



BRITISH COLUMBIA  
FERRY COMMISSION

ORDER  
NUMBER: 11-02

P.O. Box 1497, Comox, B.C. V9M 8A2  
Telephone (250) 339 2714

<http://www.bcferrycommission.com>  
[info@bcferrycommission.com](mailto:info@bcferrycommission.com)

IN THE MATTER OF  
Section 40 and 41 of the Coastal Ferry Act S.B.C. 2003, c. 14  
and Preliminary Determination of Price Caps  
on Fares Charged by Coastal Ferry Operators  
on Designated Routes  
for the Third Performance Term

**BEFORE:** Martin Crilly, Commissioner on March 31, 2011

**PRELIMINARY DECISION**

**WHEREAS:**

- A. The *Coastal Ferry Act* requires the commissioner to make by March 31, 2011 a preliminary determination of price caps for the third performance term, which starts April 1, 2012 and ends March 31, 2016;
- B. The ferry operator, British Columbia Ferry Services (BCFS), has provided information satisfactory to the commissioner respecting each designated ferry route that is included in a route group for which a price cap is to be set, and the commissioner has published this material on his website;
- C. The commissioner retained external advisors to assist in the review of BCFS' submission, and met with BCFS representatives to obtain and review supporting information;
- D. The commissioner has been guided by the principles that price caps must enable BCFS to recover the portion of operating, administration and amortization costs that can reasonably be applied to each route group, and to receive a pre-tax return on equity;
- E. The commissioner has examined the capital expenditures that BCFS undertook in relation to the second performance term, and expects to undertake in the balance of that term, and, being satisfied that they are reasonable, has taken them into account in setting price caps for the third performance term;
- F. The commissioner has also been guided by the principles that the price caps must take into account a productivity gain which he has determined on a preliminary basis, and that

BCFS is, on an ongoing basis, to actively seek additional or alternative service providers on the designated routes, to reduce the cost of services;

- G. The commissioner has invited BCFS to respond by April 30, 2011 to his determinations on cost reductions and productivity, and will publish BCFS' responses for public comment;
- H. The commissioner has decided to adopt, on a preliminary basis, a flat traffic growth forecast as proposed by BCFS, but has asked BCFS to submit, by May 31, 2011 an updated forecast using best-practice methodology;
- I. The commissioner will permit the continuation through the third performance term of fuel cost deferral accounts, accompanied by a trigger mechanism for fuel surcharges and rebates on ferry fares; and, for the operation of the deferral accounts, he has determined a "set" price per litre for marine diesel fuel as a reasonable forecast of the actual delivered price that BCFS will pay for fuel, and that shall be included in BCFS' operating expenses in the third performance term;
- J. The provincial government and BCFS have provided to the commissioner a signed statement of their intent to amend their Coastal Ferry Services Contract for the third performance term, amalgamating Route Groups 1 (Major Routes) and 2 (Route 3), and reassigning taxpayer funding to Route Groups 3 (Northern Routes) and 4 (Minor Routes) so as to balance price cap increases for the latter two groups;
- K. In considering the interests of ferry users, in this decision the commissioner is:
  - (a) shielding users from sharp fare increases, as far as is possible, by setting a constant percentage annual growth in price caps and
  - (b) providing ferry users with a particular opportunity to comment on:
    - BCFS' response to cost reductions and productivity challenge; and
    - ten service level changes identified by BCFS as opportunities to enhance its efficiency;
- L. The commissioner has prepared a report, attached to this Order, which elaborates his findings and determinations and identifies, without limitation, new information that he will consider before making a final determination of price caps by September 30, 2011; and
- M. The commissioner is today publishing this Order and the attached Report and is requesting comments from the public through June 30, 2011; and, as required by s.40(2)(a.1) of the Act, he is also requesting public comment on BCFS' submissions, and its Annual Reports and Quarterly Reports under s.68(3), all of which are available on the commissioner's web site at [bcferrycommission.com](http://bcferrycommission.com);

**NOW THEREFORE** the Commissioner's preliminary decision is as follows:

1. The price caps applicable to the route groups are increased annually from April 1 2012 to the end of the third performance term at March 31, 2016 as follows:
  - (a) **by 4.15 per cent for the newly amalgamated major route group**—comprising the groups currently numbered one (the three Vancouver Island to Lower Mainland routes) and two (the Horseshoe Bay to Langdale route)—using the price caps that will be in effect April 1, 2011 for currently-defined route groups one and two respectively as the base for the calculation of the 4.15 per cent increase to the price cap;
  - (b) **by 8.23 per cent for the other route groups**—currently numbered three (northern routes) and four (minor routes)—using the price caps that will be in effect April 1, 2011 for each group as the base for the calculation of the 8.23 per cent increase to the respective price cap;
2. the set price per litre for the operation of fuel deferral accounts, being a required input into the calculation of fuel surcharges or rebates on the base fares to be charged within the above price caps, shall be as shown in Schedule A below.

