BC Ferry Commission
MEMORANDUM 45

To: Mr. Rob Clarke
Executive Vice President and
Chief Financial Officer
British Columbia Ferry Services Inc.

From: Gord Macatee
British Columbia Ferries Commissioner

Date: March 20, 2014

Re: Management of Regulatory Account Balances-Policy Proposal

This Memorandum 45 responds to your attached letter of December 4, 2013 proposing a policy respecting the management by British Columbia Ferry Services Inc. ("BC Ferries") of its regulatory account balances.

In your letter you have outlined a number of factors which together may result in a situation whereby BC Ferries may have to announce a fuel surcharge and a fare discount promotion in approximately the same time frame which may cause confusion among your customers. To mitigate this confusion BC Ferries proposes that it be granted the authority, on an ongoing basis and at its discretion, to make transfers from time to time of revenue earned in excess of the price cap to a fuel deferral account.

In considering this matter we posted your letter on the Commission's website on January 6, 2014 and invited public comments by January 27, 2014. We received a submission providing comments from the Ferry Advisory Committee Chairs ("FACC") also attached hereto.

After considering the comments from the FACC we have concluded that such a policy may have a negative consequence of disturbing the easily understood and effective mechanism for addressing fuel price volatility. The policy may also have a negative impact on the transparency of the price cap compliance process whereby incidences of average fares exceeding the price caps are identified and remedied within the timeframe established by the commissioner.

Accordingly, we are not prepared to grant BC Ferries the authority, on an ongoing basis and at its discretion, to make transfers from time to time of revenue earned in excess of the price cap to a fuel deferral account. However, because of the extenuating circumstances which existed in fiscal 2014, BC Ferries is granted the authority to transfer the amount of revenue earned in fiscal 2014 in excess of the price cap to a fuel deferral account.

Yours truly,

Gord Macatee
BC Ferries Commissioner

BCFerries

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December 4, 2013

Mr. Gord Macatee
British Columbia Ferries Commissioner
BC Ferry Commission
RPO Hillside P.O. Box 35119
Victoria, BC V8T 5G2

Dear Mr. Macatee:

Re: Management of Regulatory Account Balances – Policy Proposal

We write to propose a policy respecting the management by British Columbia Ferry Services Inc. ("BC Ferries" or the "Company") of its regulatory account balances.

Notwithstanding the recent easing of retail gasoline prices at the pump, diesel prices have not abated in the same fashion. During the current fiscal year through to October 31, 2013, BC Ferries' cost of procurement has averaged approximately $1.05 per litre, and this week prices range from a low of $1.0822 at Horseshoe Bay to a high of $1.1503 for Route 18 (Powell River to Texada). As the British Columbia Ferry Commission (the "Commission") is aware, the fiscal 2014 fuel set price used to establish the Performance Term 3 price caps is $0.952 per litre. As a result of these circumstances, the debit balance in the fuel deferral accounts is growing.

Based on the terms of Commission Order 12-03 and in consideration of the above, it is likely that BC Ferries will soon be in a position whereby it is required to implement a fuel surcharge. At the same time, the Company is in an overage position with respect to the approved price cap set by Commission Order 12-02, and will need to offer a fare reduction promotion in order to bring the average of its tariffs charged within the price cap.

BC Ferries believes that implementing both a fuel surcharge and a fare promotion at the same time will cause confusion among its customers, including uncertainty on their part of the all-in fare to be paid, which could have a negative impact on traffic.

The circumstance currently facing BC Ferries, whereby it must implement a fuel surcharge while also offering discounted fares, has the potential to occur again in the future. Accordingly, BC Ferries respectfully requests that it be granted the authority, on an ongoing basis, to make transfers from time to time at its discretion, of revenue earned in excess of the price cap to a fuel deferral account.

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A detailed description of and the rationale for the Company's proposal is attached as Appendix 1. Should you have any questions or require further information please contact me.

Sincerely,

Robert P. Clarke, CGA
Executive Vice President & Chief Financial Officer

attach.

Copy: Mr. Sheldon Stoilen, Deputy Commissioner

Appendix 1:

Management of Regulatory Account Balances – Policy Proposal

Background

Since March 31, 2013, the balance in BC Ferries' fuel deferral account for the non-Northern routes has grown by $5 million, from a credit balance of $1.5 million to a debit balance of $3.5 million (as at September 30, 2013). With current marine diesel prices at more than $0.10/litre higher than the regulated fuel set price (as established by British Columbia Ferry Commission Order 12-03), the debit balance is expected to continue growing. In order for BC Ferries to continue to have discretion in setting surcharges and rebates, Order 12-03 requires that the fuel deferral account balance remain within a stipulated bandwidth and reach zero within a two year period. Given the current balance and fuel price forecasts, a surcharge in the order of 3 percent will likely be required in order to reach a zero balance by the end of December 2014. In order to comply with Order 12-03, the balance must reach zero by May 2015 at the latest.

