



OFFICE OF THE
BRITISH COLUMBIA
FERRIES COMMISSIONER

ORDER NUMBER: 16-01

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IN THE MATTER OF

Section 45.1 of the *Coastal Ferry Act*, S.B.C. 2003, c. 14
And Regulation of Unfair Competitive Advantage

BEFORE: Gord Macatee, British Columbia Ferries Commissioner
Sheldon Stoilen, British Columbia Ferries Deputy Commissioner
(collectively, the "Commissioner")

DETERMINATIONS

WHEREAS:

- A. In 2010-11, after conducting a review of British Columbia Ferry Services Inc. ("BC Ferries") drop trailer service pursuant to section 45.1 of the *Coastal Ferry Act*, S.B.C. 2003, c. 14 (the "Act"), the Commissioner determined that:
- i. the drop trailer service offered by BC Ferries on its major routes was a competitive service, as defined by the Act;
 - ii. BC Ferries was pricing its drop trailer service below its direct costs and an appropriate proportion of indirect costs associated with providing that service; and
 - iii. BC Ferries had certain unfair competitive advantages in providing its drop trailer service.

- B. As a result of the determinations made in (A) above, the Commissioner issued Order 11-01 and Confidential Order 11-01A (originally issued February 7, 2011, and subsequently amended March 4, 2011), Memorandum 42, requiring BC Ferries to charge a minimum average allowable tariff (“MAAT”) at a level that would recover direct costs and an appropriate portion of indirect costs, including a corporate and route overhead charge, associated with its drop trailer service;
- C. Confidential Order 11-01A stipulated a certain volume of drop trailer business that, when met, would trigger a review by the Commissioner;
- D. The Commissioner, having received notice from BC Ferries that it had reached the volume of drop trailer business stipulated in Confidential Order 11-01A, issued a public notice in that regard on December 2, 2015, and invited submissions from interested parties regarding the Commissioner’s review;
- E. The Commissioner retained PricewaterhouseCoopers LLP to assist in the review of relevant financial information provided by BC Ferries, related to the Commissioner’s review;
- F. The Commissioner has reviewed and considered all of the submissions received from interested parties on this matter; and,
- G. The Commissioner has released Reasons, dated September 6, 2016, setting out in full the Commissioner’s reasons and determinations related to this Order.

NOW THEREFORE the Commissioner has determined that:

1. BC Ferries’ drop trailer service on its major routes remains a “competitive service”, as defined in the Act.
2. Since the inception of the MAAT, BC Ferries has not, and is not currently, pricing its competitive drop trailer service below its direct costs and the appropriate proportion of indirect costs associated with providing that service.
3. BC Ferries does not have any unfair competitive advantages in providing its drop trailer service.
4. Given that BC Ferries is not pricing its drop trailer service below costs, and given that BC Ferries does not have any unfair competitive advantages in providing its drop trailer service, the Commissioner is not authorized by the Act to set a minimum tariff for the drop trailer service.

5. It was unnecessary for the Commissioner to make a determination regarding whether he could consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making this determination under section 45.1.
6. To ensure BC Ferries does not price its drop trailer service below cost in future, BC Ferries will be required to submit quarterly reports to the Commissioner, on a four quarter rolling basis, of revenues, direct costs and the appropriate proportion of indirect costs associated with its drop trailer service, as determined by the Commissioner (the "Drop Trailer Quarterly Reports"). The Commissioner will undertake independent audits of the Drop Trailer Quarterly Reports from time to time, at the Commissioner's discretion.
7. BC Ferries' commercially sensitive financial information, including that provided to the Commissioner in the Drop Trailer Quarterly Reports, should be held in confidence to protect its commercial interests. In the Commissioner's view, disclosure of such information could reasonably be expected to harm BC Ferries' financial interests.
8. This Order supersedes Order 11-01, Confidential Order 11-01A and Memorandum 42. The MAAT set pursuant to Order 11-01 and Confidential Order 11-01A is discontinued, effective September 6, 2016.

DATED in Victoria, in the Province of British Columbia, this 6th day of September, 2016.

BY ORDER



Gord Macatee
British Columbia Ferries Commissioner



Sheldon Stoilen
British Columbia Ferries Deputy
Commissioner



British Columbia Ferries Commissioner

IN THE MATTER OF

Section 45.1 of the *Coastal Ferry Act*, S.B.C. 2003, c. 14

And Order 11-01 and Confidential Order 11-01A

Reasons for Order 16-01

September 6, 2016

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PART I - OVERVIEW

British Columbia Ferry Services Inc. ("BC Ferries"), an independent corporation, is the only ferry operator having a Coastal Ferry Services Contract with the Province of British Columbia. As such, it is the only ferry operator regulated by the British Columbia Ferries Commissioner (the "Commissioner"), under the *Coastal Ferry Act*, S.B.C. 2003, c. 14 (the "Act").

In 2009, BC Ferries began to offer a drop trailer service onboard its existing roll-on roll-off vessels on certain of its scheduled sailings. Drop-trailer services allow truckers to leave loaded and/or empty highway trailers at the ferry dock for transport without tying up their own power units (tractors). At the time BC Ferries entered the drop trailer market, it competed with two other private sector service providers already in the business, Seaspan Ferries Corporation (formerly Seaspan Coastal Intermodal Company) ("Seaspan") and Van-Isle Barge Services Ltd. Currently, to the Commissioner's knowledge, Seaspan is the only drop trailer service provider in competition with BC Ferries.

In 2010, the Provincial Government amended the Act to include section 45.1, which broadened the Commissioner's role in regulating ferry transportation services. Section 45.1 of the Act requires the Commissioner to determine whether BC Ferries is pricing a competitive service (such as carriage of drop trailers) lower than its direct costs and an appropriate portion of its indirect costs, or whether BC Ferries has an unfair competitive advantage in delivering a competitive service. If the Commissioner finds that either of these scenarios exists, it must order BC Ferries to provide the competitive service through an alternative service provider or to charge a minimum average tariff, to be set by the Commissioner.

In 2010 and 2011, in light of the amended Act, BC Ferries' entry into the drop trailer service market, and complaints from its competitors that BC Ferries was competing unfairly in the drop trailer market, the Commissioner conducted a section 45.1 review of BC Ferries' drop trailer service. As part of that review, the Commissioner found that the drop trailer service offered by BC Ferries on its major route group was substantially similar to services provided by two competitors, and that BC Ferries' drop trailer service was thus a competitive service, as defined under the Act. The Commissioner determined that, at the time, BC Ferries was pricing its drop trailer service below its direct costs and an appropriate portion of its indirect costs. The Commissioner further determined that BC Ferries had two unfair competitive advantages in providing its drop trailer service.

As a result, on February 7, 2011, the Commissioner issued Order 11-01 and Confidential Order 11-01A, which set a minimum allowable average tariff that BC Ferries could charge for drop trailers on its major routes, commencing in April 2011. Order 11-01 also set a horizon traffic volume for drop trailers on BC Ferries which, if attained in the future, would trigger a review of the minimum average allowable tariff for BC Ferries' drop trailer service.

The horizon traffic volume set out in Order 11-01 was met in June 2015. On December 2, 2015, the Commissioner issued a notice to the public regarding its intention to review the minimum average allowable tariff for BC Ferries' drop trailer service, and invited submissions from interested parties.

These Reasons set out the Commissioner's review process and determinations in relation to BC Ferries' drop trailer service, pursuant to section 45.1 of the Act. The Commissioner notes that regulatory interventions in the market can carry a risk of unintended consequences, which could be detrimental to residents of communities which depend on drop trailer services to deliver essential supplies. Accordingly, the Commissioner believes a cautious approach is particularly important under the circumstances, and the minimum necessary intervention in a competitive marketplace is appropriate, while still adhering to the requirements of section 45.1 of the Act, and the Act generally.

In summary, upon review of all submissions from all interested stakeholders and a financial analysis provided to the Commissioner by PriceWaterhouseCoopers LLP, and based upon the Commissioner's analysis contained in these Reasons, the Commissioner has determined that:

- 1) BC Ferries' drop trailer service is a "competitive service" as defined in the Act;
- 2) BC Ferries is not pricing its drop trailer service below its direct costs and the appropriate proportion of indirect costs associated with providing that service;
- 3) BC Ferries does not have any unfair competitive advantages in providing its drop trailer service;
- 4) No minimum average allowable tariff is necessary and the minimum average allowable tariff set pursuant to Order 11-01 and Confidential Order 11-01A is discontinued, effective September 6, 2016;
- 5) It is, at this point in time, unnecessary for the Commissioner to make a determination regarding whether he can consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a determination under section 45.1 of the Act;
- 6) BC Ferries will be required to submit a quarterly report to the Commissioner, on a four quarter rolling basis, of revenues, pricing, direct costs and the appropriate proportion of indirect costs, as determined by the Commissioner, associated with its drop trailer service; and
- 7) BC Ferries' commercially sensitive financial information should be held in confidence.

These determinations are explained in detail in Part VI of these Reasons, and set out in full in Part VII of these Reasons.

PART II - REGULATORY FRAMEWORK

A. The Coastal Ferry Act, BC Ferries and the Coastal Ferry Services Contract

Introduced in 2003, the *Coastal Ferry Act* provides the legislative framework under which BC Ferries operates, and provides the regulatory mandate for the Commissioner.

BC Ferries, which is the successor to the crown British Columbia Ferry Corporation, was created in 2003 by the Province, as a corporation under the *Company Act (British Columbia)* (now called the *Business Corporations Act (British Columbia)*), and as a ferry operator under the Act.

BC Ferries is the only ferry operator to have a Coastal Ferry Services Contract with the Province of British Columbia; as such, BC Ferries is the only ferry operator regulated by the Commissioner. Pursuant to the 60-year Coastal Ferry Services Contract, BC Ferries is required to provide route-specific minimum levels of ferry service on various saltwater routes that have been designated as regulated. BC Ferries cannot, at will, go below the minimum level of services it has agreed to provide on certain routes. Generally, this minimum service requirement results in the delivery of more service and surplus capacity, particularly in off-peak periods.

In 2009, in part as a result of surplus capacity, BC Ferries began offering a drop trailer service on certain of its routes in order to increase utilization and earnings; both of which the Commissioner recognizes as legitimate and important corporate objectives of BC Ferries.

B. BC Ferries Commissioner

When BC Ferries was created, the Province also established the office of the BC Ferries Commissioner, a quasi-judicial regulatory agency operating under the Act, represented by a Commissioner and a Deputy Commissioner (collectively, the "Commissioner"). The Commissioner regulates BC Ferries on 24 saltwater routes. The Commissioner is independent of both the provincial government and of BC Ferries.

In 2011, in large part as a response to public concerns regarding rising ferry fares the Province requested that the Commissioner conduct a review of the Act and provide recommendations for changes to the Act. The Commissioner's review involved an assessment of the price cap model in place at the time, and its impact on affordability of future ferry fares and the sustainability of ferry-dependent coastal communities, as well as an assessment of the relative efficiency of BC Ferries compared to other ferry operators. On January 24, 2012, the Commissioner released a report with recommendations for amendments to the Act, which, in the Commissioner's view, would better balance the interests of ferry users, taxpayers and BC Ferries.

In May 2012, the Provincial legislature amended the Act, adopting most of the Commissioner's recommendations (the "2012 Amendments"). Notable changes to the Act as a result of the 2012 Amendments—particularly in the context of the role of the Commissioner—included changing the financial sustainability target for setting price caps for regulating fares; broadening of Commissioner's regulatory oversight powers; and changing the focus of the primary role of the Commissioner. These changes are briefly discussed below.

1) Regulating fares

The primary responsibility of the Commissioner is to regulate ferry fares. Every four years, the Commissioner sets a ceiling, or "price cap", on the average level of fares that BC Ferries can charge.

The 2012 Amendments changed the principles applicable to price cap reviews by the Commissioner. When setting the price cap, the Commissioner must now allow for a return sufficient to enable BC Ferries to meet its debt obligations and maintain access to reasonable borrowing rates. Further, when setting the price cap, the Commissioner must now balance the interests of ferry users, taxpayers and the financial sustainability of the ferry operator. In addition, pursuant to the 2012 Amendments, there is no longer a prohibition on cross subsidization among route groups; for price cap setting purposes, the route groups are consolidated into one system wide route group.

This is in contrast to the prior price cap setting model, which required the Commissioner to set the price cap for each route group without reference to the price cap set for any other route group, and required price caps be set based on a target pre-tax return on equity, calculated by adding an equity risk premium and a bond yield that was consistent with Government of Canada bonds.

The methodology for setting the price caps before and after the 2012 Amendments are similar in that, after determining subsidy levels and the forecast for ancillary revenue for the next performance term, the revenue required from tariffs is calculated based on achieving the targeted return on equity (pre-2012 Amendments) or satisfying certain debt/equity and debt service coverage ratios (post-2012 Amendments).

The Commissioner recognizes that, as a result of the price caps set by the Commissioner, BC Ferries will only reach its financial targets if it reaches the productivity targets set by the Commissioner. The Commissioner further recognizes that BC Ferries' drop trailer service is a legitimate part of its efforts to meet these financial targets, and demonstrates an innovative commercial approach to ferry service delivery.

2) Regulatory oversight

The 2012 Amendments enhanced the regulatory oversight powers of the Commissioner to improve the efficient delivery of coastal ferry services. As a result of the 2012 Amendments, the Commissioner is now required to approve major capital expenditures and is able to conduct routine performance reviews, request ferry operators to prepare plans, review policies and conduct public consultations.