Dated at Comox, in the Province of British Columbia, this 31st day of March, 2011.

BY ORDER



Martin Crilly  
Commissioner  
British Columbia Ferry Commission

**SCHEDULE A**

<b>Fuel Set Prices Per Litre for Operation of Fuel Cost Deferral Accounts</b>						
Route Group Number	Routes	At the end of Performance Term Two FY2012	Performance Term Three			
			FY2013	FY2014	FY2015	FY2016
1+2 Amalgamated	Routes 1, 2, 30	C\$0.806	C\$0.922	C\$0.940	C\$0.959	C\$0.978
	Route 3	C\$0.842	C\$0.959	C\$0.978	C\$0.997	C\$1.017
3	Routes 10, 11, 40	C\$0.843	C\$0.960	C\$0.979	C\$0.999	C\$1.019
4	18 Minor Routes	C\$0.829	C\$0.945	C\$0.964	C\$0.984	C\$1.003

# British Columbia Ferry Commission



## Report on the **Preliminary Price Cap Decision** for the Third Performance Term

*Prepared and submitted in accordance with  
Sections 40 and 41 of the Coastal Ferry Act  
of the Province of British Columbia*

British Columbia Ferries Commissioner  
P.O. Box 1497  
Comox, B.C.  
V9M 8A2

<http://www.bcferrycommission.com>  
[info@bcferrycommission.com](mailto:info@bcferrycommission.com)

## CONTENTS

<b>1</b>	<b>STATUTORY REQUIREMENTS.....</b>	<b>3</b>
a.	Role of the Commissioner .....	3
b.	Setting Price Caps .....	3
c.	Principles Applicable to Price Cap Review .....	4
d.	Determinations Required .....	4
<b>2</b>	<b>APPROACH TO THE REVIEW .....</b>	<b>5</b>
a.	Outline of Method .....	5
b.	Assumption for Ferry Services to be Provided .....	6
c.	Assumptions for Taxpayer Funding .....	6
<b>3</b>	<b>FINDINGS AND DETERMINATIONS .....</b>	<b>7</b>
a.	BCFS' Information Submitted .....	7
b.	Estimates for Current Performance Term .....	7
c.	Reservation Fees.....	7
d.	Executive Compensation and Marketing Cost Reductions.....	8
e.	Cost Allocation Methods.....	8
f.	Capital Expenses in Performance Terms Two and Three.....	8
g.	Fuel Surcharges/Rebates and Price Hedging .....	8
h.	Use of Current Replacement Costs for Assets .....	9
i.	Return on Equity and Leverage .....	10
j.	Traffic Forecasts through 2016 .....	11
k.	Assumption on Changes to Service Contract.....	11
l.	Commissioner's Productivity Challenge to BCFS.....	12
m.	Alternative Service Providers .....	13
<b>4</b>	<b>NEXT STEPS .....</b>	<b>15</b>
a.	One Month for BCFS to Respond .....	15
b.	Three Months for Public Input .....	15
c.	Matters to be Considered Before Final Decision .....	15

### Abbreviations Used in this Report

ASPs	Additional or Alternative Service Providers
BCFS	British Columbia Ferry Services Inc.
CFSC	Coastal Ferry Services Contract
PT2	Performance Term Two (the current term) ending March 31, 2012
PT3	Performance Term Three, from April 1, 2012 to March 31, 2016
WACC	Weighted Average Cost of Capital

# 1 Statutory Requirements

## **a. Role of the Commissioner**

Under s.38(1) of the Coastal Ferry Act (the “Act”), the commissioner must, after considering public feedback obtained under the Act, regulate each ferry operator in relation to the core ferry services and the tariffs and must undertake that regulation according to with the following principles:

- a) priority is to be placed on the financial sustainability of the ferry operators;
- b) ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;
- c) ferry operators are to be encouraged to seek additional or alternative service providers;
- d) ferry operators are to be encouraged to minimize expenses without adversely affecting safety;
- e) cross subsidization from major routes to other designated ferry routes is to be eliminated within the first performance term;
- f) the designated ferry routes are to move towards a greater reliance on a user pay system so as to reduce, over time, the service fee contributions by the government.

