



**BC Ferry Commission  
Memorandum 42**

To: Mr. Rob Clarke  
Executive Vice President and CFO  
BC Ferry Services Inc.

From: Martin Crilly  
BC Ferries Commissioner

Date: February 7, 2011

**Re: Summary of Determinations on Drop Trailer Inquiry under s. 45.1 of the Coastal Ferry Act**

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This Memorandum summarizes the commissioner's determinations in the recent inquiry under the provisions of the Coastal Ferry Act (the "Act") which address circumstances of unfair competitive advantage in relation to the drop trailer service of British Columbia Ferry Services Inc. ("BCFS") on its major routes. This Memorandum has been released now in order to reduce uncertainty in the marketplace regarding drop trailer services. Formal Reasons for Decision will be issued and made public in due course.

**Public Information**

The Memorandum is a public document. It contains no revenue, price, cost or traffic data or other information of direct commercial value to BCFS' competitors or customers. It does however contain qualitative statements. Further, a diagram is included which illustrates the relationships between some of these variables, but not drawn to scale. The commissioner considers that such information is essential to enable all stakeholders and the public to understand the commissioner's findings and their foundation.

The determinations appear formally in Commission Order 11-01. This contains all required specifications to implement minimum tariff regulation, including price levels, growth factors and other quantities. The commissioner is publishing Order 11-01 itself but with certain data removed, on the basis that disclosure of this data would cause a real and substantial possibility of future harm to the financial or economic interests of BCFS.

The determinations are presented here in the same sequence as the relevant matters appear in s. 45.1 of the Act. The Memorandum also outlines how a minimum tariff regulation will be implemented.

**1. Determination: BCFS is providing a “Competitive Service”**

Commission Memorandum 37 of July 19, 2010 stated that BCFS’ drop trailer service on its major routes is a competitive service as defined in s. 1 of the Act. This finding triggered a requirement for the commissioner to make determinations under s. 45.1 of the Act.

**2. Determination: commissioner’s overall cost estimate exceeds BCFS’ estimate**

Section 45.1(1) of the Act requires the commissioner to determine if BCFS is pricing below costs.

To compare price and costs, the commissioner expresses both prices and costs in averages, in dollars per vessel-foot. Vessel-feet are the lane-feet on a vessel occupied by a trailer and its attached BCFS hostler unit.

The findings respecting costs are as follows.

- a) For costs directly attributable to the drop trailer service (labour to load/unload drop trailers to/from vessels, financing and amortization of hostler units, etc), the commissioner accepts BCFS’ submissions for fiscal 2010. He also accepts BCFS’ statement of the decline in direct costs per vessel-foot, due to economies of utilization, at higher throughput of drop trailers at a target “mature” state some years in the future.<sup>1</sup>
- b) For costs indirectly attributable to the drop trailer service, the commissioner finds it appropriate to apply a “route overhead charge” to the costs of drop trailer service to recognize the provision of terminal and deck space, and marine transport. In this respect the commissioner disagrees with BCFS’ approach to costing the drop trailer service, whereby the cost of providing terminal and vessel capacity, and the cost of moving the vessel across the water, are excluded.
- c) The commissioner considers that an after-tax return to equity is not a cost: it should not be included in the calculation of costs, direct or indirect, of the drop trailer service. In this the commissioner disagrees with BCFS’ submission which made such an inclusion.<sup>2</sup>

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<sup>1</sup> Referring to the diagram shown under Determination 6 below, economies of utilization of inputs dedicated to drop trailer service are the reason for the downward slopes of lines A, B and C.

<sup>2</sup> To illustrate the impact of this determination, Line C on the diagram includes a return on equity at the after-tax rate equivalent to the pre-tax rate of 13.16% ruled by the Commission as applicable for setting price caps for the second performance term. Line C has no other purpose and is not used in setting a minimum tariff.

### 3. Determination: BCFS is pricing drop trailer service below costs

BCFS charges a range of prices to drop trailer customers: it offers two classes of service and charges different customers different prices. There is a fixed (terminal) charge per trailer plus a charge that varies with trailer length. By taking total revenues from all drop trailer customers and dividing by the total lane-feet of vessel space used by the drop trailer service, the commissioner arrived at an average price per vessel-foot charged by BCFS in fiscal 2010.