Other key tasks of the Commissioner include monitoring BC Ferries' adherence to the terms of the Coastal Ferry Services Contract, regulating unfair competitive advantage (pursuant to section 45.1 of the Act) and the approval and monitoring of BC Ferries' customer complaints process.

3) Primary role of the Commissioner: section 38(1) of the Act

Section 38(1) of the Act sets out the principles the Commissioner must adhere to in regulating core ferry services under the Act. The 2012 Amendments resulted in a shift in the principles set out in section 38(1). Prior to the 2012 Amendments, section 38(1)(a) directed that "priority is to be placed on the financial sustainability of the ferry operator."¹ The 2012 Amendments to section 38(1)(a) shifted the Commissioner's primary role; the Commissioner is now required to balance, in the manner the Commissioner considers appropriate, the interests of ferry users, taxpayers, and the financial sustainability of the ferry operator.

Section 38(1) provides as follows:

38 (1) Without limiting any other power of the commissioner under this Act, the commissioner must, after considering public feedback obtained under this Act, regulate each ferry operator in relation to the core ferry services that are to be provided by that ferry operator and the tariffs, including, without limitation, reservation fees, that may be charged for those core ferry services, and must undertake that regulation in accordance with the following principles:

(a) the primary role of the commissioner is to balance, in the manner the commissioner considers appropriate,

(i) the interests of ferry users,

(ii) the interests of taxpayers, and

(iii) the financial sustainability of ferry operators;

(b) ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;

¹ *Coastal Ferry Act*, [SBC 2003] c. 14 at s. 38(1)(a) [no longer in force, as of June 25, 2012]

(c) ferry operators are to be encouraged to seek additional or alternative service providers on designated ferry routes through fair and open competitive processes;

(d) ferry operators are to be encouraged to be innovative and to minimize expenses without adversely affecting their safe compliance with core ferry services;

In addition to the changes to the Commissioner's primary role in section 38(1)(a), the 2012 Amendments also deleted two principles from section 38(1) of the Act. First, the 2012 Amendments removed a requirement that cross-subsidization from major routes to other designated ferry routes be eliminated (formerly section 38(1)(e)). Second, the 2012 Amendments removed a requirement that greater reliance be placed on a user pay system (formerly section 38(1)(f)).

C. Regulating competitive services: section 45.1 of the Act

In 2010, the Provincial legislature amended the Act to include section 45.1, which requires the Commissioner to regulate competitive services provided by BC Ferries. Section 45.1 provides that, if BC Ferries is operating a competitive service, the Commissioner must regulate that service if either of two conditions exists:

- i. BC Ferries is pricing the competitive service below the direct costs and an appropriate portion of the indirect costs of providing that service; or
- ii. BC Ferries has an unfair competitive advantage in providing that service.

Section 45.1 provides as follows:

45.1(1) If a ferry operator is providing a competitive service, the commissioner must determine whether the ferry operator is pricing the service below the direct costs and an appropriate proportion of the indirect costs associated with providing that ferry transportation service, or has an unfair competitive advantage, including, without limitation, an advantage resulting from the ferry operator having been provided with

(a) use of, access to or ownership of vessels or terminals that are or had been owned by the government or a government body within the meaning of the Financial Administration Act,

(b) any tax exemption, or

(c) any subsidy.

(2) If the commissioner makes the determination referred to in subsection (1), the commissioner must regulate the ferry transportation service in one of the following ways:

(a) make an order under section 69 (1) and, after an alternative service provider satisfactory to the commissioner has been located through a competitive process established in a plan approved under section 69 (4) (a) or created under section 69 (4) (b) (i), order the ferry operator to arrange with that alternative service provider, under contract, franchise agreement or otherwise, for the alternative service provider to provide the ferry transportation service;

(b) 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 subsection (1) of this section present, and order the ferry operator to charge at least that tariff when providing that ferry transportation service.

D. Relevant definitions in the Act

The Act, at section 1, provides certain definitions, which are relevant to the Commissioner's review pursuant to section 45.1 of the Act, as follows:

- "competitive service" means a ferry transportation service, including, without limitation, a drop trailer service, that is the same as or substantially similar to a service being provided
 - (a) by a person other than a ferry operator, and
 - (b) in a geographical area that is sufficiently near to where the ferry transportation service is or may be provided that the 2 services could reasonably be in competition.
- "core ferry services" means, in relation to a ferry operator, the ferry transportation services that the ferry operator is required to provide under the Coastal Ferry Services Contract;
- "drop trailer service" means a service in which a ferry operator
 - (a) loads on a vessel,
 - (b) transports on the vessel on a major route, and
 - (c) unloads from the vessela trailer left with the ferry operator for those purposes;

PART III - 2010 DROP TRAILER REVIEW

As a result of BC Ferries' entry into the drop trailer service market in 2009, the amendments to the Act to include section 45.1 in 2010, and assertions by competitors in the drop trailer market that BC Ferries was competing unfairly in providing its drop trailer service, in 2010-2011 the Commissioner engaged in a section 45.1 review of BC Ferries' drop trailer service (the "2010 Drop Trailer Review").

A. Memorandum 37

As part of the 2010 Drop Trailer Review, on July 19, 2010, the Commissioner found that BC Ferries' drop trailer service is a "competitive service", as defined by section 1 of the Act. This finding is set out in the Commissioner's Memorandum 37, dated July 19, 2010.

In Memorandum 37, the Commissioner found that the drop trailer service offered by BC Ferries on its major route group was substantially similar to services being provided by Seaspan and Van Isle Barge Services Ltd, and in service areas sufficiently near to those service providers, that the Commission considered that BC Ferries drop trailer service was in competition with these providers. Accordingly, the Commissioner found that BC Ferries drop trailer service on its major routes across Georgia Strait was a competitive service, as defined in section 1 of the Act.

B. Memorandum 42, Order 11-01 and the April 29, 2011 Reasons

Having made the finding that BC Ferries' drop trailer service was a competitive service, the Commissioner was required to make a determination under section 45.1 of the Act, regarding whether BC Ferries was pricing its drop trailer service below costs, or if BC Ferries had any unfair competitive advantages in its drop trailer service.

In the course of the 2010 Drop Trailer Review, the Commissioner received submissions from BC Ferries, stakeholders and the public. Further, the Commissioner retained the consulting firm of PricewaterhouseCoopers LLP to review relevant cost information provided by BC Ferries and to recommend adjustments required to account for any sources of unfair competitive advantage BC Ferries may have.

On February 7, 2011, the Commissioner issued Order 11-01 in both non-confidential and confidential versions (subsequently amended March 4, 2011). On the same date the Commissioner issued Memorandum 42, which provided a summary of his determinations on the 2010 Drop Trailer Review. The Commissioner provided a detailed analysis of the 2010 Drop Trailer Review, in Reasons dated April 29, 2011², which support Memorandum 42, Order 11-01 and Confidential Order 11-01A.

² British Columbia Ferries Commissioner Reasons for Determination for Order 11-01, *In the matter of Section 45.1 of the Coastal Ferry Act, S.B.C. 2003, c. 14 and regulation of competitive advantage respecting BCFS' drop trailer services on its major routes* (April 29, 2011) ["2011 Reasons"].

In the 2010 Drop Trailer Review, the Commissioner concluded that:

- 1) BC Ferries was charging its drop trailer customers less than the direct costs and an appropriate proportion of indirect costs; and
- 2) BC Ferries had two unfair competitive advantages in providing its drop trailer services; first, due to the price cap regulatory framework in which it operates, and second, due to its exemption from corporate income tax.

To regulate the drop trailer service provided by BC Ferries, the Commissioner, by Order 11-01 and Confidential Order 11-01A and Memorandum 42, set a minimum allowable average tariff ("MAAT") that BC Ferries would be allowed to charge for drop trailers on its major routes, commencing in April 2011.

The Commissioner also stated in Confidential Order 11-01A a horizon traffic volume for drop trailers on BC Ferries which, if attained in the future, would trigger the Commissioner's review of the MAAT. That horizon traffic volume was met in June, 2015, which triggered the 2016 Drop Trailer Review.

PART IV - 2016 DROP TRAILER REVIEW PROCESS

In June 2015, BC Ferries advised the Commissioner that its drop trailer service had reached the horizon traffic volume stated in Confidential Order 11-01A, triggering the current review by the Commissioner of the MAAT set by Order 11-01 (the "2016 Drop Trailer Review").

A. Review process

In conducting the 2016 Drop Trailer Review, the Commissioner sought to engage in a review process that was both procedurally fair and transparent to the public, and which took into account the views of all stakeholders. In that regard, on December 2, 2015, the Commissioner issued a notice to inform the public that BC Ferries had surpassed the drop trailer volume specified in Confidential Order 11-01A, and that the Commissioner would be conducting a review of the MAAT. Submissions were invited to be provided to the Commissioner on or before January 15, 2016.

A total of 8 submissions were received and accepted by the Commissioner by January 15, 2016. Based on the submissions received, the Commissioner issued a Notice of Procedures (originally issued February 1, 2016 and revised on April 13, 2016) that outlined five questions the Commission intended to consider in the 2016 Drop Trailer Review, as follows:

- 1) Is BC Ferries pricing the drop trailer service below the direct costs and an appropriate portion of indirect costs associated with providing that ferry transportation service?
- 2) Does BC Ferries have an "unfair competitive advantage" in the drop trailer business which requires a determination by the Commissioner under section 45.1 of the *Coastal Ferry Act* (the "Act")? The Commissioner requests evidence to be filed to support the position that there is an unfair competitive advantage or to support the position that there is no unfair competitive advantage.
- 3) If the answer to (1) or (2) is affirmative, which of the available remedies set out in section 45.1 of the Act should the Commissioner employ? If the answer to (3) is a tariff, what factors should be taken into account in setting a tariff, and how frequently would it reasonably need to be adjusted?
- 4) If the existing minimum tariff needs to be reset, are there any alternatives to a confidential order which would provide a transparent result, without compromising legitimate concerns about commercial confidentiality by any of the parties in the drop trailer business?

- 5) Does any provision of the Act compel the Commissioner to consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a decision under Section 45.1?

The Notice of Procedures invited the 8 persons or entities that filed submissions by the January 15, 2016 deadline to make further submissions, both to respond to arguments in any or all of the other submissions and to address the above questions set out by the Commissioner. The deadline for additional submissions was set for March 1, 2016, though this deadline was repeatedly extended, ultimately to May 20, 2016, with final responses to submissions due by June 10, 2016.

A summary of the submissions received in the 2016 Drop Trailer Review is provided in Part V of these Reasons.

B. Engagement of PricewaterhouseCoopers LLP

The Notice of Procedures also provided notice to the public that the Commissioner intended to engage the accounting firm of PricewaterhouseCoopers LLP (“PwC”) to provide assistance to the Commissioner in the 2016 Drop Trailer Review.

PwC’s assisted the Commissioner with the 2016 Drop Trailer Review in two manners. First, PwC assisted the Commissioner in assessing BC Ferries’ compliance with the MAAT set out in Order 11-01, since its inception. Second, PwC assisted the Commissioner in providing an analysis of BC Ferries’ current financial information in connection with its drop trailer service, and with the assessment of tax and other impacts related to the drop trailer service, as requested by the Commissioner.

PwC’s methodology, calculations and analysis were provided in a report to the Commissioner (the “PwC Report”). The PwC Report is included in redacted form at **Appendix A** to these Reasons. Redactions of the PwC Report were made to ensure the confidentiality of commercially sensitive financial information provided by BC Ferries, in accordance with the principles regarding confidentiality outlined in these Reasons, and pursuant to the Act.

PART V - SUMMARY OF SUBMISSIONS RECEIVED IN THE 2016 DROP TRAILER REVIEW

The Commissioner received submissions regarding the 2016 Drop Trailer Review from the following parties:

- BC Ferries - submissions by Dennis Dodo
- Seaspan - submissions by Steve Roth
- Penta Transport Ltd. - submissions by Gord Putz, Ken Slawson and Cheryl Zmaeff
- Central Island Distributors - submissions by Alex Dugan
- BC Trucking Association - submissions by Greg Kolesniak and Louise Yako
- Vicki Huntington, MLA Delta South

Some parties, particularly BC Ferries and Seaspan, provided multiple submissions, often as a result of requests for further submissions by the Commissioner, or in response to each other's submissions.

The Commissioner notes that the summary of submissions provided in these Reasons is in no way comprehensive. The failure to refer to or discuss any specific submissions in these Reasons, either in whole or in part, does not in any way indicate a failure on behalf of the Commissioner to fully consider those submissions. All submissions were reviewed and considered carefully by the Commissioner in making his determinations in the 2016 Drop Trailer Review.

The submissions received in the 2016 Drop Trailer Review are available in full on the Commissioner's website.

A. Responses to Commissioner's request for submissions

As is set out in Part IV of these Reasons, in the Notice of Procedures the Commissioner sought submissions in response to five questions. Those questions, and a summary of the responses received in the submissions, are set out here.

- 1) **Is BC Ferries pricing the drop trailer service below the direct costs and an appropriate portion of indirect costs associated with providing that ferry transportation service?**

Seaspan submits that BC Ferries is pricing its drop trailer service below costs, because it is not including a return on equity component in its indirect cost calculations, and because indirect costs should no longer be calculated on an "off peak" assumption.

BC Ferries submits that BC Ferries is pricing its drop trailer service above direct costs and an appropriate portion of indirect costs.

In making submissions regarding whether BC Ferries is underpricing its drop trailer service, the parties generally focused on the appropriate method of calculating BC Ferries' costs in providing that service. These submissions apply to both the question of whether BC Ferries is currently underpricing, and also the issue of how to calculate a MAAT, if necessary.