For the purposes of s.38(1) of the Act the commissioner must, under s.38(2)(g), consider the interests of ferry users.

## **b. Setting Price Caps**

The commissioner is required to establish the price caps for each route group under s.38(2)(c) of the Act. For this purpose, under s.40(1) of the Act, each ferry operator must, at least 18 months before the beginning of a performance term for which a price cap is to be set, provide to the commissioner, the BC Ferry Authority and the Minister of Transportation and Infrastructure information, satisfactory to the commissioner, respecting the core ferry services. The material must include tariffs, service fees, revenues and expenses, cost allocations to the route groups, all relating to the current performance term which ends on March 31, 2012. Under s.40(2) of the Act, at least 12 months before the beginning of a performance term for

which a price cap is to be set, the commissioner must review the information and the plans provided by the ferry operator, make public a request for public comment in relation to the information and plans provided to the commissioner and issue and publish a report to the ferry operator and the government. The report must:

- describe the findings of the review of the information and plans provided to the commissioner
- describe the determinations under s.41(3) of the Act respecting costs reasonably applicable to route groups;
- indicate a preliminary decision on price caps for each route group for the next performance term; and
- be made public.

**c. Principles Applicable to Price Cap Review**

Under s.41(2) of the Act, in setting a price cap for a route group the commissioner must be guided by certain principles which allow for a return sufficient to enable the ferry operator to recover reasonable portions of operating, administrative, and capital costs applied to the route group plus generate a pre-tax rate of return on equity.

Another principle is that the ferry operator is, on an ongoing basis, to actively seek additional or alternative service providers to provide service on its routes.

**d. Determinations Required**

Under s.41(3) of the Act the commissioner is required to make a number of determinations in setting a price cap for a route group.

The determinations include the reasonableness of operating, administrative and terminal expenses applied to the route group, the reasonableness of capital costs included in the route group and the appropriate value of capital assets deployed within a route group. Acting reasonably, the commissioner must also determine the productivity gain that the ferry operator should achieve in the following performance term.

## 2 Approach to the Review

### a. Outline of Method

This price cap review is the second to be held under the Coastal Ferry Act of 2003. The first one occurred in 2006/07, to set price caps for the current performance term.

The commissioner reviewed the lessons learned from the first review, and adapted his approach accordingly. He also recognized new developments: one was that BCFS completed its development and testing of a financial forecasting tool (Cognos) which produces estimates of future costs by route group.

With further advice from independent consultants, the commissioner selected the following approach:

- a) obtain BCFS' forecast of its **annual expenditures** required to supply core ferry services in performance term three, by route group;
- b) obtain BCFS' forecast of its **annual revenues** from non-fare sources (contracted provincial and federal taxpayer funding, and net revenues from BCFS ancillary services such as catering) in performance term three, by route group;
- c) **review these forecasts** with the assistance of external advisors<sup>1</sup>; accept those expenditures and non-fare revenues which the commissioner considers reasonable to be applied to each route group;
- d) determine a **maximum allowed revenue** from fares by route group by year that is sufficient for BCFS to recover its costs and:
  - generates a pre-tax return on equity set by commissioner; and

---

<sup>1</sup> The commissioner engaged MMK Consulting Inc. of Vancouver, BC, as its advisor on this stage of the process. MMK's report to the commissioner is to be released to the public.



- incorporates a future gain in productivity as a challenge for improving overall efficiency in the operation of the company.
- e) identify the **forecast of traffic** in BCFS' submission and assess its reasonableness.
- f) determine the values of the **price cap index** (which is a measure of the maximum allowed average fare level) for each route group and for each year of PT3, which, if (a) BCFS actual fare levels were to equal and (b) traffic forecasts proved accurate, would generate the maximum allowed revenue computed at step d) above.

**b. Assumption for Ferry Services to be Provided**

The commissioner's preliminary decision assumes that the ferry services that BCFS is to provide are unchanged from those in the current version of the Coastal Ferry Services Contract (CFSC). This contract specifies the ferry routes, the annual ferry capacity to be supplied, hours of service, and numbers of round-trip sailings.