The commissioner finds that this average price:

- a) is below the above-described commissioner estimate of direct cost plus an appropriate portion of indirect cost for fiscal 2010, and also for some years afterward using BCFS' assumed growth in volume of drop trailers it handles; and
- b) in BCFS' target "mature" state beyond, is above that cost.

In the diagram, these two findings are illustrated by the position of the lower, red star (BCFS price today, i.e. fiscal 2010) relative to the blue Line B and the green Line C.

### 4. Determination: BCFS has an unfair competitive advantage

Section 45.1(1) also requires the commissioner to determine whether BCFS has an unfair competitive advantage resulting from three specified circumstances, or any others.

**a) Determination re: use of vessels/terminals that are/were government-owned**

The commissioner finds no competitive advantage from these factors.

**b) Determination re: any tax exemption**

The commissioner finds that BCFS exemption from income tax affords it an unfair competitive advantage.

**c) Determination re: any subsidy**

The commissioner finds no competitive advantage from subsidy.

**d) Determination re: any other factor**

The commissioner considered whether there were any other sources of unfair competitive advantage beyond the above three specified for examination.

The commissioner finds there is a competitive advantage for BC Ferries inherent in the price cap regulatory framework under which it operates. Every four years the commissioner must set maximum allowed fares for other (i.e. non-drop trailer) monopoly traffic, to meet BCFS' cost of providing contracted capacity on each route. This capacity cannot be changed without the consent of the Province through amendments to the contract. This means that, once price caps for a performance term have been set, BC Ferries may take the view that any vessel/terminal capacity used by incremental drop trailer traffic has

already been paid for by monopoly base traffic. Because this framework is available to BC Ferries, and to no other operator for reasons of government policy, this advantage is unfair with respect to competitive services.

The commissioner identified no other sources of unfair competitive advantage.

#### **5. Determination: the commissioner will regulate using a minimum tariff**

As stated above, the commissioner finds that BCFS is both:

- (a) pricing drop trailer service below the direct costs and an appropriate portion of the indirect costs associated with the drop trailer service, and
- (b) enjoying unfair competitive advantage from two sources.

Due to the use of the word “or” in the first paragraph of s. 45.1 of the Act, only one of these determinations has to be made for the commissioner to be required to regulate BCFS’ drop trailer service.

Flowing from these findings, s. 45.1(2) requires that the commissioner must regulate by ordering BCFS either to:

- (a) provide the service through an alternative service provider or
- (b) charge for the service at least a minimum tariff.

The commissioner has decided on (b), i.e. to set a minimum tariff, as the simpler and more workable option for the drop trailer services on the major routes.

#### **6. Determination: the Minimum Allowed Average Tariff (MAAT)**

Accordingly, under s. 45.1(2)(b) the task is to “calculate the amount that the commissioner considers would be charged as a tariff for that ferry transportation service to recover the direct costs and an appropriate proportion of the indirect costs attributable to providing the service were none of the factors referred to in [s. 45.1(1)] present, and order the ferry operator to charge at least that tariff when providing that ferry transportation service.”