The submissions generally raised four issues with respect to assessing BC Ferries' costs related to providing its drop trailer service: (1) whether to include BC Ferries' indirect costs in calculating the cost of providing the drop trailer service; (2) whether indirect costs should also include a return on equity component; (3) whether calculations should continue to be based on "horizon volumes"; and (4) whether the drop trailer service is or should be calculated on an "off peak" basis.

i. Indirect costs

BC Ferries submits that developments since the 2010 Drop Trailer Review—including, for example, changes in the drop trailer market and demands by drop trailer customers, as well as the importance of off-setting core ferry user fares with drop trailer revenues—should inform what is considered an appropriate allocation of indirect costs.³ BC Ferries submits that the aggregate effect of these changes means Seaspan has a competitive advantage over BC Ferries as a result of the MAAT currently in place.⁴

BC Ferries submits that an appropriate proportion of indirect costs of the drop trailer service should be zero. BC Ferries urges the Commissioner to adopt an average avoidable cost approach, and to conclude that only the direct costs of the drop trailer service are avoidable, and thus no allocation for indirect costs should be made.⁵ BC Ferries relies on the opinion of its consultant, Dr. Roger Ware, in support of its submissions on indirect costs.

Seaspan submits that the changes in circumstances raised by BC Ferries are not relevant, as they are external factors that do not relate directly to the question of whether BC Ferries has priced its drop trailer service unfairly or whether it has unfair competitive advantages.⁶ Seaspan also refutes BC Ferries' assertion that only direct costs are relevant in determining the costs of providing its drop trailer service and submits that the average avoidable cost approach advanced by BC Ferries is inappropriate.⁷

³ BC Ferries submissions dated January 15, 2016 at pp. 15-20.

⁴ BC Ferries submissions dated January 15, 2016 at p. 20

⁵ BC Ferries submissions dated January 15, 2016 at pp. 2

⁶ Seaspan submissions dated May 20, 2016 at p. 17.

⁷ Seaspan submissions dated May 20, 2016 at pp. 17-20.

ii. Return on equity

Season submits that the Commissioner should include return on equity in the calculation of BC Ferries' costs in providing its drop trailer service, and that the failure to do so results in the underpricing of BC Ferries' drop trailer service, despite the existence of the MAAT.⁸

BC Ferries submits that the Commissioner's determination in the 2010 Drop Trailer Review, that a return on equity is not an applicable cost to the drop trailer service, remains valid.⁹

iii. Horizon volume of traffic

Both Seaspan and BC Ferries submit there is no longer a need for unit costs to be assessed on a projected volume of traffic rather than actual volume basis.¹⁰

iv. "Off peak" assumptions

Seaspan submits that the MAAT is currently calculated on an "off peak" basis; that is, it assumes that the deck space allocated to drop trailer traffic would be surplus space, otherwise unused by passengers.¹¹ Seaspan argues this approach results in an allocation of indirect costs attributed to BC Ferries' drop trailer service that is too low, as it leaves unaddressed the fact that other forms of traffic are being significantly forgone (or otherwise discriminated against) as a result of the provision of the drop trailer service.¹²

BC Ferries responds to Seaspan's submissions regarding the use of "off peak" assumptions by noting that the allocation of indirect costs to off-peak services is only justified on the basis of rate design principles that are not at play under the price cap regulatory framework applicable to BC Ferries.¹³ BC Ferries further submits that drop trailer services are subject to restrictions that are not applicable to live trailer services, and that allocating costs in a way that assumes drop trailer and live trailer use the system in the same way cannot be reconciled with the fact that BC Ferries operationally restricts drop trailer service and that drop trailer service represents a much small portion of its overall business.¹⁴

⁸ Seaspan submissions dated May 20, 2016 at pp. 10-12.

⁹ BC Ferries submissions dated May 20, 2016 at pp. 8-9.

¹⁰ Seaspan submissions dated May 20, 2016 at p. 21; BC Ferries submissions dated May 20, 2016 at p. 9.

¹¹ Seaspan submissions dated May 20, 2016 at pp. 8-10.

¹² Seaspan submissions dated May 20, 2016 at p. 8.

¹³ BC Ferries submissions dated June 10, 2016 at p. 9.

¹⁴ BC Ferries submissions dated June 10, 2016 at p. 9.

- 2) Does BC Ferries have an “unfair competitive advantage” in the drop trailer business, which requires a determination by the Commissioner under section 45.1 of the *Coastal Ferry Act*? The Commissioner requests evidence to be filed to support the position that there is an unfair competitive advantage or to support the position that there is no unfair competitive advantage.

The submissions touched on three potential sources of unfair competitive advantages available to BC Ferries’ in providing its drop trailer service, namely: (1) the regulatory regime under which BC Ferries operates (including the Coastal Ferry Services Contract); (2) tax exemptions; and (3) the Building Canada Fund.

i. Regulatory regime

BC Ferries submits that, if the Commissioner accepts BC Ferries’ submission that an appropriate portion of indirect costs is defined by average avoidable costs/incremental costing, then the Commissioner’s finding in the 2010 Drop Trailer Review, that there is an advantage inherent in the price cap regulatory framework, can no longer be sustained.¹⁵

Seaspan asserts that BC Ferries has an unfair competitive advantage as a result of the regulatory regime under which it operates, particularly given the existence of the Coastal Ferry Services Contract.¹⁶ Seaspan asserts that the findings of the Commissioner in the 2010 Drop Trailer Review remain valid in this regard. Seaspan submits that BC Ferries recovers all its costs from core services in return for accepting the obligation to undertake a defined number of sailings, which in turn creates a surplus capacity and the incentive to adopt marginal pricing of its competitive services.¹⁷

ii. Tax exemptions

BC Ferries submits that changes to BC Ferries’ fiscal framework have reduced the potential impact of tax exemptions on its drop trailer business. BC Ferries submits that, as a result of the 2012 Amendments, the practical effect has been to reduce BC Ferries’ pre-tax return on equity from a regulated rate of 13.16% for Performance Term 2 to an actual rate of 7.83% for the first three years of Performance Term 3, which in turn reduces the impact of the tax exemption on BC Ferries’ drop trailer business.¹⁸ BC Ferries’ asserts that the existence of the tax exemption would be highly unlikely to affect pricing decisions and competition in the drop trailer market, and as such is not a competitive advantage.¹⁹

¹⁵ BC Ferries submissions dated June 10, 2016 at p. 32.

¹⁶ Seaspan submissions dated May 20, 2016 at pp 12-14.

¹⁷ Seaspan submissions dated May 20, 2016 at p. 12.

¹⁸ BC Ferries submissions dated January 15, 2016 at p. 20.

¹⁹ BC Ferries submissions dated January 15, 2016 at pp. 30-31

Seaspan submits that any tax advantage afforded to BC Ferries, no matter how small, should be considered an unfair competitive advantage.²⁰

iii. The Building Canada Fund

Seaspan submits that BC Ferries has an unfair competitive advantage as a result of the Building Canada Fund, an infrastructure program created by the federal government. Seaspan submits that the Building Canada Fund enables BC Ferries to acquire vessels in a preferential manner; an entitlement that Seaspan is not privy to.

BC Ferries submits that it has not, to date, received any funding or benefits from the Building Canada Fund, and has no knowledge that it will receive any in the future.²¹ BC Ferries further submits that the Building Canada Fund is accessible to private sector actors, and as such does not represent a competitive advantage to BC Ferries.²²

- 3) If the answer to (1) or (2) is affirmative, which of the available remedies set out in section 45.1 of the Act should the Commissioner employ? If the answer to (3) is a tariff, what factors should be taken into account in setting a tariff, and how frequently would it reasonably need to be adjusted?**

Both Seaspan and BC Ferries submit that a MAAT is the appropriate remedy if the Commissioner finds that BC Ferries is pricing its drop trailer service below its direct costs and appropriate proportion of indirect costs, or has an unfair competitive advantage.²³

BC Ferries requests that the Commissioner, in setting any MAAT, adopt a four quarter rolling average—as opposed to requiring the MAAT be met each quarter—in order to account for changes in traffic and customer mix within a particular quarter.²⁴ Seaspan submits that it does not oppose a quarterly rolling average approach, but is of the view that such an approach should only be utilized if the MAAT were made public.²⁵

Seaspan notes that a MAAT may not be appropriate to correct certain unfair competitive advantages BC Ferries may have, and that the Commissioner may find it necessary to impose an alternative service provider.²⁶ However, Seaspan concedes that it is unclear how, or through whom, alternative service would be provided, and as such, at this time, in Seaspan's view a MAAT would be the appropriate remedy.²⁷

²⁰ Seaspan submissions dated May 20, 2016 at p. 14.

²¹ BC Ferries submissions dated June 10, 2016 at p. 11.

²² BC Ferries submissions dated June 10, 2016 at p. 11.

²³ BC Ferries submissions dated January 15, 2016 at pp. 32-33; Seaspan submissions dated May 20, 2016 at p. 15.

²⁴ BC Ferries submissions dated January 15, 2016 at p. 35.

²⁵ Seaspan submissions dated May 20, 2016 at p. 21.

²⁶ Seaspan submissions dated May 20, 2016 at p. 15.

²⁷ Seaspan submissions dated May 20, 2016 at p. 15.

BC Ferries submits primarily that a MAAT is not appropriate, but that if there is to be a minimum tariff, it should reflect only avoidable costs and a very small tax exemption adjustment.²⁸

Seaspan submits that any MAAT should include a charge, over and above direct costs and indirect costs, with three specific features: (1) a route overhead charge for terminals and vessels, no longer calculated on an “off peak basis”; (2) the opportunity costs imposed on other ferry users as a result of the provision of drop trailer service (arising from asset use that might otherwise be allocated to other users); and (3) a return on equity.²⁹

Seaspan further submits that a MAAT should remain in place as long as the Coastal Ferry Services Contract between BC Ferries and the Province is in force.³⁰ BC Ferries submits that a MAAT, if necessary, should be reset with each performance term.³¹

- 4) If the existing minimum tariff needs to be reset, are there any alternatives to a confidential order which would provide a transparent result, without compromising legitimate concerns about commercial confidentiality by any of the parties in the drop trailer business?**

BC Ferries submits that it is possible to protect the confidentiality of BC Ferries' pricing and costs without resorting to a confidential order, provided that the public order is framed in such a way as to avoid any reference to specific cost information.³²

Seaspan submits that a MAAT should be made public as a matter of constitutional and common law, and that there is no legitimate concern about commercial confidentiality that would justify a confidential order.³³

- 5) Does any provision of the Act compel the Commissioner to consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a decision under Section 45.1?**

Seaspan submits that the Commissioner is explicitly prevented from considering the interests of ferry users and taxpayers under Section 45.1. Seaspan asserts that section 38 of the Act, which requires the Commissioner consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators, explicitly applies only to core ferry services. Seaspan submits that the drop trailer services is not a core service, rather it is designation as a “competitive service” for purposes of section 45.1.³⁴

²⁸ BC Ferries submissions dated January 15, 2016 at p. 36

²⁹ Seaspan submissions dated May 20, 2016 at p. 16.

³⁰ Seaspan submissions dated May 20, 2016 at p. 21.

³¹ BC Ferries submissions dated May 20, 2016 at p. 6.

³² BC Ferries submissions dated May 20, 2016 at p. 6-7

³³ Seaspan submissions dated May 20, 2016 at pp. 21-25.

³⁴ Seaspan submissions dated May 20, 2016 at pp. 25-26.

In BC Ferries' view, while the Commissioner is not compelled to consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a decision under section 45.1, it is open to the Commissioner to consider how drop trailer customers, other ferry users, and the public generally are impacted in a section 45.1 review.³⁵

B. Submissions on confidentiality

In addition to responding to the questions posed by the Commissioner, the issue of confidentiality and transparency was raised by the submissions in the 2016 Drop Trailer Review.

While confidentiality was not the only additional issue raised, it was a significant concern in multiple submissions, and as such the Commissioner wishes to address it directly. As is noted above, the Commissioner reviewed and considered all submissions, and the failure to refer to specific submissions, in whole or in part, or issues raised therein, does not indicate that those submissions were not reviewed and considered in full by the Commissioner.

Seaspan made three arguments against keep any MAAT imposed by the Commissioner confidential, as follows:

- 1) As a matter of law, such concerns are presumptively illegitimate;
- 2) There is no statutory rule requiring the tariff to be confidential; and
- 3) Constitutional and common law principles require the tariff to be public absent serious harm to an important commercial interest, and proportionality between the salutary benefits of confidentiality when weighed against its detrimental effects, neither of which has been established by BC Ferries, according to Seaspan.³⁶

Seaspan submits that the Commissioner should thus elect to disclose BC Ferries' financial information related to its drop ferry service, and any MAAT that is imposed.

Throughout the 2016 Drop Trailer Review process, Seaspan also raised several disclosure issues, requesting disclosure of all material documents even where confidentiality was claimed, and requesting that the Commissioner obtain and make public certain information regarding BC Ferries' drop trailer service on certain routes.

Several other submissions—including those from the BC Trucking Association, Penta Transport Ltd. and MLA Vicki Huntington—raised concerns regarding confidentiality. These submissions generally urged for transparency in the section 45.1 review process, disclosure of BC Ferries' pricing for the drop trailer service, and advocated

³⁵ BC Ferries submissions dated June 10, 2016 at p. 4.

³⁶ Seaspan submissions dated May 20, 2016 at pp. 21-25.

for any MAAT applied as a result of the Commissioner's section 45.1 review to be made public.

