British Columbia Ferry Commission

Reasons for Determinations
Regarding Final Decision on Price Caps for Performance Term Three (PT3)

Background

Section 40 of the *Coastal Ferry Act* (the "Act") outlines the process and timelines for the determination of price caps for each Performance Term. Except for the initial Performance Term, which was for five years, all subsequent Performance Terms are four years in duration, with Performance Term 2 concluding on March 31, 2012. Performance Term Three (PT3) runs from April 1, 2012 until March 31, 2016.

The Act (prior to being amended) specified the following timelines for development of the PT3 price cap:

- By September 30, 2010, the ferry operator was required to submit to the Commissioner information about core service levels, tariffs, service fees, revenues from all sources, operating expenses, administrative expenses, expenses applicable to terminals, and requests for proposals issued.
- By March 31, 2011, the Commissioner was required to make the information received from the operator public, issue a preliminary decision on price caps for each route group, and invite public comment.
- By June 30, 2011, the ferry operator was required to submit to the Commissioner the most current version of the Coastal Ferry Services Contract that is to apply to the upcoming performance term, indicating any changes to core services and/or service fees from government.
- By September 30, 2011, the Commissioner was required to issue a final price cap decision for PT3.
- On April 1, 2012, the new price caps are to take effect.

Accordingly, Ferry Commissioner Martin Crilly announced a preliminary price cap decision for PT3 on March 31, 2011 and invited public comment. The preliminary decision was for price cap increases of 4.15% per year on the major routes and 8.23% per year on all other routes. On April 30, 2011, Mr. Crilly's term as Commissioner expired, and the new Commissioner was appointed effective May 1, 2011.

In June 2011, the Legislature passed Bill 14, which directed the Commissioner to undertake a six-month review of the *Coastal Ferry Act*, and submit a report to the Minister of Transportation and Infrastructure. The Bill established a price cap for the first year of PT3 at 4.15% for all routes, and directed the Commissioner to issue a final price cap decision for the remaining three years by September 30, 2012.

The Commissioners' report was delivered on January 24, 2012 as required, and contained 24 key recommendations for changes to the *Coastal Ferry Act*. Amendments to the Act were brought forward, passed, and came into force on June 28, 2012.

The principle changes to the *Coastal Ferry Act* are as follows:

- Cross subsidization between route groups is no longer prohibited;
- The primary role of the Commissioner is now to balance the interests of ferry users, taxpayers and the financial sustainability of the operator;
- The Commissioner can now issue orders to the operator to prepare plans or review policies which may not be in the interests of ferry users and taxpayers;
- The former provisions for return on equity have been repealed and replaced by a requirement that the Commissioner set price caps which allow the operator a return sufficient to meet debt obligations and maintain access to reasonable borrowing rates;
- Explicit authority for establishment of fuel deferral accounts and authority for the Commissioner to set terms and conditions;
- Additional tools provided to the Commissioner for addressing extraordinary circumstances;
- The Commissioner is now authorized to conduct performance reviews on the operator's operations;
- The Commissioner now must approve major capital expenditures, based on a determination on whether such expenditures are reasonable, prudent and consistent with the Coastal Ferry Services Contract and approved long term capital plans.

PT3 Price Cap Determination and Reasons

The price cap for year one of PT3 was set by Bill 14 at 4.15% for all route groups. The Commissioners are setting price caps for the remaining three years at a common level for all route groups at 4.1% for year 2; 4.0% for year 3; and 3.9% for year four.

The preliminary price cap decision was for 4.15% per year on the major routes and for 8.23% per year on all other routes.

Subsequent to posting of the preliminary decision, the operator provided the Commissioner with a legal opinion, which argued that the preliminary price cap decision was not compliant with the legislation, and had been set too low. There were four specific citings of error. The Commission recalculated the preliminary price caps based on this legal opinion, and the result produced year one price cap increases ranging from 16.4% on the majors, to 43.1% on the minors and 81.1% in the north.

It should also be remembered that the preliminary decision was based on a forecast which predicted that traffic would be flat for the duration of PT3. In the period of time that elapsed between the submission of the traffic forecast to the posting of the preliminary decision, traffic had in fact declined by over 3%, meaning the increases noted above may still have been too low. This analysis was a key factor in the Commissioner's proposal to the Minister of Transportation and Infrastructure that the price cap setting model was in need of a review.

The price cap decision for the final three years of PT3 are well below the numbers outlined in the discussion above, for the following main reasons:

1. Legislative changes have shifted the price cap calculations away from a Return on Equity model which has provided significant relief to price caps, while still ensuring the ongoing financial sustainability of the operator.
2. The Province has committed additional transportation service fee support for PT3 to the ferry system, and a one-time equity injection, to improve the operator's balance sheet. The equity injection strengthens the key financial ratios for debt service coverage and debt-to-equity.
3. The prohibition on cross subsidization between route groups has been eliminated.