**c. Assumptions for Taxpayer Funding**

The preliminary decision also rests on continuation through PT3 of (a) the Provincial service fees for PT2 as agreed in the CFSC, (b) the 1977 Federal-Provincial Subsidy Agreement and (c) the CFSC terms which provide the proceeds of the Federal subsidy to BCFS, but with the following important changes<sup>2</sup> in the CFSC:

- the amalgamation of Route Group 2 (Route 3 between Horseshoe Bay and Langdale) and Route Group 1 (the Major Routes);
- the reassignment of the Provincial service fee and Federal subsidy:
  - from Route Group 2 to Route Group 3 (Northern Routes) and Route Group 4 (Minor Routes); and
  - between Route Groups 3 and 4 in such a way as to balance the price cap increases of the two route groups.

---

<sup>2</sup> The Provincial Government and BCFS have informed the Commission, by letter dated March 24, 2011, of their intent to amend the Coastal Ferry Services Contract to incorporate these changes.

## 3 Findings and Determinations

Based upon the review of the information submitted by BCFS, the commissioner's findings and determinations are as follows.

**a. BCFS' Information Submitted**

BC Ferries met the Act's requirement to submit information by September 30, 2010, with an amended version filed on October 15, 2010, relating to the core services to be provided in the current performance term.<sup>3</sup> The commissioner made BC Ferries' submission publicly available shortly after receiving it.

**b. Estimates for Current Performance Term**

BC Ferries' filing, together with the company's responses to the commissioner's follow-up questions, has satisfied the commissioner that BC Ferries' estimates of its non-fare revenues, expenses and capital expenditures for the current performance term generally rest upon reasonable data and assumptions, subject to further detailed determinations stated below.

*Subsequent Development*

After filing its submission with the commissioner, BCFS advised that the revenue estimate for the last year of the current performance term may be optimistic due to anticipated lower traffic volumes. The resulting drop in estimated earnings will translate to a lower total equity value for BCFS at the end of the current performance term, but have no other effect on the commissioner's price cap calculation.

Of greater importance are the estimated expenses and capital expenditures in the determination of the price caps for performance term three.

**c. Reservation Fees**

Under amendments to the Coastal Ferry Act in 2010, revenues from reservation fees are no longer to be considered ancillary, but are to be regulated under the price cap.

The commissioner is satisfied that reservation fees have been properly accounted for in the determination of the price cap for the applicable route group.

---

<sup>3</sup> The information was submitted as required to the Minister of Transportation and Infrastructure and the commissioner but because of an oversight was not submitted to the BC Ferry Authority until March 2011.

**d. Executive Compensation and Marketing Cost Reductions**

The commissioner has determined that, for purposes of determining preliminary price caps, it is reasonable to apply a reduction in operating costs of \$0.5 million annually in respect of executive compensation expenses and \$2.0 million annually in respect of marketing costs. Both figures are to apply for each of the four years of PT3, for a total of \$10 million.

**e. Cost Allocation Methods**

The commissioner is satisfied that BCFS has applied operating, administrative and terminal expenses to each of the route groups according to reasonable allocation formulas, meeting the requirements of the Act.

**f. Capital Expenses in Performance Terms Two and Three**

For the current performance term, PT2, the commissioner is satisfied that it was reasonable for BCFS to have incurred its capital expenditures, on a route group basis, including those capital expenditures which he had approved under s.55 of the Act.

In respect of BCFS' capital programme for PT3, the commissioner has made an adjustment, for purposes of determining preliminary price caps, to reduce BCFS' amortization expense estimate by \$1 million annually. Following this, he is satisfied that the capital programme is reasonable for the purposes of the required forecast of amortization costs.

The abovementioned reduction is for each of the four years, for a total of \$4 million for PT3. The commissioner recognizes that, if BCFS chooses to reduce its actual amortization charges by this amount, it will be necessary to reduce or defer expenditures for assets that were planned to be brought into service during PT3.

*Vessel Replacements*

The commissioner has noted that for the next performance term BC Ferries has included a provision for advance deposits on replacement vessels for the Queen of Nanaimo and the Queen of Burnaby. The commissioner believes there is an opportunity to consider options for the replacement of these vessels, other than like-for-like, and anticipates receiving from BCFS, in due course, an application under s.55 of the Act. This formal application would ask the commissioner to declare whether the proposed replacements of these vessels are reasonably required.