At the same time, BC Ferries forecasts its average tariffs to be over the price cap by approximately $1.8 million at the end of both Quarter 3 (December 31) and Quarter 4 (March 31) of fiscal 2014 (before contemplating fare promotions). The original forecast contemplated average tariffs being under the price cap by the end of Quarter 3 and slightly over the price cap by the end of Quarter 4.

The *Coastal Ferry Act* contemplates that the average of tariffs charged may exceed the price cap from time to time. Specifically, Section 48(2) provides that the British Columbia Ferries Commissioner (the "Commissioner") must not make an Order with respect to a price cap overage unless the overage condition exists for a period of greater than four consecutive fiscal quarters. BC Ferries has historically managed its tariffs such that a price cap overage has not existed for longer than the stipulated four quarter period, and it is the Company's intention to continue this practice.

This can be challenging, however, as forecasting the average of tariffs charged (the yield in-market) can be difficult as it is affected by both traffic type and route performance. A missed forecast can occur as a result of:

- The type of traffic experienced differing from the forecast (for example, if the overall traffic composition has a greater proportion of commercial vehicles than forecast, or if a greater proportion of reservations are made within 7 days of a sailing than initially forecast, then the yield will be higher);
- The proportion of route traffic differing from the forecast (for example, if higher yielding routes like those connecting Vancouver Island with the Lower Mainland make up a greater portion of overall traffic than initially forecast, then the yield will be higher).

This challenge of forecasting the yield is further exacerbated by the added variable of traffic growth associated with a promotional fare.

Given the statutory limitation that the price cap cannot be exceeded for more than four consecutive quarters, if BC Ferries is over the price cap at the end of Quarter

3 in fiscal 2014 it will be required to be under it by the end of Quarter 4 to avoid a possible disciplinary Order by the Commissioner. Consequently, BC Ferries must implement price promotions with enough precision to be at or slightly below the price cap by the end of Quarter 4 of fiscal 2014.

Normally, BC Ferries would address the price cap overage by discounting fares before the end of Quarter 4. However, BC Ferries believes that discounting fares while a fuel surcharge may be in effect will cause its customers confusion, which could potentially have a negative impact on traffic.

Proposed Approach

To avoid the situation where BC Ferries must raise one form of pricing while reducing another, it is proposed that a policy be established that would enable the Company to transfer the fiscal 2014 year-end price cap regulatory account balance (currently forecast to be $1.8 million) to the fuel deferral account for the non-Northern routes at fiscal year-end. As the current circumstance facing BC Ferries (i.e. the possible simultaneous implementation of promotional discounts and a fuel surcharge) has the potential to occur in the future, it is proposed that the Company be granted the authority to make such transfers, from time to time, at its discretion.

Benefits

Applying a price cap regulatory account balance against a fuel deferral account balance yields several benefits. Firstly, the fuel surcharge rate will be less than otherwise required. For example, to reach a zero balance in the fuel deferral account for the non-Northern routes by the end of December 2014, it is expected that the surcharge rate would be 0.3 percent to 0.5 percent lower than if the $1.8 million transfer from the price cap regulatory account were not to be made. Secondly, this approach effectively applies a fuel surcharge retroactively, which helps align cost with use (i.e. those customers that effectively paid a combined yield over the price caps were at the same time not paying adequately for fuel). In respect of the proposal as it relates to the current situation, the transfer of the price cap regulatory balance to the non-Northern fuel deferral account is appropriate as the price cap overage has specifically occurred on non-Northern routes. Finally, the transfer eliminates the need to simultaneously apply discounts and fuel surcharges, thereby avoiding the associated concerns and confusion that may occur among our customers which, in turn, may negatively affect traffic.

Request

BC Ferries respectfully requests that the Commissioner grant authority to BC Ferries, as a price cap management tool, to make transfers from time to time at its discretion, of revenue earned in excess of the price cap to the fuel deferral account(s).

Ferry Advisory Committee Chairs Comment on BC Ferries Proposal re Regulatory Account Balances.

Thank you for the opportunity to comment on this BC Ferries proposal.

We have some comments and some concerns.