One of the key recommendations in the Commissioners' report was to set a target of CPI for future increases to price caps. This was based on concerns that rapidly rising fares may contribute to further traffic declines which in turn could put financial sustainability at risk. At the time of this writing, provincial CPI is 2.6%. Price caps will be higher than CPI for the remainder of PT3, but noting the current global economy and the fiscal challenges confronting government, the Commissioners consider price caps in the 4% range to be a considerable improvement over the preliminary price caps. The Commissioners are satisfied that the downward trend in the price caps over the next three years is moving in the direction of meeting a CPI target within a reasonable time frame.

The final decision on price caps for the remainder of PT3 is based on updated traffic information which factors in the decline in traffic that was referred to earlier. Looking forward, the Commissioners have accepted the projection for a flat situation for the foreseeable future, ie, no growth and no further declines. This assumption is recognized as the greatest risk factor to the price cap decision. There are predictions for both economic recovery and further economic declines. If there is a recovery which translates into higher traffic over the next three years, the financial situation for the operator will improve considerably, and will allow for further reductions to price caps in future performance terms. If things go the other way, there is a risk that the operator will need to seek relief under section 42 of the Act. If that occurs, the Commissioners will be required to consider adjustments to price caps, reductions in service levels, operating efficiencies, or such other interventions as necessary to maintain a financially viable operator. Given the wide range of views about the economy and the low level of confidence in traffic projections for the future, the Commissioners have elected to accept the flat traffic forecast for purposes of price cap setting at this point.

Financial Performance Metrics:

The ferry operator goes to the private market to raise capital to finance fleet renewal and terminal upgrades. Those borrowings are governed by a Master Trust Indenture (MTI), which specifies certain financial ratios which must be maintained. If those ratios are not achieved, there is a risk that the operator may not be able to renew debt which expires, may not be able to raise new capital in future, and may be faced with higher interest rates to service its debt.

The Commissioners have been guided by the financial metrics in the MTI in setting the price caps. The price caps are set to allow the operator to achieve a level of equity not lower than 17.5% of total capitalization and a debt service coverage ratio of 2.5 or higher by the end of PT3. The MTI minimums are 15% and 2.0 respectively. It is not reasonable to require the operator to perform at the minimum allowable level on an ongoing basis. Accordingly, the price caps make allowance for a reasonable margin of safety above the minimums specified in the MTI. To be clear, the Commissioners realize that these metrics may not be achieved at all times during the course of PT3, and that there could be times when performance falls below the minimums. However, if it becomes clear that either of the key performance metrics cannot be achieved and sustained by the end of the Performance Term the Commissioners would consider that sufficient reason to be considering an application for relief under section 42 of the Act. The Commissioners fully recognize the necessity of continued access to financing at favourable interest rates in future.

Price Cap index:

The price cap index is a calculation of maximum allowable weighted average fares for each route group. The Ferry Commission website posts the index on a graph, which plots the price cap with the actual weighted average fares for each route group. If the actual weighted average fares exceed the allowable amount, the operator is required to give back the excess amounts in the form of a fare discount until the excess amount is eliminated. There are times when the actual average weighted fares fall below what is allowed, and a gap is created.

The most recent amendments to the Coastal Ferry Services Contract specify that route groups 1 and 2 will be collapsed into a single route group. Bill 14 specified a price cap for all route groups at 4.15% and prohibited the operator from increasing fares above that rate, even if there was unused price cap room available from previous years.

At the end of PT2, there was in fact a gap between actual average weighted fares and the price cap on some route groups, meaning the operator had not implemented the full amount of fare increases that was permitted. Price caps are an upper limit on fares, but there is nothing preventing the operator from applying fares below the price cap if they choose. This has occurred from time to time when the operator determines that fare increases could not be achieved on a particular route group without an offsetting loss of ridership that would equal or exceed the additional revenue it hopes to gain. This does mean that the operator is able to "catch up" on available room for fare increases at a point in the future.

To eliminate the gaps, which were forecasted for the end of PT2, the provincial government has provided an additional amount of service fees and an injection of equity to improve the operator's balance sheet. With these complex factors in mind, the Commissioners have concluded that the price cap index has become excessively complicated, and is no longer intuitive or easily understood by the general public. Accordingly, the index will be reset to 100 as of April 1, 2012, based on the actual weighted average fares in effect on March 31, 2012. This means the operator cannot catch up on any unused price cap room that existed at the end of PT2. At the end of the first year the index for all route groups will be 104.15 based on the Bill 14 provision for a price cap increase of 4.15%. At the end of year two, the index will be 100 + 4.15 + 4.1, and so on.

