



**BC Ferry Commission
MEMORANDUM 23**

To: Mr. John Dyble, Deputy Minister
Ministry of Transportation

and Mr. David Hahn, President and Chief Executive Officer
British Columbia Ferry Services Inc.

From: Martin Crilly, Commissioner

and Alan Eastwood, Deputy Commissioner

Date: March 30, 2007

**Re: Preliminary Price Caps for Performance Term Two:
Report Required under Section 40 (2) of the Coastal Ferry Act**

1. Purpose of Our Report

This report gives the Commission's preliminary decision on price caps for performance term number two, being the four years starting April 1 2008, for each of seven groups of ferry routes.

2. Statutory Requirements and Timelines

Under section 40 of the Coastal Ferry Act, at least 18 months before the start of a performance term, the ferry operator, British Columbia Ferry Services Inc. (BC Ferries), must provide information satisfactory to the Commission, respecting the core ferry services. The material must include tariffs, service fees, revenues and expenses, all relating to the first performance term which started April 1, 2003.

Under section 40 (2), at least 12 months before the start of a performance term, the Commission must review the material and issue a report to BC Ferries and the government. Our report must:

- describe determinations under section 41(3) respecting costs reasonably applicable to route groups;
- indicate a preliminary decision on price caps for the next performance term; and
- be made public.

3. Reasonableness of BC Ferries' Costs and Cost Allocations: Our Determinations Made under Section 41(3) of the Act

BC Ferries met the Act's requirement to submit information by September 30, 2006, relating to the core services to be provided in the first performance term. We made BC Ferries' submission publicly available shortly after receiving it.

We and our external consultants have reviewed BC Ferries' material to determine whether it meets the requirements of the Act. In our opinion, confirmed by our consultants, BC Ferries' material, taken with the company's responses to our follow-up questions, satisfies us that BC Ferries' estimates of revenues, expenses and capital expenditure to the end of performance term one rest upon reasonable data and assumptions.

We and our consultants are also satisfied that BC Ferries has applied revenues and expenses to each of the route groups according to reasonable allocation formulas, meeting the requirements of the Act. We will shortly publish our consultants' report.

4. How We Determined Price Caps

For our calculations, we started with the forecast costs in the final year of performance term one (the base year), by route group. From this base, we projected a **maximum allowed revenue** (from all sources of revenue) by route group by year through the second performance term, as follows:

- inflate the base year costs through the second performance term using forecasts of inflation in the prices for BC Ferries' inputs (fuel, labour, materials and maintenance, capital items), some of which are expected to fluctuate with the consumer price index, others not;
- allow for changes in costs due to changes in the quantities of inputs that BC Ferries must use to produce ferry services, as a result of forecast changes in the volume of traffic through the second performance term;
- make specific allowance for major deployments of capital (notably for vessels and terminals) in performance term two, which result in higher amortization and cost of capital, and associated changes in operating expenses (typically, savings). We had already approved most of these deployments as reasonable after BC Ferries' earlier applications under section 55 of the Act. We account for the insurance proceeds from the loss of the Queen of the North as reducing the costs of deploying the replacement vessel;
- add an amount for recovery of the fuel cost deferral accounts, being the "backlog" of extraordinary fuel cost not recovered through fuel surcharges in performance term one;
- allow for a return on equity, as a component of the cost of capital, on a company-wide basis, sufficient to meet the pre-tax return on equity calculated in accordance with the formula in the Act; and
- incorporate a future gain in productivity, as determined by us, beyond the productivity change which may occur through new vessel deployment, as a challenge for the company's performance.

To generate these total maximum allowed revenues, besides revenue from fares, BC Ferries has three other main sources of revenue in performance term two:

- ancillary revenues (e.g. from onboard catering)¹;
- a Federal subsidy which varies with consumer prices; and
- Provincial service fees under the Coastal Ferry Services Contract.

By taking the total maximum allowed revenue and subtracting the revenue from these three sources, we obtained the **maximum allowed revenue from fares** by route group. By dividing by a forecast index of the quantity of traffic which will pay the fares, we then derived maximum fare levels, or **price caps**, required to generate that revenue, on an annual basis through the second performance term.

5. Decision on Use of Replacement Values

In the course of setting the preliminary price caps, we reviewed BC Ferries' calculation of the current replacement costs of its capital assets, in accordance with the requirement of section 41 (3) (d) of the Act. BC Ferries has a substantial capital expenditure programme for rejuvenation of the fleet and terminals with a significant effect on costs. In our opinion it is not appropriate to use current replacement cost values in determining the price caps, beyond what we inherently recognize in accepting the capital programme as reasonable.