BC Ferries submits that its confidential financial information and any MAAT, should not be made available to the public because it is commercially sensitive information, and BC Ferries has a legitimate concern that disclosure of such information could be harmful to its interests.³⁷ BC Ferries further submits that the Act contains no legislative requirement to disclose such information, and that BC Ferries should be afforded the protections provided to it by section 54 of the Act and the *Freedom of Information and Privacy Act*.³⁸ BC Ferries further submits that its drop trailer service is not a core ferry service, and as such is subject to a different regulatory scheme under section 45.1 than that applicable to its live trailer services.³⁹

BC Ferries does not seek to make an order by the Commissioner completely confidential; rather, BC Ferries requests that any order or reasons by the Commissioner not reference commercially sensitive financial information provided by BC Ferries to the Commissioner.⁴⁰

³⁷ BC Ferries submissions dated June 10, 2016 at pp. 12-13.

³⁸ BC Ferries submissions dated May 20, 2016 at pp. 9-10; BC Ferries submissions dated May 20, 2016 at p. 10; BC Ferries submissions dated June 10, 2016 at p. 14-15.

³⁹ BC Ferries submissions dated May 20, 2016 at p. 10.

⁴⁰ BC Ferries submissions dated May 20, 2016 at p. 6; BC Ferries submissions dated June 10, 2016 at p. 13.

PART VI - 2016 DROP TRAILER REVIEW: COMMISSIONER'S DETERMINATIONS AND REASONS

The Commissioner's determinations and reasons in the 2016 Drop Trailer Review are based on the Commissioner's review and analysis of the submissions received, the analysis provided by PwC in the PwC Report, and the Commissioner's analysis of the Act and the relevant circumstances.

The Commissioner, in conducting the 2016 Drop Trailer Review, also considered the determinations and reasons of the Commissioner in the 2010 Drop Trailer Review, though the Commissioner did not consider itself bound by those determinations and reasons, and engaged in a new and independent analysis of the issues raised in the 2016 Drop Trailer Review.

A. BC Ferries' drop trailer service is a competitive service

Section 45.1(1) of the Act requires the Commissioner to first determine whether BC Ferries is providing a competitive service. In the Commissioner's view, BC Ferries' drop trailer service provided on its major routes is a competitive service, as defined by the Act.

Memorandum 37, issued by the Commissioner on July 19, 2010, established that BC Ferries' drop trailer service provided on its major routes is a competitive service. This determination was based on the fact that the drop trailer service offered by BC Ferries was substantially the same service as that offered by its competitors at the time, Seaspan and Van Isle Barge Services ("VISB"), with all three competitors operating in the same geographical area.

The Commissioner notes that the drop trailer market has changed in an important way since Memorandum 37 and Order 11-01 were issued. At that time, there were three participants in the drop trailer market. Based on information provided by Seaspan at the time, the market shares showed Seaspan held roughly 63% of the market, Van Isle Barge Services held roughly 28%, and BC Ferries held roughly 9% of the market. Since then, Seaspan has acquired Van Isle Barge Services. The market share splits today are not known, as Seaspan's sales are not publicly reported and were not made available to the Commissioner. Anecdotal evidence suggests that Seaspan remains the dominant player in this business by a large measure.

Despite this shift in the market, the Commissioner remains of the view that the BC Ferries continues to provide a competitive service and adopts the findings made by the Commissioner in the 2010 Drop Trailer Review and Memorandum 37 in that regard. However, the Commissioner is aware that the number of competitors in this business sector is now limited to only two parties, and that the exit of either remaining competitor would create a monopoly situation.

B. BC Ferries is not pricing its drop trailer service below the direct costs and an appropriate proportion of the indirect costs associated with providing that service

Having determined that BC Ferries' drop trailer service on its major routes is a competitive service, section 45.1(1) of the Act requires the Commissioner to determine whether BC Ferries is pricing its drop trailer service below the direct costs and an appropriate proportion of the indirect costs associated with providing that service.

1) Methodology for assessing BC Ferries costs associated with providing the drop trailer service

The Commissioner notes that section 45.1 of the Act uses the present tense when it directs Commissioner to make the determination regarding whether BC Ferries is underpricing its drop trailer service. As such, in the Commissioner's view, this determination must be made based on circumstances that currently exist. Given that actual cost data for BC Ferries' drop trailer service is readily available, the Commissioner is of the view that any determination of whether revenue exceeds direct costs and the appropriate proportion of indirect costs should take into account any changes in actual input costs, up or down.

In assessing BC Ferries' direct and indirect costs related to its drop trailer service, the Commissioner adopts the approach that is used in setting the current MAAT. Costs directly attributable to BC Ferries' drop trailer service, which are currently reflected in the MAAT, include:

- Direct labour and hostling unit costs;
- Direct terminal operating costs;
- Direct office and administration costs;
- Management costs allocated to drop trailer operations; and
- Direct asset costs that include amortization of hostling units and net financing costs of drop trailer assets.

Costs indirectly attributable to BC Ferries' drop trailer service, which are currently reflected in the MAAT, include an allocation of certain costs (vessel, terminal, regional management and corporate overheads) allocated on the basis of the lane feet occupied by the drop trailers as a percentage of total vehicle deck space. The MAAT also contains a small adjustment for the tax advantage determined by the Commissioner in the 2010 Drop Trailer Review.

In addition, the Commissioner wishes to address four issues regarding the appropriate method of calculating BC Ferries' direct and indirect costs associated with providing

its drop trailer service, which were raised in submissions for the 2016 Drop Trailer Review. These issues are: the inclusion of indirect costs; return on equity; the use of horizon volume estimates; and off-peak assumptions.

i. Including indirect costs

BC Ferries has submitted that, because of off peak surplus capacity resulting from its obligations under the Coastal Ferry Services Contract, only direct or avoidable costs should be considered in pricing its drop trailer service.

In the Commissioner's view, it is reasonable to assume that BC Ferries' indirect costs reflect the resources deemed necessary to provide ferry transportation services—including drop trailer services—and to meet its obligations under the Coastal Ferry Services Contract. To allow BC Ferries to price its drop trailer service based only on its direct costs would potentially create an unfair competitive advantage for BC Ferries.

Accordingly, in the Commissioner's view, there must be an appropriate proportion of indirect costs, including corporate and route overhead, allocated to drop trailer services on those routes where the service is being provided. In the 2010 Drop Trailer Review, the Commissioner came to this same conclusion, and the MAAT the Commissioner established pursuant to Order 11-01 made provision for such indirect costs, including corporate and route overhead. The Commissioner notes that, in contrast to statements made by Seaspan, the current MAAT calculation does include corporate overhead.

The overhead allocation in the MAAT and in the calculation of BC Ferries' costs is consistent with the overhead allocation BC Ferries applies to its route statements linked to its general ledger system in support of its audited financial statements. The overhead allocation, which has been in place since BC Ferries was created as an authority, was reviewed by the Commissioner as part of the 2016 Drop Trailer Review, and the Commissioner is satisfied that it allocates an appropriate portion of indirect costs to BC Ferries' drop trailer services.

ii. Return on Equity

In the 2010 Drop Trailer Review, the Commissioner considered whether return on equity should be included as a cost attributable to BC Ferries' drop trailer service. At that time, the Commissioner found that including return on equity was not appropriate for purposes of a section 45.1 review. The Commissioner noted that section 45.1 is clear that costs are to be considered, but makes no mention of a profit or return on capital. Conversely, other provisions of the Act, such as sections 40 and 41, expressly distinguish costs and return on equity. The Commissioner in the 2010 Drop Trailer Review thus considered that return on equity should not be included in the calculation of costs, direct or indirect, of BC Ferries' drop trailer service.

The British Columbia Court of Appeal found that the determinations of the Commissioner as regards return on equity were not unreasonable, in *Seaspan Ferries Corp. v. British Columbia Ferry Services Inc.*, 2013 BCCA 55.

The issue of whether return on equity should be included in calculation of BC Ferries' costs of providing the drop trailer service has been raised once again by submissions in the 2016 Drop Trailer Review. The Commissioner here adopts the same approach with respect to return on equity as was adopted by the Commissioner in the 2010 Drop Trailer Review.

In the Commissioner's view, BC Ferries' direct and indirect costs should be analyzed from a cost accounting perspective. This is in contrast to the concept of recovery of the cost of capital in regulated industries, which is typically expressed as a revenue requirement, not a cost. As such, return on equity is treated differently and is not included in a calculation of direct and indirect costs. The Commissioner notes that the recovery of all direct and indirect costs—including amortization and debt service costs—is reflected in the setting of price caps.

iii. Use of Horizon Volume Estimates

At the time of the 2010 Drop Trailer Review, and in the context of setting the MAAT pursuant to Order 11-01, the Commissioner found that unit costs could not reasonably be based on initial start-up volumes, but could also not be too forward looking. As a result, the Commissioner accepted costs at a "horizon" volume. The assumed horizon volume was based on the 2010 drop trailer market size and an estimate of BC Ferries' market share.

Both BC Ferries and Seaspan have submitted it is unnecessary to base cost allocation on estimates of future traffic volumes. The Commissioner agrees that the horizon volume of traffic calculation that informed the 2010 Drop Trailer Review is no longer necessary; actual data is now available and should be used in making such cost allocations.

iv. Off peak assumptions

Seaspan submits that "[a]s it stands, the MAAT is calculated on an "off-peak" basis: that is to say, it assumes that the deck space allocated to drop trailer traffic would be surplus space".⁴¹ In the Commissioner's view, this is incorrect. The PWC Report confirms that the MAAT is set at a level which captures both corporate and route overheads, and makes no adjustment for off-peak service considerations. The MAAT is not calculated on the basis of off-peak assumptions; rather, it is calculated on actual costs for the entire year.

In contrast, BC Ferries has contended since the 2010 Drop Trailer Review that there should not be an allocation of overhead to drop trailer pricing, due to the existence of surplus space resulting from its contractual obligation to provide sufficient capacity during the peak demand period of the year. The Commissioner considers that every transportation business, whether regulated or not, often maintains sufficient capacity

⁴¹ Seaspan submissions dated May 20, 2016 at p. 8.

in the system to meet peak demand at certain times of year, which creates surplus capacity at other times. This is the reality of a capital intensive, seasonal business, and is not unique to BC Ferries. Seaspan argues that the peak demand capacity requirement does not justify the failure to charge overhead to BC Ferries' drop trailer service. The Commissioner agrees with Seaspan on this point. Placing all overhead burdens on other traffic would put an unreasonable cost burden on those customers, and would create an unfair advantage over other drop trailer service providers. The Commissioner considers "peak" versus "off-peak" distinctions to be irrelevant to the question of allocating overhead costs to drop trailer pricing.

Seaspan also submits that BC Ferries' drop trailer service results in bumping of other traffic, thus necessitating full allocation of overheads to BC Ferries' drop trailer service.⁴² The Commissioner notes that advance reservations for vehicle passengers provide BC Ferries with notice of traffic volumes. When a customer books a drop trailer service for a future date, the drop trailer customer is also making a type of reservation, and BC Ferries is able to plan for that volume. Seaspan's "bumping" allegation implies that a vehicle customer with a reservation is being denied service in favour of a drop trailer. There is no evidence that drop trailers have bumped any other kind of reserved traffic. However, travelers that arrive at a ferry terminal without a reservation should not expect to "bump" traffic that does have a reservation. Reservations and traffic scheduling are important tools for keeping ferry fares lower. That said, the Commissioner understands that BC Ferries endeavors to schedule drop trailer business at times when other traffic is less likely to be impacted. The Commissioner also notes that BC Ferries' primary drop trailer offerings provide certainty to customers of their trailers being shipped to the destination terminal within two and four sailings.

As such, the Commissioner has determined that the costs of providing BC Ferries' drop trailer service are not being calculated on an off-peak basis. Further, in the Commissioner's view, BC Ferries' drop trailer service does not result in bumping of other traffic, but the Commissioner is nonetheless of the view that there should be a full allocation of overheads to the drop trailer service for other reasons, discussed elsewhere in these Reasons.

2) Analysis of BC Ferries' costs associated with providing its drop trailer service

The Commissioner engaged PwC to review BC Ferries' financial information, and to provide an analysis regarding whether BC Ferries is pricing its drop trailer service below the direct costs and an appropriate proportion of the indirect costs associated with providing that service. The PwC Report is included in redacted form as **Appendix A** to these Reasons.

⁴² Seaspan submissions dated May 20, 2016 at p. 8-10.

As part of its analysis, PwC conducted a review of BC Ferries' historical compliance with the drop trailer MAAT, put in place pursuant to Order 11-01 and Confidential Order 11-01A (the "Performance Review"). The Performance Review demonstrates that BC Ferries has priced its drop trailer service above direct costs and an appropriate proportion of indirect costs since the inception of the MAAT.

In addition to the Performance Review, the Commissioner requested that PwC conduct an analysis of BC Ferries' current drop trailer costs, based on the same methodology applied by Order 11-01 and Confidential Order 11-01A to calculate the MAAT, and adopting the definitions of indirect and direct costs set out by the Commissioner in the 2010 Drop Trailer Review.

The PwC Report indicates that, overall, drop trailer costs have decreased on a per foot basis since the 2010 Drop Trailer Review. The decrease in costs results mainly from economies of scale and increased operational efficiencies. PwC noted that these cost decreases were offset slightly by an increase in the per foot route overhead allocation.

The Commissioner notes that the MAAT that was set as a result of the 2010 Drop Trailer Review was based on estimates of future traffic and an assumption that costs would rise every year at the rate of inflation. The MAAT did not consider the possibility that costs would decrease. In fact, according to information provided by BC Ferries and analyzed by PwC, direct costs on a per foot basis have not risen since 2011, due to a number of factors, but primarily related to increased efficiencies and economies of scale with BC Ferries' drop trailer operations. BC Ferries' indirect costs are also being held in check as a result of mandated operator efficiency targets and capacity utilization improvements, lower fuel costs and more fuel-efficient vessels.