1. **Regulatory account vs deferral account:** These terms seem to be getting used interchangeably. We understand the deferral account process as used with fuel costs that fall over or under the set price that are deferred until a later date rather than appearing as operating costs. The process is transparent and designed to focus solely on fuel price volatility. On the other hand, we've not seen the accumulated losses or gains associated with the gap between the fare cap and the average fare described as a deferral account, or any other kind of account. If such has been the case, it's been kept from public view.

   Comment: if the gains or losses arising from the gap between the fare cap and the average fare are to be accumulated in something equivalent to a deferral account (a regulatory account?), then those transactions need to be identified and made publicly available, just as happens with the fuel accounts.

2. **Fuel Surcharges and Fare Promotions:** BC Ferries submits that running a fare promotion while fuel surcharges are in place will 'cause confusion among its customers'. We question this assumption. Fuel surcharges or rebates effectively become embedded as part of the fare on a long-term basis. Fare promotions, on the other hand, are spot offerings providing high profile discounts on whatever the fares happen to be at the time.

   Comment: There is minimal likelihood of confusing a 33% discount on specified days with a 3½% surcharge that's embedded in the fare.

3. **Fare Cap vs Average Fare Gap Requirements:** Until now, the requirement, as we understand it, has been that in the event the average fare exceeds the fare cap for any route group, steps need to be taken by BC Ferries to bring the average fare in line with the fare cap. There is no additional requirement that excess revenues gained while the average fares exceeded the fare cap need to be paid back to customers (as is the case with negative fuel deferral accounts). By the same token, if the average fares fall under the fare cap, BC Ferries is entitled to raise fares to bring the average fare up to the fare cap, but not sufficiently to recapture revenue lost while the average fares fell short of the fare cap. They have been reluctant to do so, perhaps because of bad optics.

   Comment: Authority and means presently exist to manage the gap between average fares and the fare cap. Nothing further is needed.

4. **The Gap Reality:** The request is framed in the context of there being an accumulated surplus from the average fare exceeding the fare cap. This surplus could then be transferred to the fuel deferral account, reducing the need for, or magnitude of, any fuel surcharges. Sounds attractive. However, the gap reality is that the average fare has typically fallen under the fare cap, forever on the non-majors and recently, even on the majors. This appears to be the result of migration from cash fares to e-fares and vehicle fares to passenger fares, driven by current barrier level fares. The proposal opens up the opportunity for BC Ferries to recover revenue lost as a result of such a shortfall – likely to occur in the future - by taking it from the deferral account, increasing the likelihood and amount of future 'fuel' surcharges. Or by reducing the amounts of any fuel rebates.

   Comment: The proposal seems to be presenting an under the table means of recovering revenue lost due to the average fare falling short of the fare cap, by disguising it as fuel surcharges. We resist any such means of obscuring the real cause of any surcharges.

5. **Muddy Waters:** To this point, the purpose and application of fuel deferral accounts, surcharges and rebates has been clear and generally understood. Creating a new, quasi-deferral account to serve an entirely different purpose, and then mixing the contents of the two accounts together, can only muddy the water, effectively de-legitimizing the existing fuel cost management process.

   Comment: If the Commission deems it appropriate that there should be a deferral account process to allow BCF to recapture revenue lost due to the gap between the average fare and the fare cap, then separate accounts should be set up and managed with the same visibility and accountability as the fuel accounts. That would mean separately identified surcharges and rebates as appropriate, but with full accountability. The public could handle that and it wouldn't necessarily take away from the opportunity to run fare promotions as a means of lowering the average fare.

6. **Route Groups:** Until April 2013, the minor route groups and route 3 have been separate from the majors as far as fuel deferral accounts and surcharges are concerned. Typically, the surcharges for the minors and route 3 have been about double those on the majors. This changed in PT3, when route 3 was more or less integrated with the majors and the minors were then included with the majors to provide common fare caps, a single fuel deferral account and common surcharges. *However*, this arrangement is only in place for PT3. It expires Mar 31, 2016, and may or may not be renewed for PT4. In the event the process reverts to separate fare caps and fuel accounts, the minors and rte 3 would be exposed to manipulation of their fuel accounts to address average fare shortfalls from fare cap levels. These gaps are more likely to occur on the minors and route 3 due to the migration from cash fares to e-fares as fares climb ever higher. This migration is in fact due to cash fare traffic falling even faster than e-fare traffic, and not an increase in e-fare traffic.

   Comment: The minor routes and route 3 are at even greater risk than the majors of having the fuel accounts (and surcharges) corrupted by having the two accounts able to flow between each other.