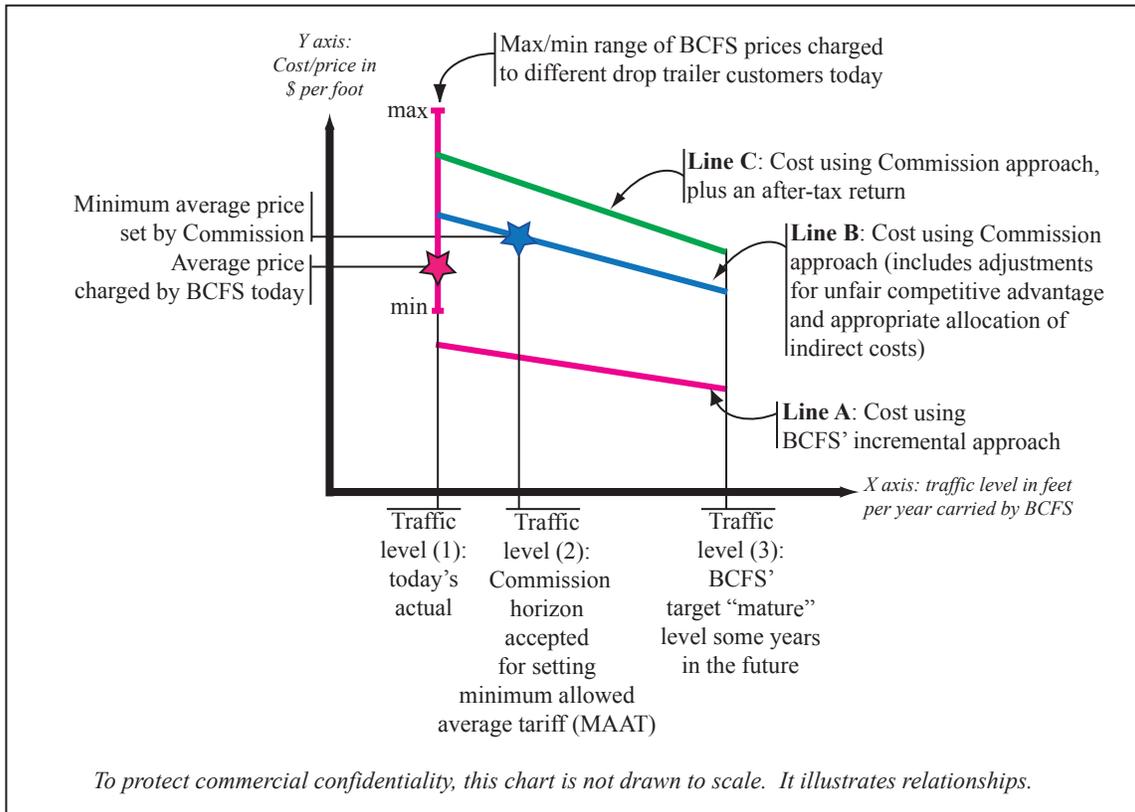
The commissioner engaged the firm of Pricewaterhouse Coopers to advise on the calculation of costs and the adjustments required to account for sources of unfair competitive advantage.

The diagram overleaf illustrates the results of the calculation, in terms of the average dollars per vessel-foot. It shows, as a function of traffic volume today and at the target “mature” state in some years’ time, the charge needed to recover the costs and an appropriate proportion of the indirect costs (line B).

Included in the calculation are allowances for the two sources of unfair competitive advantage as found above:

- (a) to account for BCFS' income-tax exempt status, which is a relatively small adjustment, the cost calculation includes an amount each year equal to the equity directly and indirectly associated with the drop trailer service, multiplied by the difference between a pre- and post-tax percentage annual return; and
- (b) to account for the advantage inherent in the price cap regulatory framework, the commissioner's allocation of a portion of "route overhead charge" makes the appropriate adjustment, which is a significant one. The commissioner accepts a method used by BCFS to allocate certain costs between passengers and vehicles onboard vessels, which is to use deck area exclusively used by passengers and vehicles as the basis for allocation.

The allocation of a portion of the "route overhead charge" also addresses the factor of the service being priced below cost, by requiring that an appropriate proportion of indirect costs are associated with the drop trailer service.



The commissioner recognizes that BCFS' unit costs cannot reasonably be based on an initial start-up volume of drop trailer traffic, which might be expected to increase quickly from a small base. On the other hand, basing the unit cost on BCFS target "mature" volume which is a multiple of current volumes and several years in the future also seems unreasonable. Accordingly, for the purpose of setting a minimum tariff the commissioner accepts the expected costs at a horizon volume of traffic which is less than BCFS' target mature state. This is illustrated by the position of the upper, blue star in the diagram.

The Minimum Allowed Average Tariff (MAAT) is expressed in dollars per vessel-foot. To be in compliance, BCFS must show the commissioner that for a given period

*total revenue from drop trailers (including all charges, e.g. terminal fees)*  
*~divided by~*  
*the total number of drop trailer service feet (including hostlers) carried*

is greater than or equal to the MAAT.<sup>3</sup>

The minimum tariff regulation will begin April 1, 2011. The initial dollars per vessel-foot figure for the MAAT will be inflated over time. Fuel surcharges and rebates applied to other traffic types carried by BCFS on the major routes shall apply in the same proportion to the MAAT. When the drop trailer traffic reaches a threshold volume in vessel feet set by the commissioner, or at the discretion of the commissioner, the MAAT will be recalibrated against BC Ferries' current actual cost and traffic data by a method similar to that used for the initial figure.



BC Ferries Commissioner

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<sup>3</sup> BCFS will be free to charge a range of prices for its drop trailer services, as long as the above condition is met for the average revenue per vessel-foot. Drop trailer traffic is subject to existing maximum as well as this new minimum rate regulation: its traffic and revenue data must also be included in the calculations of weighted average fares for price cap regulation.