The Commissioner accepts and agrees with PwC's analysis of BC Ferries costs of providing its drop trailer service, and the Commissioner has determined that BC Ferries is not pricing its drop trailer service below its direct costs and an appropriate proportion of indirect costs.

C. BC Ferries does not have an unfair competitive advantage in providing its drop trailer service

Section 45.1 of the Act requires the Commissioner to determine whether BC Ferries has an unfair competitive advantage in delivering its drop trailer service. The Commissioner notes that, having determined that the drop trailer business provided by BC Ferries on its major routes is a competitive service, it is understood that each participant in that market is likely to enjoy certain competitive advantages. Competitive advantage is a relative concept, and in every competitive situation, it can be expected that each participant is likely to experience certain advantages and disadvantages relative to their competition and these advantages and disadvantages can change over time. The key question is whether any competitive advantage BC Ferries has in the drop trailer market is unfair.

1) The Commissioner's methodology for assessing unfair competitive advantage

In the 2010 Drop Trailer Review, the Commissioner provided definitions for competitive advantage and unfair competitive advantage in the context of section 45.1;⁴³ the Commissioner adopts those definitions here. As such, for purposes of section 45.1 of the Act, a competitive advantage will be found to exist when a ferry operator secures or develops attributes that allow it to outperform rival ferry operators. The competitive advantage is fair where it results from the ferry operator being well-run. The competitive advantage is unfair where it is secured not as a result of the ferry operator's own merit, but through privilege, benefit or protection conferred upon it from outside and which is not available to its rivals.

The Commissioner's approach to determining whether BC Ferries holds an unfair competitive advantage in the drop trailer business is first to consider whether a competitive advantage exists, and secondly to consider whether that competitive advantage is unfair. This approach is consistent with the Commissioner's approach in the 2010 Drop Trailer Review, and, in the Commissioner's view, is also consistent with the legislative intent of section 45.1. The legislative history of section 45.1 indicates that the legislature contemplated that not all competitive advantages held by BC Ferries would necessarily be considered unfair, and that the Commissioner is to use his discretion in assessing whether any competitive advantages amount to unfair competitive advantages.⁴⁴

2) Potential unfair competitive advantages set out in section 45.1 of the Act

Section 45.1 identifies three possible sources of unfair competitive advantage that the Commissioner is required to specifically consider, namely: use of or access to vessels or terminals that are or had been owned by government; tax exemptions; and subsidies.

i. Use of, access to or ownership of vessels or terminals that are or had been owned by the government

In the 2010 Drop Trailer Review, the Commissioner determined that the use of, access to or ownership of vessels or terminals that are or had been owned by the government and available to BC Ferries did not represent an unfair competitive advantage. In the context of the 2016 Drop Trailer Review, the Commissioner considers the findings made in the 2010 Drop Trailer Review in this regard as still valid, and notes that, since 2003, BC Ferries has acquired all vessels and terminal upgrades at fair market value. As such, the Commissioner finds that the use of, access to, or ownership of vessels or terminals that are or had been owned by the government is not currently a competitive advantage enjoyed by BC Ferries.

⁴³ 2011 Reasons at pp. 35-36

⁴⁴ Hansard, June 2, 2010 at 6126-6127

ii. Tax exemptions

In the 2010 Drop Trailer Review, the Commissioner determined that a tax exemption afforded to BC Ferries was an unfair competitive advantage, as its tax free status allowed BC Ferries to build equity more quickly than it would otherwise have been able to, and this advantage was not available to other competitors in the drop trailer market. In the 2010 Drop Trailer Review, the Commissioner calculated the income tax benefit to BC Ferries as a result of its tax-exempt status as the difference between taxable and non-taxable status, and included the income tax benefit as a component of the MAAT.

While the non-taxable status of BC Ferries continues today, in the Commissioner's view it can no longer be viewed as an unfair competitive advantage. The PwC Report notes that the impact of any tax advantage has been substantially reduced since the 2010 Drop Trailer Review as a result of a lower estimated cost of equity and a reduction in corporate tax rates. Using the same approach as that used in the 2010 Drop Trailer Review and the setting of the MAAT, the PwC Report re-calculated today's value of BC Ferries' tax advantage to be insignificant. The Commissioner thus considers BC Ferries' tax exemption to have a negligible effect, if any, on BC Ferries' pricing for drop trailer services. Accordingly, the Commissioner considers a tax advantage to be too small to be a competitive advantage at the present time.

iii. Subsidies

In the 2010 Drop Trailer Review, the Commissioner found no unfair competitive advantage resulting from any subsidy for BC Ferries' drop trailer service. While provincial service fees provided under the Coastal Ferry Services Contract cover deficits on minor routes, no subsidy is provided on the routes where BC Ferries' competitive drop trailer services are offered. Moreover, the major routes in question, as a group, are profitable after indirect costs are applied. There has been no material change regarding the issue of subsidies since the 2010 Drop Trailer Review; as such, the Commissioner finds that the determinations of the Commissioner in the 2010 Drop Trailer Review in that regard are still valid, and subsidies do not provide BC Ferries with a competitive advantage in the drop trailer business.

The Commissioner also notes that there is no cross-subsidization of BC's Ferries' competitive drop trailer service from other services.

3) Other potential unfair competitive advantages

The Act also requires the Commissioner to consider any other potentially unfair competitive advantages; in that regard, the Commissioner has considered two additional potential sources of unfair competitive advantages, namely: the regulatory framework under which BC Ferries operates and access to the Building Canada Fund.

i. *The regulatory framework under which BC Ferries operates*

In the 2010 Drop Trailer Review, the Commissioner found BC Ferries' had an unfair competitive advantage as a result of the regulatory framework in which it operates. This was based on three reasons.

- First, the Commissioner noted that the Coastal Ferry Services Contract minimum-service obligations created surplus capacity.
- Second, the Commissioner considered the fact that the price cap regime results in the Commissioner setting price caps high enough to cover BC Ferries costs, including the cost of surplus or unused capacity. The Commissioner also noted that, in setting the price caps in 2007, the Commissioner did not factor into the calculations any traffic (such as drop trailer) outside BC Ferries' traditional traffic base.⁴⁵
- Third, the Commissioner considered that the pricing mechanisms in existence at the time allowed BC Ferries to price its drop trailer services with a low mark-up to attract higher volumes, and allowed it to price other (monopoly) services higher.

The Commissioner considers the regulatory framework under which BC Ferries operates its drop trailer service today to be different than it was at the time of the 2010 Drop Trailer Review, in part as a result of the 2012 Amendments to the Act. It is the Commissioner's view that the regulatory framework under which BC Ferries operates does not currently provide an unfair competitive advantage in its drop trailer service, for three reasons.

First, the Commissioner does not consider surplus or excess capacity created by the minimum service requirements in the Coastal Ferry Services Contract to create a competitive advantage; indeed, in the Commissioner's view it may even create a competitive disadvantage to BC Ferries. The Commissioner notes that the minimum service levels in the Coastal Ferry Services Contract must be fulfilled by BC Ferries, regardless of traffic levels or profitability of a route. The Commissioner further notes that BC Ferries is not permitted to make unilateral decisions about service levels which might result in more favourable financial outcomes. This means BC Ferries is not permitted to reduce its service levels to meet lower market demand. In contrast, BC Ferries' competitor in the drop trailer market is able to adjust service levels in line with the market demands to increase profitability, an option unavailable to BC Ferries.

Second, the Commissioner does not consider the price cap system under which BC Ferries operates to create a competitive advantage. The argument has been made by Seaspan that, because BC Ferries is regulated, it has a guarantee it will recover its

⁴⁵ Reasons, at p. 14

costs. The Commissioner notes that the price cap is set based on various forward-looking assumptions, such as traffic volumes, costs, and efficiencies. BC Ferries operates in a dynamic market place, which challenges those assumptions daily; if those assumptions are not met, BC Ferries may not be profitable, or even cover its costs. The price cap system does not provide any kind of guarantees – it simply requires the Commissioner to determine what a reasonable increase in cost would be for a four year term, and puts it on BC Ferries to meet that cost. This is in contrast to a private company that can set its pricing on its own, and can charge higher prices if it believed the market can sustain it. Further, the Commissioner, in setting the current price cap, took into account the revenues received by BC Ferries' drop trailer service, and factored those revenues into the current price cap calculation. Conversely, at the time of the 2010 Drop Trailer Review, the price cap did not take into account the revenues earned from BC Ferries' drop trailer service.

Third, as a result of the 2012 Amendments, BC Ferries is now subject to significantly more oversight by the Commissioner than it was at the time of the 2010 Drop Trailer Review. The Commissioner is now empowered to regulate and monitor BC Ferries' services more closely by virtue of his authority to approve major capital expenditures and to perform periodic performance reviews. Together these measures promote more efficient use of resources concentrated on the delivery of core ferry services and do not promote or facilitate the expansion of competitive services. BC Ferries' competitors are not subject to any such regulation and monitoring. They are free to expand their competitive service at their will.

As such, the Commissioner does not consider the regulatory regime under which BC Ferries operates to confer upon it a competitive advantage.

ii. Access to the New Building Canada Fund

The Commissioner has considered whether BC Ferries enjoys an unfair competitive advantage due to the creation of the Building Canada Fund by the federal government. Through the New Building Canada Fund, the Government of Canada is encouraging investments in infrastructure projects that contribute to economic growth, job creation and productivity. The federal government works with provinces, territories, municipalities and the private sector to provide funds to economically-focused projects.

The Commissioner notes that BC Ferries has not, to date, received any funding from the New Building Canada Fund, and has no knowledge that it will receive any such funding in the future.

The Commissioner further notes that the Building Canada Fund is accessible to the private sector. Specifically, private-sector bodies (both for-profit and not-for-profit) may apply to be recipients of the Building Canada Fund for economically focused projects that are critical to the support of international trade (including rail infrastructure, port infrastructure, and Intelligent Transportation Systems).

The Commissioner thus does not consider BC Ferries' potential access to the New Building Canada Fund to have created a competitive advantage for BC Ferries at this time.

D. No minimum average allowable tariff is required

The Commissioner has determined that the drop trailer service provided by BC Ferries is a competitive service, and that BC Ferries is not pricing that service below its direct costs and an appropriate proportion of its indirect costs in providing the service as required under the Act. The Commissioner has also determined that BC Ferries does not have any unfair competitive advantages in providing its drop trailer service. As a result, the Act does not authorize the Commissioner to regulate BC Ferries' drop trailer service, and no MAAT needs to be imposed or calculated.

As such, the MAAT that came into effect as a result of Order 11-01 and Confidential Order 11-01A is discontinued, effective September 6, 2016.

E. Considering the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a determination under section 45.1

For the purposes of the 2016 Drop Trailer Review, it was not necessary for the Commissioner to make a determination regarding whether he may consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a determination under section 45.1.

F. Quarterly monitoring of BC Ferries' drop trailer service pricing

The Commissioner has determined that BC Ferries is not pricing its drop trailer service below its direct costs and an appropriate proportion of its indirect costs at the present time. However, it would not be in the interest of ferry users or taxpayers, or in accordance with section 45.1 of the Act, if elimination of a minimum tariff at this time were to result in future unfair pricing practices by BC Ferries in relation to its drop trailer service.

To address this concern, the Commissioner will monitor BC Ferries' drop trailer revenues and costs on an ongoing basis, to ensure that the intent of section 45.1 of the Act is respected, with drop trailer tariff revenues covering direct costs and an appropriate proportion of the indirect costs attributable to providing the service.

BC Ferries will thus be required to provide a report to the Commissioner each quarter, detailing total revenue, direct costs and an appropriate proportion of indirect costs (as set out in these Reasons), being attributed to drop trailer services (the "Drop Trailer Quarterly Reports"). The Drop Trailer Quarterly Reports will enable the Commissioner to monitor whether BC Ferries is engaging in a practice of unfair competition.

The power of the Commissioner to require the Drop Trailer Quarterly Reports is based in section 65(e) of the Act, which provides:

65 Each ferry operator must provide to the commissioner, quarterly after the effective date of the Coastal Ferry Services Contract, or more or less often as the commissioner may order, a report, in a form satisfactory to the commissioner, respecting, for each of the designated ferry routes,

[...]

(e) any other information that the commissioner may require relating to the core ferry services.

The Commissioner's power to require the Drop Trailer Quarterly Reports is further supported by section 67 of the Act, which provides:

67 (1) In addition to the reports required under sections 65 and 66, each ferry operator must provide to the commissioner information reasonably required by the commissioner and, for the purposes of this Act, must answer all questions of the commissioner.

(2) A ferry operator that receives from the commissioner any form of return must fully and correctly answer each question in the return and deliver it to the commissioner.

If the Drop Trailer Quarterly Reports indicate that BC Ferries' revenues from its drop trailer service falls below its costs during any period, the Commissioner may take steps to bring BC Ferries back into compliance with section 45.1, by whatever means the Commissioner considers appropriate in the circumstances and are available to it under the Act.

The Commissioner has both the discretion and the intent to undertake independent audits of the Drop Trailer Quarterly Reports to be provided on drop trailer services from time to time. The Commissioner considers that a monitoring approach of the Drop Trailer Quarterly Reports should be based on a four quarter rolling average basis, as this is consistent with price cap compliance monitoring methodology.