7. **Authority Level:** BC Ferries is asking for the authority to transfer any average fare over fare cap account surpluses to the fuel deferral account at the end of fiscal FY2014. They are further requesting authority to make similar transfers from time to time at its discretion. This means that beyond the regulatory requirement to stay within the fare cap, BCF would then have free license to create or increase 'fuel' surcharges to recover any shortfalls in the average fare. Or to dip into negative fuel deferral accounts (which occur when fuel surcharges more than pay off the deferral accounts) without any public scrutiny.

   Comment: In the event the Commissioner sees merit in the application, any approval of it should be on a case-by-case basis, on specific application. Such approval should be granted only in the case of passing surplus average fare over fare cap funds to the fuel deferral account, and never drawing funds from the deferral account or from fuel surcharges. Such application should only be considered at the end of each fiscal year and should be applied uniformly across all the non-Northern routes.

8. **Seniors' Discounts:** There's an anomaly about to occur in the average fare picture starting Apr 1. Up to then, seniors' fares, paid for by the government, had been recorded at 100% of the cash fare. As of Apr 1, seniors' fares, paid then by the seniors, will be recorded at just 50% of the fare. As well, most seniors travelling on the minor routes will be paying 50% of the e-fare. Weighing both these factors, a significant drop in the apparent average fare is inevitable. That appearance is deceiving however, as BC Ferries will be receiving the same full amount as they received for the seniors' cash fares, but as an addition to the service fee. The amount they receive from the seniors will be over and above that amount. Thus, while not defined as tariff revenue, the money will still be there for the next two years. Any adjustment to 'top up' the apparent loss of tariff revenue, from any source, would be a mistake in these specific circumstances. Given the fact that the amounts determined by the present cost of reimbursing BC Ferries for seniors' free rides will still be paid to BC Ferries for the next two years, albeit in the form of service fee, it would seem appropriate that that amount should still be included in fare revenue along with the 50% being paid by the seniors. This would then increase, not lower, the average fare. And properly so, as that's exactly what's happening.

   Comment: With the pending shift from full government payment of seniors' fares to seniors paying 50% of their own fares, the appearance of a drop in average fares is inevitable. It is equally misleading. To allow BC Ferries to siphon money from fuel surcharges to make up this apparent shortfall, as proposed, would be entirely inappropriate.

9. **Deferral Accounts, the Big Picture:** Deferral accounts have recently been in the news as they've been seen as a means to skirt around what might be perceived as responsible public policy. While there's a place for deferral accounts, they can also be used to hide expenses or transfers that properly should be subject to full public disclosure. Expansion of, or tampering with, deferral accounts warrants critical, proactive public scrutiny. Simply meeting GAAP or IFRS requirements does not mean such an application reflects sound public policy.

   Comment: Before the proposal is granted any form of approval, it would behoove the Commission to seek comment from independent professional sources, as to the propriety of such a change.

10. **Whither the Fare Cap?** It's our understanding that the fare cap process was put in place to insure the average fare charged by BC Ferries did not exceed the fare cap. While there is some latitude for the average fare to occasionally exceed the fare cap, the basic principle states that if the average fare exceeds the fare cap for an extended period – recently increased to four consecutive quarters – then the fares must be adjusted downward to get within the fare cap. If a process is approved whereby the overages can be bled into the fuel deferral accounts on a 'time to time' basis, then the 'too-high' fares can be sustained in perpetuity. It would seem this abrogates the whole intent of the fare cap process.

    Comment: If the concept of the average fare exceeding the fare cap triggering the need to adjust the fares is valid, then it seems inappropriate to permit a device whereby the average fare can be artificially reduced to avoid the corrective trigger.

In summary, we see no compelling reason for making this change. The argument with respect to customer confusion occurring to the extent that traffic would be lost, is speculative at best, without support and, we would argue, without merit. The downside is that:

- **the clarity of process that presently exists to deal with fuel price volatility would be lost,**
- **customers would be subject to increased surcharges disguised as fuel surcharges but in reality arising from the consequences of extreme fares, and**
- **it appears the regulatory principle addressed by the fare cap process becomes subject to being invalidated at the pleasure of the operator.**

Recommendation: If BC Ferries wishes to manage the overages and shortfalls arising from variances of average fares to fare caps, let them propose a system parallel to the fuel account process, but totally isolated from it and with full disclosure requirements and rigorous criteria for imposition of any surcharges. And then let that proposal be fully vetted in terms of appropriate public policy.

09 January 2014