**g. Fuel Surcharges/Rebates and Price Hedging**

The commissioner has decided to continue to permit the use through PT3 of fuel cost deferral accounts for regulatory purposes. They have the effect of transferring fuel price risk from BCFS to ferry users.

Under this arrangement, BCFS charges only a per-litre “set” price to current operations. The set price is set by the commission and is recognized as the fuel cost built into the cost base recoverable through the price caps. The set price level for PT3, which is ideally equal to the future price of fuel, is integral to this price cap determination.

The commissioner considers that price certainty has its own value to ferry users, e.g. in respect of the fuel surcharges/rebates they may pay for travel. Provided it can be operated with reasonable transaction costs, a fuel price hedging programme is desirable, to reduce the volatility of fuel surcharges/rebates.<sup>4</sup> Accordingly the commissioner’s Order respecting price caps includes a requirement that BCFS present a fuel price hedging strategy for PT3 for the commissioner’s approval.

**h. Use of Current Replacement Costs for Assets**

*Merits and Challenges*

The Act s.41(3)(d) requires the commissioner, in setting price caps, to “determine, based on current replacement costs, the appropriate value of capital assets deployed within, or in support of, a route group.” He has considered carefully the question of the appropriate valuation of capital assets.

The commissioner sees the appeal of replacement costing, i.e. having BCFS’ fares reflect the cost of the consumption of its capital assets in *current replacement* terms, rather than at the *historical* cost of the asset. Where the acquisition price of assets changes over time, e.g. through inflation, the conventional approach to costing them at historical levels produces a jump in amortization charges, and therefore prices, at the moment when the asset is replaced.<sup>5</sup> However, once the practice of replacement-costing all assets is in place, further such rate shocks are avoided.

The challenge is how to achieve that practice: where assets in service were bought many years ago at nominal prices which were low compared to today’s, moving to replacement costing of all assets in a single step will force customers to endure a substantial one-time rate increase. It would also create a remarkable one-time lift in BCFS’ surplus, as conventionally accounted for. This is likely to be controversial, and not readily explained to ferry users. It might also affect how

<sup>4</sup> The difference between the set price and actual fuel prices results in fuel cost debits/credits to the deferral accounts, which are to be kept to reasonable limits through periodic fuel surcharges/rebates on ferry fares, using a trigger mechanism similar to that used in the second performance term.

<sup>5</sup> Such an impact occurred on the major route group in FY2009, at the start of performance term two, when four 50-year-old vessels on the major routes were replaced with brand new vessels.

BCFS' suppliers, including labour, regard the company's ability to pay higher costs.

*Two route groups now closer to replacement costing*

The commissioner observes that for two route groups, i.e. the major and northern groups, much of the asset base (both vessels and terminals) was renewed and upgraded in performance term two. This results in price caps which, in some measure, now reflect replacement costs. For these two groups the commissioner is satisfied that amortization charges now sufficiently reflect current replacement costs for the purposes of this price cap review. For future price cap reviews, the commissioner is better positioned to adopt full replacement costing.

*Minor route group not close*

This is not the case for the minor route group, where the asset base is relatively aged. For the minor routes this price cap review finds that, even without moving to replacement costing, there is a need to raise price caps substantially to address other cost increases, to adjust for weak traffic growth, and to allow BCFS to earn a return on equity.

Accordingly, having considered current replacement costing, the commissioner finds that continuing to use historical capital costs is, for the time being, the appropriate method of valuation for capital assets on these two groups.

**i. Return on Equity and Leverage**

The commissioner has made a determination of 12.73% as the before-tax rate of return on equity to be used in setting preliminary price caps.<sup>6</sup>

The commissioner has noted that BCFS' earnings over the current performance term are now expected to fall substantially below the level projected when the PT2 price caps were set. In fact BCFS' equity position at the end of the current performance term is expected to be lower than at the end of the first performance term reducing the company's debt/equity ratio to approximately 83/17. This situation may not be sustainable if traffic demand remains weak.

The commissioner considers that the price caps for the next performance term should allow BCFS to build equity up to give a more reasonable debt/equity ratio of approximately 75/25 by the end of performance term three.

In estimating BCFS' revenue requirements for financial sustainability, the commissioner has determined a weighted average cost of capital (WACC) of 7.01%, for all four years of PT3. This is equal to (1) 12.73% x 22.5% (percentage equity),

---

<sup>6</sup> Commission Memorandum 41 dated January 7, 2011

plus (2) 5.35% (BCFS' projected FY 2012 average cost of debt) x 77.5% (percentage debt).