For purposes of the Drop Trailer Quarterly Reports, BC Ferries will be required to adhere to the same methodology for the determination of its direct costs and the appropriate proportion of indirect costs as was employed by the Commissioner in setting the MAAT pursuant to Order 11-01 and Confidential Order 11-01 A (with the exception of the adjustment made to cover tax advantages), and as is further explained in these Reasons. Specifically, BC Ferries is required to include an appropriate allocation of indirect costs, including corporate and route overhead, allocated to drop trailer services on those routes where the service is provided.

The Drop Trailer Quarterly Reports will be treated as confidential by the Commissioner, such that commercially sensitive information provided by BC Ferries will be held in confidence.

G. Confidentiality

Many of the concerns regarding confidentiality raised in the submissions in the 2016 Drop Trailer Review are repetitive of issues raised in the 2010 Drop Trailer Review, and ultimately seek the disclosure of information related to BC Ferries' financial information related to its drop trailer service.

In the 2010 Drop Trailer Review, the Commissioner declined to disclose BC Ferries' commercially sensitive financial information, and further declined to make the MAAT set pursuant to Order 11-01 public. At that time, the Commissioner found that access to the BC Ferries' commercially sensitive information would likely allow a competitor to target easily identifiable high volume drop trailer customers of BC Ferries with potentially predatory pricing incentives, which would likely erode BC Ferries' customer base.⁴⁶ The Commissioner ultimately considered that the disclosure of BC Ferries' commercially sensitive information would be harmful to the business interests of BC Ferries.

In the context of the 2016 Drop Trailer Review, the Commissioner adopts the determinations and reasoning regarding confidentiality made by the Commissioner in the 2010 Drop Trailer Review. The Commissioner thus determines that BC Ferries' commercially sensitive financial information should be held in confidence.

While the Commissioner has determined that no MAAT is necessary as a result of the 2016 Drop Trailer Review, if circumstances change, such that the establishment of a MAAT for BC Ferries' drop trailer service is necessary in the future, the question of confidentiality with respect to that MAAT will no doubt be raised again. In the Commissioner's view, none of the submissions received in connection with the 2016 Drop Trailer Review offered any alternatives to confidentiality that, in the Commissioner's view, would achieve a higher level of transparency without eroding BC Ferries' right to the protection of commercially sensitive information.

It is the Commissioner's view that BC Ferries' commercially sensitive financial information should remain confidential. The Commissioner endeavours to be as transparent as possible regarding its methodology of assessing BC Ferries' financial information and in establishing any future MAAT. Such methodology is outlined in these reasons and in the PwC Report, attached as Appendix A to these Reasons.

The Commissioner finds further support for its position regarding confidentiality in both the decision of the British Columbia Court of Appeal decision in *Seaspan Ferries Corp. v. British Columbia Ferry Services Inc.*, 2013 BCCA 55, which upheld the Commissioner's decision regarding confidentiality, and in the provisions of section 54

⁴⁶ 2011 Reasons at p. 21

of the Act and the *Freedom of Information and Privacy Act*, [RSBC 1996] c. 165, which permit the Commissioner to keep such information confidential.

Section 54 of the Act provides as follows:

Despite any obligation imposed on the commissioner under this Act to obtain, maintain or make available information or records, the commissioner, every deputy commissioner, every employee of the commissioner and every inspector must not disclose or be compelled to disclose any information or record that is obtained in, or that comes to the person's knowledge during, the course of the administration of this Act or the course of any inspection authorized under this Act, unless and only to the extent that such disclosure is consistent with the *Freedom of Information and Protection of Privacy Act*.

The *Freedom of Information and Protection of Privacy Act* ("FOIPPA"), at section 17, permits the Commissioner to refuse to disclose financial or commercial information, the disclosure of which could reasonably be expected to harm the financial or economic interests of a public body (including BC Ferries). The Commissioner recognizes that the protections afforded to a public body, pursuant to section 17 of FOIPPA, are not mandatory; rather, it is left to the discretion of the Commissioner to assess the information provided and the potential harm that could reasonably be caused by its disclosure. In this case, the Commissioner declines to exercise any rights it may have in disclosing the commercially sensitive financial information provided to it by BC Ferries as, in the Commissioner's view, to do so would likely harm the financial or economic interests of BC Ferries, including by exposing it to potential predatory pricing by its competitors.

PART VII - SUMMARY OF DETERMINATIONS

Upon review of all submissions from all interested parties and the public, and based upon the analysis and determinations contained in these Reasons, the Commissioner has determined that:

1. BC Ferries' drop trailer service on its major routes remains a "competitive service", as defined in the Act.
2. Since the inception of the MAAT, BC Ferries has not, and is not currently, pricing its competitive drop trailer service below its direct costs and the appropriate proportion of indirect costs associated with providing that service.
 - a. An appropriate proportion of indirect costs associated with providing BC Ferries' drop trailer service must be included in calculating BC Ferries costs associated with providing that service, including an allocation of reasonable corporate and route overhead.
 - b. The overhead allocation BC Ferries currently applies to its route statements linked to its general ledger system in support of its audited financial statements allocates an appropriate portion of indirect costs to BC Ferries' drop trailer services.
 - c. Return on equity is not to be included in a calculation of BC Ferries' direct and indirect costs associated with its drop trailer service.
 - d. In calculating direct and indirect costs, actual costs and volumes are to be used; a calculation based on horizon volumes is no longer appropriate.
3. BC Ferries does not have an unfair competitive advantage in providing its drop trailer service. The Commissioner examined five potential sources of competitive advantage, and found that none currently provides BC Ferries with an unfair competitive advantage in providing its drop trailer service.
 - a. The use of, access to or ownership of vessels or terminals that are or had been owned by the government is not currently considered to be a competitive advantage to BC Ferries in the drop trailer service. The 2010 Drop Trailer Review made this finding, which the Commissioner endorses. Since that time, BC Ferries' acquisition of vessels and terminal upgrades has been at fair market value.
 - b. The tax advantage enjoyed by BC Ferries provides it with negligible benefits with respect to the costs of the drop trailer service, and as such is not considered a competitive advantage in providing the drop trailer service.

- c. No competitive advantage results from any subsidy or cross-subsidization for BC Ferries' competitive drop trailer service, as no subsidy is provided on the routes where BC Ferries' competitive drop trailer services are offered, and there is no cross-subsidization of BC's Ferries' competitive drop trailer service from other services.
 - d. The regulatory framework under which BC Ferries operates, including the Coastal Ferry Services Contract, does not provide BC Ferries with a competitive advantage for three reasons:
 - i. First, the Coastal Ferry Service Contract contains significant restrictions on BC Ferries' ability to maximize profits, including as a result of minimum service obligations. As such, BC Ferries is unable to make market based decisions regarding its service, and often must operate at a loss as a result of the requirements contained in the Coastal Ferry Service Contract.
 - ii. Second, the price cap regime under which BC Ferries operates does not guarantee BC Ferries a profit, or even an ability to cover its costs. Further, the price cap regime currently takes into account the revenues from BC Ferries' drop trailer service.
 - iii. Third, as a result of the 2012 Amendments, BC Ferries is now subject to significantly more oversight by the Commissioner.
 - e. The Building Canada Fund is not a competitive advantage to BC Ferries, both because BC Ferries has never benefited from it and has no reason to think it will in the future, and also because this fund is open to private for-profit actors.
4. Given that BC Ferries is not pricing its drop trailer service below costs, and given that BC Ferries does not have an unfair competitive advantage in providing its drop trailer service, the Commissioner is not authorized by the Act to set a minimum average allowable tariff for the drop trailer service.
 5. The minimum average allowable tariff set pursuant to Order 11-01 and Confidential Order 11-01A is discontinued, effective September 6, 2016.
 6. It was unnecessary for the Commissioner to make a determination regarding whether he could consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making a determination under section 45.1.
 7. BC Ferries will be required to submit quarterly reports to the Commissioner, on a four quarter rolling basis, of revenues, direct costs and the appropriate proportion of indirect costs associated with its drop trailer service. The Commissioner will undertake independent audits of the quarterly reports from time to time, at the Commissioner's discretion.

8. BC Ferries' commercially sensitive financial information, including that provided to the Commissioner in the Drop Trailer Quarterly Reports, should be held in confidence to protect its commercial interests. In the Commissioner's view, disclosure of such information could reasonably be expected to harm BC Ferries' financial interests.

APPENDIX A

PRICEWATERHOUSECOOPERS LLP REPORT TO THE COMMISSIONER

Analysis of BC Ferries' Drop Trailer Service

BC Ferry Commission

August 2016

Note: This report has been redacted such that information of a confidential and commercially sensitive nature is not included.



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Appendix A - Questions to BCFS and their Responses *[Removed as it includes information of a confidential and commercially sensitive nature]*

Appendix B – 2011 MAAT Calculation *[Removed as it includes information of a confidential and commercially sensitive nature]*

Appendix C – Actual Drop Trailer Pricing Compared to the MAAT *[Removed as it includes information of a confidential and commercially sensitive nature]*

Appendix D – Current Drop Trailer Pricing *[Removed as it includes information of a confidential and commercially sensitive nature]*

Appendix E – MAAT Calculation based on Current Pricing *[Removed as it includes information of a confidential and commercially sensitive nature]*

Appendix F – Route Overhead Charge Methodology

Notice to Reader

This Report is issued by PwC for the exclusive use of the BC Ferry Commission in connection with its review of British Columbia Ferry Services Inc.'s ("BCFS") drop trailer service under Section 45.1(1) of the Coastal Ferry Act (the "Act").

Our work did not constitute an audit conducted in accordance with generally accepted auditing standards, an examination of internal controls nor attestation nor review services in accordance with the standards established by the Chartered Professional Accountants of Canada. Accordingly, we do not express an opinion nor any other form of assurance on the financial or other information, or operating internal controls, of the BCFS drop trailer service.

PwC did not examine, compile or apply agreed upon procedures to satisfy the requirements of the Chartered Professional Accountants of Canada to the financial information used in this Report and we therefore are unable to express assurances on such information except where expressly stated in the Report to form part of the scope of our work.

Further this Report does not constitute an opinion as to legal matters, including the interpretation of the Coastal Ferry Act or any other similar matters.

Our work is based primarily on the information and assumptions listed in the body of this Report. While we read information from various sources we did not perform checking or verification procedures except where expressly stated in the Report to form part of the scope of our work. Our work and commentary is subject to assumptions, which may change with the benefit of further detailed information. We make no representation regarding the sufficiency of our work and had we been asked to perform additional work, additional matters may have come to our attention that would have been reported to the BC Ferry Commission.

Some of the documents and figures we reviewed were produced by third parties. We did not corroborate or verify these documents and figures with these parties. It is outside the scope of our review to evaluate the methodology used to conduct independent studies; therefore, we have accepted the information as presented, including conclusions.

The outputs of the Report are intended to provide the BC Ferry Commission with information to assist in informing their decision making process pertaining to the regulations of BCFS' drop trailer service. PwC accepts no liability in respect of any loss, damage or expense of whatsoever nature caused by any use the reader may choose to make of this Report, or which is otherwise consequent upon the gaining of access to the Report by the reader.

Our Report, including schedules and appendices, must be considered in its entirety by the reader. Selecting and relying on specific portions of the analyses, or factors considered by us in isolation may be misleading.

Background

In April 2003, the Province of British Columbia (the “Province”) established the B.C. Ferry Authority, an independent corporation that holds the single issued voting share of British Columbia Ferry Services Inc. (“BC Ferries” or “BCFS”).

The Office of the BC Ferries Commissioner (the “Commission or Commissioner”) is a regulatory agency operating under the Coastal Ferry Act (British Columbia) (“Act”). The Commission’s mandate includes regulation of price caps for ferry fares, monitoring the compliance of BCFS to the Coastal Ferry Services Contract (“CFSC”), and approvals of major capital expenditures.

BCFS commenced drop trailer services in October 2009 enabling commercial customers to drop off their semi-trailers full of goods at one of the BCFS terminals and to pick up their trailers on the other side of the route. In the drop trailer service, hostling units haul the trailers onto vessels. This service is in contrast to the live trailer service where truckers drive directly onto vessels.

The Act was amended in June 2010 whereby the Commission became responsible for regulating unfair competitive advantage, initiating searches for Alternative Service Providers, monitoring of the customer complaints process and for considering the interests of ferry users in the regulation of ferry operators.

More specifically, Section 45.1 of the Act required the Commission to determine whether BC Ferries was operating a competitive service and, if so, determine whether the competitive service was:

- i. pricing below direct costs and an appropriate proportion of indirect costs associated with providing the service; and
- ii. at an unfair competitive advantage, including but not limited to:
 - a) the use of, access to, or ownership of vessels or terminals that are or had been owned by the government or a government body within the meaning of the Financial Administration Act;
 - b) any tax exemption; and
 - c) any subsidy.

If the Commission found that BCFS’ drop trailer service was a competitive service and is priced below cost, or had an unfair competitive advantage over other companies’ drop trailer services, it must order BC Ferries either to (a) handle drop trailers through an alternative ferry service provider, or (b) charge a Commission-specified minimum tariff for them.

On July 19, 2010 the Commission found (in Memorandum 37) that the drop trailer service was a competitive service as defined in the Section 45.1 of the Act. The drop trailer service offered by BC Ferries on its major route group was substantially similar to services being provided by Seaspan Coastal Intermodal Company (“Seaspan”) and Van Isle Barge Services Limited (“Van Isle”). These companies provided drop trailer services across Georgia Strait between terminals near to those of BC Ferries. They were sufficiently near BC Ferries’ terminals that the Commission considered that BC Ferries’ drop trailer service to be in competition with Seaspan and Van Isle. Accordingly the Commission found that BC Ferries’ drop trailer service on its major routes across Georgia Strait was a competitive service as defined in Section 45.1 of the Act. The findings in Memorandum 37 triggered a requirement for the Commission to make certain determinations under Section 45.1 of the Act.

