies, including:

- The BC Ferry Commission
- The Competition Bureau (Canada)
- The New Zealand Commerce Commission
- The Canadian Transportation Agency
- Transport Canada
- The Minister of Transport (Canada)
- The Canada Transportation Act Review Panel
- The Australian Bureau of Transport and Communication Economics.

He has also served as an advisor or consultant to various service providers, including BC Ferries, various ports, terminal operations, airports, airlines, rail carriers, tourism organizations and others.

Dr. Tretheway was retained by the BC Ferry Commissioner in 2003 to provide consulting services related to the development of the price cap monitoring requirement employed by the Commissioner. Since then, he has been engaged by BCFS to assist in the price cap reviews.

Mr. Robert J. Andriulaitis

Mr. Robert J. Andriulaitis is a resident of Burnaby, British Columbia, Canada. He is employed by Inter*VISTAS* Consulting Inc. Mr. Andriulaitis is currently Vice President, Logistics and Transportation Studies. He holds a B. Commerce (Hons.) degree from Queen's University and a M.Sc. in Business Administration (Transportation and Logistics) from the University of British Columbia.

Between 1992 and 2000 he was a Senior Policy Advisor for the Governments of Alberta and of Manitoba, where he was responsible for providing advice to the Minister and senior officials on transportation policy issues.

Mr. Andriulaitis has served as an advisor or consultant to government agencies, including:

- Transport Canada
- Indian and Northern Affairs Canada
- Manitoba Highways and Transportation
- Alberta Transportation and Utilities
- Alberta Economic Development and Trade
- The Provincial/Territorial Tourism Ministers Working Group on Air Access.

He has also served as an advisor or consultant to various service providers, including various port terminal operators, airports, airlines, rail carriers, tourism organizations and others.