The commissioner adjusted the allocation of the cost of capital among route groups, as was done in 2007 in setting price caps for PT2. The commissioner considers that the two route groups (northern and minor) which will have a portion of their revenue through PT3 guaranteed by taxpayer funding through performance term three (in the form of provincial service fee and federal subsidy) face less financial risk, other things being equal, than does the (amalgamated) major route group which does not receive taxpayer funding, and which depends entirely on revenues from ferry users. To reflect this consideration, the commissioner downward-adjusted to 5.72% the WACC for the taxpayer-supported groups, and correspondingly upward-adjusted to 7.79% the WACC for the major route group. This adjustment results in no change in the abovementioned corporate-wide WACC of 7.01%.

**j. Traffic Forecasts through 2016**

The commissioner's methodology for setting price caps requires a forecast of traffic to the end of PT3. Yet BCFS' submission states that it "has been unable to produce a traffic forecast, in which it has any degree of confidence, of travel demand through to the end of performance term three. Therefore, for purposes of establishing the price caps by route group, BC Ferries proposes that the commissioner use the current year forecast (2010/11) for each year of performance term three."<sup>7</sup>

The commissioner compared (a) the flat traffic forecast implied by BCFS' proposed approach with (b) alternative traffic forecasts generated by an econometric model independently produced for the commissioner. He has decided to accept BCFS' proposed approach on a preliminary basis but requests BCFS to submit, by May 31, 2011, an updated forecast using best practice methodology.

**k. Assumption on Changes to Service Contract**

In its plan<sup>8</sup> for providing services more efficiently in PT3, BCFS identifies nine route-specific opportunities, plus one opportunity applying to all routes. These opportunities mean changes to service levels and depend on government approval,

---

<sup>7</sup> BCFS, Performance Term Three Submission to the British Columbia Ferries Commissioner, September 30, 2010, page 66. See [http://www.bcferrycommission.com/PT3\\_Document\\_with\\_Duty\\_Updates\\_Clean.pdf](http://www.bcferrycommission.com/PT3_Document_with_Duty_Updates_Clean.pdf)

<sup>8</sup> BCFS, Opportunities for Enhanced Efficiency in Performance Term Three, October 2010. See [http://www.bcferrycommission.com/2010\\_10\\_13\\_PT3\\_Efficiency\\_Plan.pdf](http://www.bcferrycommission.com/2010_10_13_PT3_Efficiency_Plan.pdf)

*Ten efficiency opportunities requiring service level changes to be agreed between BCFS and provincial government*

through agreed changes in the CFSC, before they can be realized. They are:

- Elimination of Route 12 – Mill Bay to Brentwood Bay
- Alternatives for Route 40 – Discovery Coast
- Alternative Service Delivery for Shearwater and Ocean Falls
- Extension of Northern Service to Tsawwassen
- Change in Terminal Location for Route 19 – Gabriola to Nanaimo Harbour
- Elimination or Restructuring of Route 9 - Tsawwassen to Southern Gulf Islands
- Inclusion of Route 3 in the Major Route Group<sup>9</sup>
- Off-peak Saturday Service for Route 30 – Duke Point to Tsawwassen
- Alternatives to the Charter Agreement for the *Nicola*
- All Routes – Increased Flexibility

In this preliminary determination of price caps the commissioner has not made any adjustments in anticipation of such changes.

The commissioner urges the provincial government and BCFS, as parties to the CFSC, to seriously consider these and other opportunities to enhance efficiencies in the next performance term which, if implemented, could have a net beneficial impact on BCFS' revenues and expenditures. This would translate into lower-than-otherwise needs for fare revenue and/or taxpayer funding.

## **I. Commissioner's Productivity Challenge to BCFS**

While the commissioner accepts that BCFS will do well to manage its operating costs such that they will not increase beyond the rate of inflation built into its forecasts, there is no indication of targeted productivity improvements in PT3. On the contrary, BCFS has proposed that the commissioner allow the restoration in PT3 of \$15 million in cost reductions made by BCFS in PT2.

The commissioner finds there is insufficient justification for allowing such restoration. Accordingly, in setting the preliminary price caps for the third performance term, the

---

<sup>9</sup> This was subsequently agreed with the Province, on March 24, 2011. In terms of its service level impact, this change would appear to afford BCFS greater flexibility in managing the CFSC round trip requirements across the routes in the major route group.

commissioner has not recognized these costs. The commissioner believes BCFS should accept the challenge of maintaining the PT2 cost reductions and will treat the amount of \$15 million as the productivity challenge for PT3 in accordance with s.41(5) of the Act.