The Commission subsequently began a review of BCFS’ drop trailer service as it related to Section 45.1 of the Act. On February 7, 2011 the Commission issued Order 11-01 and Memorandum 42 (together, the “2011 Drop Trailer Decision”) determining that BCFS was pricing its drop trailer services below cost and that BCFS had an unfair competitive advantage. The Commission decided to regulate BCFS through a drop trailer minimum allowed average tariff (“MAAT”). Based on those determinations, the Commission ordered:

-
- The drop trailer MAAT was set in fiscal 2012 and changed each subsequent fiscal year by a consumer price index adjustment;
 - Beginning in fiscal 2012, BCFS shall report quarterly to the commission the quarterly total revenue from its drop trailer tariff on the major routes and the number of vessel-feet occupied (land feet occupied by drop trailers and their hostler units);
 - BCFS is required to ensure that the average revenue per vessel-foot for the quarter, shall not be less than the MAAT; and
 - When the drop trailer volume exceeds a certain rate of vessel-fee per year, or at the discretion of the commissioner, the minimum tariff will be reset in light of experiences with actual costs and drop trailer volumes.

During 2015, BCFS' drop trailer service reached the volume specified in Order 11-01. The Commission on December 2, 2015, invited interested parties to submit comments on BCFS' drop trailer services. Submissions were received from eight interested parties, including BCFS and Seaspan. The Commission will take all comments into consideration in making certain determinations under Section 45.1 of the Act.

Scope of Work

PwC was asked to assess BCFS's compliance with the MAAT and to provide analysis and decision support to the Commission in their determinations related to Section 45.1 of the Act. In order to do so, we have:

Scope	Approach
1. Review of the Act, Commission's Orders and Memorandums, and filings related to the drop trailer service	<ul style="list-style-type: none">• Reviewed the Act, Order 11-01, Memorandum 37 and Memorandum 42• Reviewed BCFS' filing regarding Section 45.1(1) of the Act and Drop Trailer Service dated August 31, 2010• Reviewed MAAT calculation methodology in the 2011 Drop Trailer Decision
2. Compliance review of BCFS' quarterly MAAT filing spreadsheets and supporting data since inception	<ul style="list-style-type: none">• Examined the structure of Excel spreadsheets and key formulas to verify that inputs and calculations were consistent with the 2011 Drop Trailer Decision• For a sample quarter (ending September 30, 2015), reconciled contract details, pricing and volumes to BCFS' general ledger for all customers• For a sample quarter (ending September 30, 2015), randomly selected three customers and traced invoice details to general ledger• Reviewed the spreadsheets for errors and formula consistency using a spreadsheet analytics tool• Compared the average tariff per vessel-foot for each quarter from Q1 2012 to Q4 2016 against the MAAT• Met with BCFS representatives in person to discuss the drop trailer service MAAT calculations• Walked through the data flow between BCFS' general ledger, customer contracts and drop trailer working papers
3. Provide analysis and decision support in relation to the drop trailer service	<ul style="list-style-type: none">• Reviewed the drop trailer service related feedback received from BCFS, Seaspan and other interested parties• Reviewed the financial information of the drop trailer service• Analyzed tax and other impacts related to the drop trailer service• Recalculated the MAAT based on fiscal 2016 results• Met with BCFS representatives in person to discuss the drop trailer service
4. Clarification of any issues observed	<ul style="list-style-type: none">• Developed written questions for BCFS• Reviewed responses to questions from BCFS• See Appendix A for questions delivered to BCFS and their responses
5. Draft and finalization of the report	<ul style="list-style-type: none">• Discussed the MAAT compliance results with the Commissioners• Discussed our analysis of the drop trailer service with the Commissioners• Debriefed a draft version of this report with the Commissioners

Overview of the Competitive Drop Trailer Service

BCFS' drop trailer business is a service offered by the company which complements existing services provided to its commercial trailer business. The drop trailer business enables commercial customers to drop off their trailers full of goods at one of the designated BCFS terminals and to pick up their trailers on the other side of the route. BCFS has storage areas at its three terminals servicing Route 1 and 30. It moves trailers back and forth from vessels with the use of hostling units. In contrast, in its traditional "live" trailer business, truckers drive on and off vessels in their trailer vehicles.

The advantages for shippers using the drop trailer service include the cost savings associated with eliminating the need to have truck drivers travel on vessels and the efficiencies that are gained from scheduling deliveries and other related aspects of supply chain management.

Competitors

There have been notable changes to the competitive landscape of the drop trailer service since the 2011 Drop Trailer Decision. Seaspan is now BCFS' only competitor in the drop trailer market. In 2011, Seaspan acquired the only other major competitor in the market, Van Isle Barge Services Ltd. ("VIBS"). Seaspan provides freight only services to Vancouver Island on a year-round basis.

Seaspan is part of the Washington Marine Group, a family-owned company that also owns Vancouver Shipyards. Formerly the Canadian Pacific Railway's Coastal Marine Operations, the company has been in operation for over 60 years. At the time of the 2011 Drop trailer Decision, Seaspan ran five or six vessels and a total of 11 daily mid-week return trips and nine weekend return trips to Vancouver Island over two routes – Tilbury, Delta to downtown Nanaimo and Tilbury, Delta to Swartz Bay. With its acquisition of VIBS, Seaspan expanded its capabilities with three Articulating Tugs and Barges that are designed for the ocean carriage of roll-on and roll-off traffic, including semi-trailers between terminals on the Fraser River in Surrey and Duke Point in Nanaimo.

Types of Services

BC Ferries' drop trailer service is offered year round. The drop trailer service uses the same space allocated to the broader Commercial Reservation Pool. However, a "live" customer can book and hold a reservation for a specific sailing, and it can do so at no additional charge. By contrast, BCFS decides which sailings will carry drop trailers and, if so, how many it will carry. BCFS also decides which specific drop trailers are to be put on a certain sailings in order to maximize efficiencies while still maintaining the commitment to a customer of getting a trailer to its destination at or by a specific time.

There are two primary product offerings:

- The "At" service requires the customer to specify the desired delivery time for their goods. It provides certainty of delivery within two sailings.
- The "By" service in contrast is less time sensitive – it provides certainty of delivery within four sailings.

Customers may also be granted the privilege of dropping their trailers off for an appointment time of one hour prior to a mutually agreed upon sailing in order to maximize operational efficiencies. However, this does not guarantee that the trailers will be shipped on the next sailing. Only "live" customers can book and hold a reservation for a specific sailing.

Regulatory Framework

Regulatory Overview of the MAAT

Section 45.1 of the Act requires the commissioner to regulate unfair competitive advantage:

45.1

(1) If a ferry operator is providing a competitive service, the commissioner must determine whether the ferry operator is pricing the service below the direct costs and an appropriate proportion of the indirect costs associated with providing that ferry transportation service, or has an unfair competitive advantage, including, without limitation, an advantage resulting from the ferry operator having been provided with

(a) use of, access to or ownership of vessels or terminals that are or had been owned by the government or a government body within the meaning of the Financial Administration Act,

(b) any tax exemption, or

(c) any subsidy.

(2) If the commissioner makes the determination referred to in subsection (1), the commissioner must regulate the ferry transportation service in one of the following ways:

(a) make an order under section 69 (1) and, after an alternative service provider satisfactory to the commissioner has been located through a competitive process established in a plan approved under section 69 (4) (a) or created under section 69 (4) (b) (i), order the ferry operator to arrange with that alternative service provider, under contract, franchise agreement or otherwise, for the alternative service provider to provide the ferry transportation service;

(b) 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 subsection (1) of this section present, and order the ferry operator to charge at least that tariff when providing that ferry transportation service.

The Commissioner found (in Memorandum 37) that the drop trailer service was competitive. The Commissioner subsequently began a review of BCFS' drop trailer service as it related to Section 45.1 of the Act. On February 7, 2011 the Commissioner issued the 2011 Drop Trailer Decision determining that BCFS was pricing drop trailer services below cost and that BCFS had an unfair competitive advantage. The Commissioner chose to regulate the drop trailer service through a tariff (i.e. the MAAT) in accordance with Section 45.1(2)(b) in the 2011 Drop Trailer Decision. The MAAT is calculated as "the amount that the commissioner considers would be charged as a tariff for that ferry transportation [drop trailer] service to recover the direct costs and an appropriate proportion of indirect costs attributable to providing the service" were there no unfair competitive advantages present. Memorandum 42 further defined the direct costs and indirect cost categories:

- Direct: costs directly attributable to the drop trailer service (labour to load/unload drop trailers to/from vessels, financing and amortization of hostler units, etc.).

-
- Indirect: costs indirectly attributable to the drop trail service applied through a “route overhead charge” to the costs of drop trailer service to recognize the provision of terminal deck space, and marine transport. The after-tax return on equity was specifically excluded as a cost for MAAT calculation purposes.

Fiscal 2012 MAAT Calculation (Order 11-01)

The 2011 Drop Trailer Decision set the MAAT in fiscal 2012. This was determined through the following calculations:

Step 1: Fiscal 2010 Expenses and Volume

The fiscal 2011 direct and indirect costs for the drop trailer service and their attributable footage volumes were used to calculate a cost per vessel-foot. The total cost per vessel-foot for fiscal 2010 was used as a starting point for the MAAT calculation. See Appendix B for detailed calculations of the Fiscal 2010 expenses per foot.

Step 2: Estimate the Horizon Volume

As described in Memorandum 42, unit costs cannot be reasonably based on initial start-up volumes nor “mature” volumes which were a multiple of 2010 volumes and too forward looking. For the purposes of setting the MAAT, the Commissioner decided to accept costs at a “horizon” volume. The assumed horizon volume was based on the 2010 drop trailer market size and an estimate of BCFS’ mature market share.

Step 3: Interpolate \$/foot to Horizon Volume Estimate

Forecasted results were prepared for the mature market (fiscal 2016) total expenses and total feet. The total expenses per foot for the fiscal 2010 MAAT cost was determined through linear interpolation at the horizon volume. See Appendix B for a calculation of the expenses per foot interpolation.

Step 4: Index to Fiscal 2012

The MAAT was brought into effect for fiscal 2012 by Order 11-01. As such, it was necessary to index the fiscal 2010 MAAT cost by two years of inflation at 2%.

MAAT Compliance

PwC was engaged in January 2016 by the Commission to review the BCFS' compliance with the MAAT since inception. The results of our work are presented as a review. The review is not intended to represent recommendations by PwC to the Commission.

PwC was asked to review the information provided by BCFS, and, using the determinations found in the Commissioner's Orders and their professional expertise, provide an assessment of BCFS' compliance with the MAAT. Our review was conducted in accordance with the 2011 Drop Trailer Decision.

MAAT Review Findings

The MAAT was determined in accordance with Section 45.1(2)(b) of the Act 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 [Section 45.1(1)] present, and order the ferry operator to charge at least that tariff when providing that ferry transportation service.”

The specific components included as direct costs and an appropriate proportion of indirect costs are:

Category	Cost Components
Direct Operating Costs	<ul style="list-style-type: none"> • Direct labour and hostling unit costs • Direct terminal operating costs • Direct office and administration costs • Management costs allocated to drop trailer operations
Direct Asset Costs	<ul style="list-style-type: none"> • Amortization costs of direct assets (IT, terminals, hostling units) • Net financing costs of direct assets
Route Overhead Allocation	<ul style="list-style-type: none"> • An allocation of certain costs (vessel, terminal, regional management and corporate overheads) allocated on the basis of the lane feet occupied by the drop trailers as a percentage of total vehicle deck space (see Appendix F for a detailed description of the allocation methodology)
Income Tax Advantage	<ul style="list-style-type: none"> • An adjustment based on the equity directly and indirectly associated with the drop trailer service, multiplied by the difference between a pre- and post-tax percentage annual return $[Pre\text{-tax cost of equity} - Post\text{-tax cost of equity}] \times [Equity\ directly/indirectly\ associated\ with\ the\ drop\ trailer\ operations]$

PwC has reviewed BCFS' compliance with the drop trailer MAAT requirements in accordance with the 2011 Drop Trailer Decision. The 2011 Drop Trailer Decision established the MAAT in fiscal 2012 and to be changed each subsequent fiscal year by a consumer price index adjustment. BCFS is required to ensure that the average revenue

per vessel-foot occupied (lane feet occupied by drop trailers and their hostler units) for the quarter, shall not be less than the MAAT.