6. Our Assumptions About Changes in Taxpayer Funding

Our preliminary decision incorporates changes in taxpayer funding through March 31, 2012, actual and expected as of today.

For Federal subsidies, we assume continuation of the Federal-Provincial contract under which the Federal subsidy increases with consumer price inflation.

For Provincial service fees, we assume that the total amount of Provincial service fees continue as agreed in 2003 in the Coastal Ferry Services Contract between BC Ferries and the Province, plus subsequent adjustments actual and expected as of today including:

- Provincial service fee increases for Routes 10 and 11 in the north which contribute to the deployment of two vessels, the associated terminal modifications and other related cost changes;
- expected pay-down by the Province, by the end of the first performance term, of a substantial portion of the balance of the fuel deferral account for the north, being

¹ The Act states that the Commission must not regulate ancillary revenues. Yet we must recognize their continuing contribution through performance term two. We chose to project them at end-of-term-one dollar levels through term two, so that BC Ferries can retain any excess over this projected level until term three.

the backlog of extra fuel cost not covered by fuel surcharge revenue in the first performance term;² and

- reallocation among route groups of both the service fees paid by the Province and the subsidy paid by the Federal government in a manner that will result in similar annual increases in the price cap for the six route groups on which the Province pays service fees.³

7. Our Preliminary Decision on Price Caps for Performance Term Two

As the starting point from which adjustments to the price cap are made in performance term two, we chose the price cap index at the end of performance term one, including the fuel surcharges in place on each route group at the end of performance term one.

We developed a formula to link the maximum allowed revenue from fares, and therefore the price caps, to the general inflation index (CPI), as contemplated in the Act.

Our preliminary decision is as follows:

Preliminary Decision at March 30 2007

On April 1, 2008, the new price cap for each route group will be defined to include the existing fuel surcharge . From this base the price cap will increase each year as follows.			
<u>Route Group</u>	On April 1 2008	On each of April 1 2009, 2010 and 2011	
	an increase of	an increase of	plus CPI* times
	Route Group 1: the three major routes	5.4%	2.0%
Route Groups 2 through 7: all other designated routes	3.6%	5.2%	0.73

**The latest available published annual percentage increase in the Consumer Price Index for British Columbia*

Accordingly, following the last statutory increase in performance term one of 2.8% for the major group and 4.4% for the other six groups on November 1 2007 as required in the Act, performance term two will begin with an increase of 5.4% for the major group and 3.6% for the other groups on April 1 2008. Subsequent annual changes in the price caps will depend on inflation.

As an example of how the CPI formula will work, suppose that, in future, inflation is higher than today. Assume for illustration that the annual CPI increase in the year

² The B.C. Ministry of Transportation and BC Ferries have informed the Commission, by letter dated March 17, 2007, of the Province's intent in this regard.

³ The B.C. Ministry of Transportation and BC Ferries have informed the Commission, by letter dated March 17, 2007, of their intent to amend the Coastal Ferry Services Contract accordingly.

leading up to April 2011 is 4%. For the major route group, the price cap increase on April 1 2011 would be $2.0\% + (4\% \times 0.5) = 4\%$. For all other route groups, the increase would be $5.2\% + (4\% \times 0.73) = 8.1\%$.

8. Matters Remaining to be Considered Before Our Final Decision

Our final decision on price caps for performance term two must be issued by September 30, 2007. Among the matters remaining to be considered for the final price caps are:

- any changes in the Coastal Ferry Services Contract beyond those indicated above;
- an adjustment mechanism providing for fuel rebates or surcharges in response to fluctuations in fuel prices through performance term two;
- extraordinary adjustments in costs for which BC Ferries provides justification satisfactory to the Commission by June 30 2007;
- changes in the interest rate on debt and the rate of return on equity for the second performance term; and
- comments received from the public following this preliminary decision.

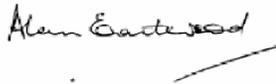
9. Next Steps

As you are aware, under the Act the Province and BC Ferries have until June 30, 2007 to consider changes to their Contract before BC Ferries must provide the most current version of the Contract to the Commission. After receiving that Contract we will finalize the price caps in light of changes to the Contract, and any additional information received from the Province and BC Ferries, and comments received from the public.

Yours truly,



Martin Crilly
Commissioner



Alan Eastwood
Deputy Commissioner