### **m. Alternative Service Providers**

The commissioner has not factored into the price caps any reduction in cost or productivity improvement that might be achieved by virtue of more of BCFS' routes being served by additional or alternative service providers ("ASPs").

#### *History of ASP Search*

Since the Coastal Ferry Act came into force in 2003, BCFS has committed considerable resources to the search for ASPs. Although it has sought, or prepared to seek, ASPs for some 10 of its 25 regulated routes, to date just one route (the passenger-only route connecting Langdale, Gambier and Keats) has actually been contracted for service by an ASP. Several factors explain this outcome.<sup>10</sup>

#### *Act's Provisions*

Section 41(2)(d) of the Act states that one of the principles by which the commissioner must be guided in this price cap review is that "the ferry operator is, on an ongoing basis, to actively seek [ASPs] to provide ferry services...in order to reduce the costs of providing services..."

Also, s.69 of the Act, as amended in 2010, empowers the commissioner to order BCFS to seek ASPs, requiring BCFS to prepare a plan for the commissioner to approve, which he may do provided he is satisfied that the plan proposes a fair and competitive process.

#### *Candidate Routes for ASPs Today*

In the commissioner's view, the following routes are among the current potential candidates for service by ASPs:

- Mid-coast service in the winter (re: Northern route group), pending finalization of discussions with the Province on potential vessel/service requirements;
- Powell-River-Comox and Powell River-Texada, pending clarification of a vessel and service strategy submitted to the Province by BCFS; and
- Buckley Bay-Denman Island, assuming that BCFS decides to convert service from free-running to cable ferry when it obtains the various environmental and other permits for which it has applied.

---

<sup>10</sup> See the commissioner's website for an elaboration of these factors at [http://www.bcferrycommission.com/asp\\_plan\\_milestones.html](http://www.bcferrycommission.com/asp_plan_milestones.html)



*Commissioner's Intention*

The commissioner intends to issue a formal Order under section 69 of the Act for BCFS to provide a plan to seek ASPs to provide service on these routes. Subject to feedback from ferry users, BCFS and stakeholders, the commissioner intends to issue the Order in conjunction with the final price cap decision, which is due by September 30, 2011.

## 4 Next Steps

### a. One Month for BCFS to Respond

BCFS will be given 30 days from the date of this Report to file a submission if it feels that:

- the above reductions in executive compensation, marketing costs and amortization of capital expenditures are unreasonable, and/or
- it is unreasonable for BCFS to meet the productivity challenge during the third performance term.
- the preliminary price caps pose a significant risk to the financial sustainability of BCFS during the next performance term relative to its ability to satisfy all of its obligations or covenants to its lenders.

### b. Three Months for Public Input

The commissioner intends to publish this preliminary decision immediately and will issue a notice in major media requesting public comments upon it.

The public will be requested also to comment on:

- a) BCFS' submission referred to immediately above, when it is received;
- b) the ten service level changes identified by BCFS as opportunities for efficiency in its October 2010 report; and
- c) as required by s.40(2)(a.1) of the Act, BCFS' Annual Reports and Quarterly reports to the Commission maintained under s.68(3).

The commissioner will consider the public feedback in his determination of the final price caps on September 30, 2011.

### c. Matters to be Considered Before Final Decision

The commissioner's *final* decision on price caps for performance term three must be issued by September 30, 2011.

Under the Coastal Ferry Act the Province and BCFS have until June 30, 2011 to consider changes to the CFSC before BCFS provides the commissioner with the version of the CFSC that will apply to the next performance term. Changes to the CFSC will be published by the commissioner.

After receiving the version of the CFSC that will apply to the next performance term the commissioner will finalize the price caps in light of any changes to the CFSC, any additional information and submissions received from the Province or from BCFS, and comments received from the public.

Additionally, among the matters remaining to be considered for the final price caps are:

- any changes in the CFSC beyond those indicated above;
- any extraordinary adjustments in costs, including potential adjustments resulting from the transition to International Financial Reporting Standards (IFRS), for which BCFS provides justification satisfactory to the commissioner by June 30, 2011; and
- changes in the forward looking rate for long term Canada bonds, affecting BCFS allowed return on equity.

\* \* \*