Efficiency Target:

The Province's commitment of additional transportation service fees came with some conditions. The operator is required to find $15 million in additional operating efficiencies during PT3, and must make service level adjustments which will deliver an additional $30 million net saving. In the preliminary price cap decision, an efficiency target was already factored into the calculations, and the operator had accepted that efficiencies of $9.8 million per year could be achieved. That $9.8 million in each of four years, plus the additional $15 million imposed by government totals $54.2 million in efficiencies which the operator is required to achieve during PT3. The Commissioners will not consider a section 42 application, should one come forward, without evidence that these efficiency targets are being met.

Service Level Adjustments:

The price cap financial modeling has assumed a $30 million net saving to operating costs as a result of service level adjustments during PT3. The Province has announced an extensive public consultation process aimed at identifying where those adjustments will occur, and at the same time, to begin framing a long-term vision for ferry services in future. The result of this process is expected to include an amendment to the Coastal Ferry Services Contract, specifying the service adjustments and the projected savings. If the contract has not been amended by June 30, 2013, or some other means of closing the $30 million shortfall has not been identified, the operator may make an application under section 42 for price cap relief.

The Commissioners' financial projection for BC Ferries in PT3 incorporating all of the above factors is attached hereto as Appendix A.

S. T. Stoilen

Gord Macatee
BC Ferries Commissioner

Sheldon Stoilen
BC Ferries Deputy Commissioner

Dated September 30, 2012 in Victoria

Ferry Commission Financial Projection for BC Ferries in PT3

All figures in $ Millions[1]

	2012-13	2013-14	2014-15	2015-16
Price Cap Increase	4.15%	4.10%	4.00%	3.90%
Operating Revenue[2]				
Tariff	508.0	528.8	550.0	571.4
Reservations	13.5	14.1	14.6	15.2
Catering & Other Revenue	82.3	83.9	85.6	87.3
Total Operating Revenue	603.8	626.8	650.2	673.9
Base Service Fees[3]	141.1	128.8	127.4	126.2
Additional Service Fees	10.0	10.5	11.0	11.5
Federal Subsidy	28.1	28.7	29.3	29.9
Total Revenue	783.0	794.8	817.9	841.5
Operating Expenses				
Base Operating Expenses[4]	588.9	599.9	612.0	624.0
BCFC Productivity Challenge	(9.8)	(9.8)	(9.8)	(9.8)
Bill 47 Announcement: Efficiency Target	0.0	(5.0)	(5.0)	(5.0)
Total Productivity and Efficiency Target	(9.8)	(14.8)	(14.8)	(14.8)
Bill 47 Announcement: Net Impact of Service Adjustments	(1.0)	(1.0)	(14.0)	(14.0)
Total Operating Expenses	578.1	584.1	583.2	595.2
EBITDA[5]	204.9	210.7	234.7	246.3
Amortization	(136.0)	(144.3)	(150.9)	(155.8)
Net Financing Expense	(72.9)	(71.0)	(71.5)	(71.8)
Other Income	2.4	2.4	2.4	2.4
Net Earnings	(1.5)	(2.2)	14.7	21.1
Capital Expenditures[6]	114.5	138.4	179.9	207.7
Debt and Equity Metrics				
Total Debt Service (Principal and Interest)[6]	83.3	82.4	92.8	97.1
Debt Service Coverage Ratio (DSCR)[7]	2.49	2.59	2.56	2.56
Equity as a Percentage of Total Capitalization	17.6%	17.2%	17.6%	18.0%
Debt as a Percentage of Total Capitalization	82.4%	82.8%	82.4%	82.0%

Notes

1. Financial projection reflects the transition by BC Ferries to IFRS effective April 1, 2012.
2. Tariff and reservations revenue forecast for 2012/13 are based on BC Ferries' financial forecast submitted on June 18, 2012. The projection for tariff and reservation revenue for the balance of PT3 is based on the impact of price cap increases. Catering and other revenues are inflated at 2% per year.
3. Base Service Fees are based on amendments to the Coastal Ferry Services Contract effective April 1, 2012.
4. Base Operating Expenses are based on BC Ferries' financial forecast submitted on June 18, 2012 and inflated at 2% per year.
5. Earnings before interest, taxes, depreciation and amortization.
6. Capital Expenditures and Total Debt Service are based on BC Ferries' financial forecast submitted on June 18, 2012.
7. DSCR is calculated as the ratio of EBITDA plus Other Income divided by Total Debt Service (Principal and Interest).