In order to determine BCFS' compliance with the drop trailer MAAT requirements, it is necessary to understand the flow of supporting inputs used to calculate the average revenue per vessel-foot occupied and to verify that calculations spreadsheets are functioning properly. The following specific procedures were performed as part of the MAAT compliance verification:

Procedure	Observations (s)
Examined the structure of Excel spreadsheets and key formulas to verify that inputs and calculations were consistent with the 2011 Drop Trailer Decision	<ul style="list-style-type: none"> • BCFS' supporting analysis has included terminal fees (hostling) and other charges (i.e. parking) in the total revenue from drop trailer in accordance with Memorandum 42 • BCFS' supporting analysis has (correctly) included hostler footage in the total number of drop trailer service feet in accordance with Memorandum 42 • BCFS' supporting analysis has correctly calculated the average tariff per foot figure used to verify compliance with the MAAT requirements • BCFS' supporting analysis starts fiscal 2012. This rate is indexed annually by the British Columbia consumer price index ("CPI") • BCFS' methodology for calculating CPI and indexation appear to be implemented correctly in the supporting analysis
For a sample quarter (ending September 30, 2015), randomly selected 3 customers and traced contract details, pricing and volumes to BCFS' general ledger	<ul style="list-style-type: none"> • PwC did not note any discrepancies between customers' contract terms, pricing/volume inputs on supporting analysis and BCFS' general ledger
Reviewed the spreadsheets for errors and formula consistency using a spreadsheet analytics tool	<ul style="list-style-type: none"> • PwC found no significant errors in the spreadsheet and any minor errors/inconsistencies had no impact on MAAT compliance
Compared the average tariff per vessel-foot for each quarter from Q1 2012 to Q4 2016 against the MAAT	<ul style="list-style-type: none"> • The average tariff per vessel-foot was above the MAAT in all quarterly instances • PwC observed that tariff rates per vessel-foot for certain individual customers are below the MAAT from time to time. It is important to note that individual customer tariff rates per vessel-foot below the MAAT does not indicate non-compliance as compliance is based on BCFS' average tariff rate per vessel-foot

Appendix C includes a table and graph which summarizes the lowest tariff per vessel-foot, average tariff per vessel-foot and MAAT for each quarter. PwC did not observe any instances where the average revenue per vessel-foot for the quarter was below the MAAT. The calculations and supporting data used by BCFS to report the quarterly total revenue from its drop trailer tariff on the major routes and the number of vessel-feet occupied (lane feet occupied by drop trailers and their hostler units) were appropriate. Based on our observations, BCFS appears to be fully compliant with the drop trailer MAAT requirements of Order 11-01 and Confidential Order 11-01A and has not been pricing its drop trailer service below its direct costs and an appropriate proportion of indirect costs.

Analysis of Current Drop Trailer Costs

BCFS updated MAAT calculations for fiscal 2017 based on the same methodology applied by Order 11-01. A comparison of fiscal 2012 and fiscal 2017 MAAT calculations (Order 11-01) can be found in Appendix D. PwC has analysed the differences between BCFS' F2012 and F2017 (Order 11-01) MAAT figures:

Cost Category	PwC Analysis
Direct Operating Costs	<ul style="list-style-type: none"> • Direct operating costs have increased • Drop trailer footage has increased. • BCFS has achieved economies of scale and as a result, the direct operation costs per foot have decreased • Overall direct asset costs have increased, however, costs have decreased on a per footage basis as costs are spread over a higher volume of drop trailer footage.
Direct Asset costs - Amortization and Net Financing costs	<ul style="list-style-type: none"> • Direct asset costs have increased • Drop trailer footage has increased • BCFS has achieved economies of scale and as a result, the direct asset costs per foot have decreased • Overall direct asset costs have increased, however, costs have decreased on a per footage basis as costs are spread over a higher volume of drop trailer footage.
Route Overhead Allocation	<ul style="list-style-type: none"> • The total capacity provided on Route 1 and 30 has decreased slightly while total route overhead charge has increased slightly • The overall result is a small increase in the route overhead allocation per foot
Income Tax Advantage – Drop Trailer	<ul style="list-style-type: none"> • The value of the drop trailer income tax advantage has increased • The total drop trailer footage has increased • The overall result is a decrease in the drop trailer income tax advantage per foot
Income Tax Advantage – Vehicle	<ul style="list-style-type: none"> • The value of the vehicle income tax advantage has decreased. The value of the vehicle income tax advantage in 2010 was based on an estimate of the mature market. The value of the vehicle income tax advantage in 2015 reflects actual results for fiscal 2015. • The total vehicle footage has decreased • The overall result is a decrease in the vehicle income tax advantage per foot
Total Cost per foot	<ul style="list-style-type: none"> • This value is calculated as the sum of the above cost categories
Total Cost per foot Interpolated to Horizon Volume	<ul style="list-style-type: none"> • An assumed horizon volume was based on the mid-point between the 2015 drop trailer market size and an estimate of BCFS' mature market share in 2020. • The total cost per foot in future years in 2020 was calculated as 90% of the 2015 total cost per foot, factoring a 10% efficiency gain assumption
MAAT after applying Inflation at 2%	<ul style="list-style-type: none"> • This value is calculated by indexing the MAAT calculated above to the applicable starting year at 2% inflation

Submissions Regarding the Drop Trailer Service

As indicated in the Background section, BCFS' drop trailer service reached the volume specified in Order 11-01 in 2015. Upon reaching this milestone, the Commission invited interested parties to submit comments on BCFS' drop trailer services. Submissions were received from eight interested parties, including BCFS and Seaspan, who provided the vast majority of the comments.

BC Ferries and Seaspan have provided extensive commentary on the drop trailer service, including responses to the following five questions posed by the Commission on January 15, 2016 on its website. PwC's comments and analysis on the submissions regarding the drop trailer service are presented below.

Direct and an Appropriate Proportion of the Indirect Costs

An earlier section of this report has demonstrated that BCFS has priced the drop trailer service above direct costs and an appropriate proportion of indirect costs, as defined by the 2011 Drop Trailer Decision, since the inception of the MAAT. PwC's assessment is based on the calculation methodology for direct costs and an appropriate proportion of indirect costs used during the development of the 2011 Drop Trailer Decision.

Whereas the initial assumption in 2011 was that per foot costs would increase at the rate of inflation, BCFS' costs have decreased on a per foot basis since the 2011 Drop Trailer Decision due to economies of scale.

Potential Sources of Unfair Competitive Advantage

The Act requires that four factors or categories be considered in the determination of possible sources of unfair competitive advantage: 1) use of or access to government owned terminals/vessels that are or had been owned by government; 2) tax exemptions; 3) subsidy; or 4) any other factor.

In the 2011 Drop Trailer Decision, the use of or access to government-owned terminals/vessels and potential subsidy of major routes were not found to be sources of competitive advantage. The same conditions remain. In addition, we observe no cross-subsidization of drop trailer services on the Major Routes.

Other conditions giving rise to the determination of unfair competitive advantage may have changed:

- the non-taxable status of BCFS continues, however, the impact of the tax advantage has been substantially reduced. The tax advantage is estimated as the difference between the pre-tax and post-tax rate of return on regulated assets directly and indirectly associated with the drop trailer service. Since 2012 there is no longer a requirement for a regulated cost of equity in the calculation of the price caps for performance terms. As a result, the cost of equity has not been updated for some time. PwC has estimated a lower cost of equity in Appendix D based on a preliminary analysis of input factors that are used in the estimation of cost of equity. Furthermore, corporate tax rates have declined since 2011;
- the obligations under the CSFC that result in excess capacity suggest they also restrict the ferry operator's ability to take full advantage of that capacity in different ways, including managing the

demands of different users, seasonal peaks and schedule inflexibility. It is also noted that excess capacity for a seasonally influenced transportation business is not unique to BCFS; and

- other changes to the regulatory framework include the requirement for oversight of the ferry operator's long term capital plan, approval of major capital expenditures and performance reviews – these provide the Commission new tools for balanced regulatory oversight of ferry services including competitive services.

Inclusion of Return on Equity as a Cost

PwC has interpreted the definition direct and indirect costs, from a cost accounting perspective. In contrast, the concept of recovery of the cost of capital in regulated industries is typically expressed as a revenue requirement, not a cost.

We note that pricing for individual services provided by BCFS does not build in a cost of capital. Rather, the recovery of debt service costs is reflected in the system for setting price caps (which includes the drop trailer service) whereby the price cap is applied to the weighted average pricing of the entire basket of regulated services.

Indirect Cost Allocation

BCFS have argued that only marginal costs should be applied in the calculation of the MAAT. This position is supported by the extensive commentary from the economist Dr. Roger Ware who was engaged by BCFS. Dr. Ware's arguments are premised on what should be included in "appropriate costs" of the drop trailer service, drawing from principles of competition law.

Seaspan, on the other hand, have provided extensive arguments that "appropriate costs" should include "fully-allocated costs" if BCFS' drop trailer service is not solely off-peak or "100% Utilization Cost"² if BCFS' drop trailer service is viewed as off-peak. Seaspan's position is supported by detailed commentary from the Drazen Consulting Group.

The approach adopted in the 2011 Drop Trailer Decision allocates indirect costs through a route overhead charge. The route overhead charge is intended to capture an appropriate portion of the indirect cost of providing terminal and deck space, and marine transport. The approach is to allocate the general overheads associated with vessels and terminals to each traffic type on the same basis, by dividing the general route overheads by the total route capacity to arrive at a per-foot charge. A cost allocation between passengers and vehicles (for vessel-related, terminal-related and system-related costs) is required in this approach. All overhead costs, including regional management, corporate services, amortization and financing, have been captured through the route overhead charge.

The Commission's position from the 2011 Drop Trailer Decision supported by PwC's analysis was that competitive services must be allocated a share of indirect costs. In the case of the drop trailer service, these costs include vessel, terminal, regional management and corporate overheads.

Drop Trailer Horizon Volume Adjustment

A strong argument exists that actual drop trailer volumes should be used as the basis for allocation of the MAAT on a go-forward basis. The challenges with the current formula using the share of the estimated "mature market state" as a basis for calculating overheads include not knowing what the total size of the market is. Estimating the horizon volume is further complicated by a lack of understanding of how

¹ This would set the MAAT at a level that includes the full indirect cost to provide drop trailer service.

² This unit cost approach calculates the unit cost of the deck space (and landside facilities) as if the capacity were 100% utilized. This is the current approach used in calculating the MAAT.

economic factors and competitive forces including pricing of other modes of transport influence both market share and the total size of the market. Under the current formula the difference in overheads calculated based on the original estimate of the horizon volume is greatly diminished with increased volumes.

Four-Quarter Trailing Average Compliance

BC Ferries have also requested that the quarterly compliance with the MAAT be assessed based on BCFS' average performance over the previous four quarters (i.e. a four-quarter trailing average). The four-quarter trailing average approach appears reasonable from an administrative efficiency perspective and is supported by a precedent in the price cap compliance calculation.

Frequency of Tariff Adjustment

If required, there appears to be benefit in adjusting the tariff from an administrative perspective at the beginning of each performance term.

Recalculated MAAT Calculation

PwC has recalculated the MAAT using the approach in the 2011 Drop Trailer Decision with some modifications to: 1) using the current tax rate and the current cost of equity as it relates to the income tax advantage; and 2) elimination of the drop trailer horizon volume adjustment. These modifications are meant to update the MAAT to reflect current operating assumptions if a minimum tariff for BC Ferries' drop trailer service is still required.

The effect of these changes on the calculation of the MAAT can be found in Appendix E.

Conclusion

PwC has reviewed BCFS' compliance with the drop trailer MAAT requirements in accordance with the 2011 Drop Trailer Decision. BCFS is required to ensure that the average revenue per vessel-foot occupied (land feet occupied by drop trailers and their hostler units) for the quarter, shall not be less than the MAAT. PwC did not observe any instances where the average revenue per vessel-foot for the quarter was below the MAAT. The calculations and supporting data used by BCFS to report the quarterly total revenue from its drop trailer tariff on the major routes and the number of vessel-feet occupied (land feet occupied by drop trailers and their hostler units) were appropriate. Based on our observations, BCFS appears to be fully compliant with the drop trailer MAAT requirements of Order 11-01 and Confidential Order 11-01A and does not price its drop trailer service below its direct cost and an appropriate proportion of indirect costs.

Overall drop trailer costs have decreased on a per foot basis since the 2011 Drop Trailer Decision. The decline in costs results mainly from economies of scale and increased operational efficiencies. These cost declines are offset slightly by an increase, on a per foot basis, in the route overhead allocation.

PwC has reviewed submissions from BCFS, Seaspan and other parties with an interest in the drop trailer service and provided support to the Commission in its review.

If a minimum tariff is still required PwC has recalculated the MAAT using the approach in the 2011 Drop Trailer Decision with some modifications made to allow the MAAT to reflect current operating assumptions. The recalculated MAAT can be found in Appendix E.

The following appendices have been removed as they include information of a confidential and commercially sensitive nature:

Appendix A - Questions to BCFS and their Responses

Appendix B – 2011 MAAT Calculation

Appendix C – Actual Drop Trailer Pricing Compared to the MAAT

Appendix D – Current Drop Trailer Pricing

Appendix E – MAAT Calculation based on Current Pricing

Appendix F

By way of background, BCFS allocates costs for the purposes of the annual route statement report prepared for the Commissioner. BCFS allocates all costs into one of four categories: Vehicle-related, Passenger-related, Revenue-related (i.e. corporate overheads) and Drop Trailer-related. The Revenue-related costs can be further disaggregated into vehicle and passenger related subcategories. All of BCFS' costs are accounted for in the cost allocation.

Costs Included in Allocation Methodology

Ships Wages
Crews Not on Board & Staffing Pool
Fuel Costs
Ship Other
Ship Refit & Maintenance
Marine Insurance
Terminal Operations
Terminal Catering Expense
Drop Trailers
Commercial Management
Terminal Maintenance
Regional Management
Corporate Services
Amortization - Capital Assets
Amortization - Deferral Accounts
Interest Expense

In the 2011 Drop Trailer Decision, the Commissioner applied a “route overhead charge” to the MAAT to recognize the provision of drop trailer overhead costs, terminal and deck space, and marine transport. The route overhead charge is calculated by allocating vehicle related costs (for vessel, terminal, regional management and corporate overheads), for Routes 1 & 30, on the basis of the lane feet occupied by the drop trailers as a percentage of total vehicle deck space. This methodology is consistent the cost allocations used by BCFS for its annual route statement report. The methodology to calculate the route overhead charge for Routes 1 & 30, as required by the MAAT, includes only Vehicle-related overhead costs and the Revenue-related overhead costs excluding the passenger related proportion. Drop Trailer-related costs are allocated to drop trailer direct costs for the purposes of the MAAT. This allocation methodology is illustrated below:

