EXECUTIVE VICE PRESIDENT & CHIEF FINANCIAL OFFICER

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December 8, 2010

Mr. Martin Crilly
British Columbia Ferries Commissioner
290 Longview Road
Comox, BC V9M 3T7

Dear Mr. Crilly:

Re: Filing With the British Columbia Ferries Commissioner Regarding Section 45.1(1) of the *Coastal Ferry Act* and Drop Trailer Service

British Columbia Ferry Services Inc. (BCF) attaches its Reply Submission dated December 8, 2010.

This filing contains appendices, some of which have been redacted in a manner consistent with the Commissioner's November 15, 2010 decision regarding confidentiality (Order No. 10-01). Specifically, the redacted appendices are:

1. Appendix 1, Exhibit A to EES Reply Report;
2. Appendix 2, Current Rates Per Foot; and
3. Appendix 3, Reports of Standard & Poor's (S&P) and DBRS.

In Exhibit A to Appendix 1 and Appendix 2, BCF has provided the description of rows and columns on these spreadsheets, with confidential numbers redacted. BCF submits that this treatment remains appropriate. Appendix 3 has been redacted in it is entirety because BCF is contractually required by S&P and DBRS to maintain confidentiality over these reports. The S&P and DBRS reports are available from those companies for a fee.

The full, unredacted appendices have been provided to the Commissioner under separate cover.

Yours truly,

Robert P. Clarke, CGA
Executive Vice President & Chief Financial Officer

Attach.

British Columbia Ferry Services Inc.

Filing With the British Columbia Ferries Commissioner

Regarding

Section 45.1 of *the Coastal Ferry Act*

And

Drop Trailer Service

British Columbia Ferry Services Inc.
Reply to Comments Received by Commissioner

December 8, 2010

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Section 1 – Introduction and Overview

1.1 Introduction

British Columbia Ferry Services Inc. ("BC Ferries" or "BCF") submits this Reply Submission in response to submissions filed with the Commissioner, and provided to BC Ferries as part of the Commissioner's review of drop trailer service under section 45.1(1) of the *Coastal Ferries Act* ("CFA"). The bulk of this Reply Submission addresses the Submission of Seaspan Coastal Intermodal Company ("Seaspan"), dated November 26, 2010, and the accompanying evidence of Mr. Linxwiler. BCF has provided additional evidence in rebuttal where required to refute arguments made by Seaspan and its expert, including a reply report prepared by EES Consulting ("EES Reply Report") included in Appendix "1".

It is evident that Seaspan's operating assumption in presenting its argument is that BCF has, to date, priced its drop trailer service at the absolute minimum it can get away with. This assumption fuels Seaspan's belief that BCF's drop trailer prices would have to be increased in order to meet a floor price established by the Commissioner under section 45.1(2)(b) based on an appropriate cost allocation. In reality, BCF has, since the inception of the drop trailer service, priced the service to maximize revenue by charging rates that the market will reasonably allow. Revenues generated from drop trailer service serve to reduce rates for the core customers. Even after factoring in BCF's customer-specific discounting of drop trailer service, BCF's prices are <u>higher</u> than the floor that would be established under section 45.1(2). Put another way, if BCF were to price its drop trailer service, and even its live service, based on marginal costs (as EES recommends) or average costs (as Mr. Linxwiler advocates), <u>its prices for these services would go **down**, not up</u>. Passenger and passenger vehicle rates, which are currently subsidized by commercial service, would go up considerably. This is the exact opposite result from what Seaspan is presumably expecting. Even though the floor price yielded by the EES and Linxwiler approaches is much lower than BCF's current rates for drop trailer service, BCF has every intention of continuing to price its drop trailer services as it had done prior to the introduction of section 45.1. That is, BCF will set prices for drop trailer service that will maximize revenue generation for the benefit of core customers to the extent permitted by competitive market conditions. Aggressive price discounting, which is of concern to Seaspan, runs counter to BCF's objective of maximizing revenue generation from drop trailer service and BCF has no interest in pursuing that strategy.

In this Reply Submission, BCF makes the following key points that demonstrate that BCF's drop trailer service is priced appropriately:

- The Cost of Service Analysis (COSA) performed by BCF employed an accepted cost allocation methodology to demonstrate that the prices for drop trailer service exceed BC Ferries' direct costs and an appropriate proportion of indirect costs associated with providing drop trailer service. The attached EES Reply Report demonstrates certain flaws in Mr. Linxwiler's evidence that undermine Seaspan's reliance on his analysis.

- In any event, BCF's pricing of drop trailer service passes all three elements of the three-part test posited by Mr. Linxwiler and Seaspan for determining an appropriate cost allocation and fair competition under section 45.1 of the CFA. BC Ferries has never charged a price for drop trailer service to any customer since the inception of the service in March 2009 that is below the unit costs yielded by Mr. Linxwiler's allocation methodology using pro-forma fiscal 2009/2010 costs.

- BCF competes on a fair basis with other providers of drop trailer service. BC Ferries' history as both a Crown corporation and a regulated entity does not, in and of itself, result in "unfair competitive advantage" within the meaning of section 45.1(1). The pertinent inquiry is whether (a) these circumstances have, in fact, conferred an advantage that helps BCF compete on drop trailer service; and (b) if so, whether the competitive advantage conveyed upon drop trailer service is "unfair". The factors identified by Seaspan do not confer an "unfair competitive advantage" vis-a-vis drop trailer services.

Accordingly, BC Ferries respectfully submits that BC Ferries' drop trailer service is priced in a manner that exceeds – both on average and in the case of every individual contract - BC Ferries' direct costs and an appropriate proportion of indirect costs associated with providing drop trailer service. BC Ferries is also competing on a fair basis with the incumbent providers of drop trailer service. BCF respectfully requests that the Commissioner make those determinations.

1.2 Focused Nature of this Reply Submission

While BCF has responded to key points raised in the submissions filed by Seaspan, in light of the time available BC Ferries has not responded to every argument. The same is true for comments filed by other interested parties, a number of which strayed beyond the proper scope of the Commissioner's inquiry under section 45.1. BCF's silence in respect of any particular submission made by commenting parties should not be interpreted as agreement.

1.3 Organization of this Filing

This Reply Submission is organized as follows:

- Section 2 – BCF discusses the Commissioner's mandate under section 45.1(1).

- Section 3 – BCF identifies key aspects of the EES Reply Report, which provides further explanation as to why the incremental approach to cost allocation is appropriate.

- Section 4 – BCF demonstrates that the application of Seaspan's (Mr. Linxwiler's) proposed analysis still supports BCF's position that BC Ferries is charging appropriate fees for drop trailer service.

- Section 5 – BCF addresses Seaspan's arguments as to why BCF enjoys an "unfair competitive advantage" on drop trailer service.

- Section 6 – BCF addresses other comments submitted to the Commissioner.

- Section 7 – BCF sets out its requested findings. It also addresses what should occur in the event the Commissioner makes a finding adverse to BCF.

- Section 8 – Conclusion.

- Appendix 1 – EES Reply Report.

    - Confidential Exhibit "A" (redacted for confidentiality)[1] – Calculations based on Mr. Linxwiler's approach that further demonstrate BCF's service is priced appropriately.

- Confidential Appendix 2 – Current rates per foot.[2]

- Confidential Appendix 3 – Reports of Standard & Poor's ("S&P") and DBRS Limited ("DBRS").[3]

[1] BCF has redacted Exhibit "A" in a manner consistent with the Commissioner's November 15, 2010 decision regarding confidentiality (Order No. 10-01). Specifically, BCF has provided the description of rows and columns, with numbers redacted. The confidential portion of the documents have been provided under separate cover.
[2] Maintaining confidentiality over this Appendix is consistent with the Commissioner's November 15, 2010 decision regarding confidentiality (Order No. 10-01). The confidential document has been provided under separate cover.
[3] S&P and DBRS require confidentiality to be maintained as part of their contract. The reports are available for a fee from these companies directly.

Section 2 – Ferry Commissioner’s Mandate is Pricing and Fair Competition

Seaspan states that it does not take issue with BC Ferries entering the drop trailer market[4], and, indeed, BCF is permitted to compete in this market as contemplated by the Act. The mandate of the Commissioner under section 45.1 is limited to ensuring that drop trailer service is priced appropriately based on cost of service principles and ensuring fair competition. The focus on cost allocation and fair competition, and not on enforcing the incumbent’s unregulated monopoly, is evident not only from the wording of section 45.1(1), but also because continued competition in the drop trailer market is the result under any of the possible outcomes in this proceeding. In particular, the Commissioner will either:

- determine that BCF is already pricing its service appropriately, without accessing an “unfair competitive advantage”, and take no further action (meaning that BCF is entitled to engage in drop trailer service that is priced fairly);

- put the service out to contract where pricing will be determined by the market, and where the incumbents will still face competition from the alternative service provider; or

- set a floor price for BCF’s drop trailer service that reflects a proper allocation, adjusted for any “unfair competitive advantage”, leaving BCF free to otherwise compete with the incumbents.

This emphasis on pricing and fair competition, rather than enforcing the incumbent’s unregulated monopoly and excluding BCF from the market, is also evident in the passages quoted by Seaspan from the Comptroller General’s Report.[5] The Comptroller General emphasized that “entrepreneurial behaviour” is to be “expected of a commercial enterprise” like BCF. Further, the Report provided that the end objective is “that <u>the allocation of costs</u> between such commercial services and passenger/vehicle services be transparent and subject to independent oversight.” [Emphasis added.]

Seaspan implicitly warns that a determination by the Commissioner that BCF is pricing drop trailer service appropriately will likely result in Seaspan leaving the business.[6] Whether or not that threat is real, Seapan obviously has an interest in requiring BCF to increase its

[4] Seaspan Submission, p.1, line 18.
[5] Seaspan Submissions, pp.6-7.
[6] Seaspan Submission, p. 24, lines 4-12; p.39 lines 1-4.

prices. BCF, for its part, believes that there are public and customer benefits associated with BCF introducing fair competition into the drop trailer market after Seaspan and Van Isle Barge Services ("VIBS") had long enjoyed an unregulated monopoly on their routes.[7] While BCF is firmly of the view that it should be engaged in drop trailer service, and that the result is beneficial to core customers and users of drop trailer service, Arguments both for and against BCF's participation in the drop trailer market[8] are really useful only as context. It follows from the Commissioner's legislative mandate to examine cost allocation and "unfair competitive advantages" that this inquiry is not about the role of regulated monopolies in society, whether or not BCF should have entered the drop trailer business, or whether continued competition is good or bad for Seaspan and VIBS.

[7] BCF addressed policy issues on pp.21-24 of its Filing.
[8] In addition to the evidence of BCF and Seaspan, other comments filed by members of the public speak either for or against BCF's involvement in the drop-trailer business. See, for example, the comments of Frank Thompson (October 9, 2010), and W.A. (Bill) New (July 19, 2010). Also, comments that amount to complaints about BCF service generally, or its executives are out of scope and BCF will not address them further in this Reply Submission.

Section 3 – Drop Trailer Pricing Should Reflect that Core Customers Are Driving Fixed Costs

3.1 Introduction

The Commission must consider under section 45.1(1) of the CFA whether BCF is "pricing the service below the direct costs and an appropriate proportion of the indirect costs associated with providing that ferry transportation service". BCF's initial Filing, in conjunction with the EES Consulting report, explained why drop trailer service is properly priced to reflect the fact that fixed costs of vessels and terminals are driven by a need to serve the core customers and not by drop trailer customers. Mr. Linxwiler, on Seaspan's behalf, is critical of BC Ferries' COSA in several respects. However, the EES Reply Report appended to this Reply Submission identifies the shortcomings of Mr. Linxwiler's analysis, and confirms the appropriateness of allocating costs based on cost causation as BCF has done.

In this Section, BCF:

- Summarizes the approach taken in the BCF COSA; and
- Explains why Mr. Linxwiler's analysis is flawed.

3.2 The BC Ferries COSA and the EES Report

BC Ferries described the COSA in detail in its initial Filing. While BCF does not propose to repeat that in-depth discussion here, it is worth reiterating the general approach to provide the context for addressing Mr. Linxwiler's comments.

BCF's COSA allocated all direct costs of providing drop trailer service to drop trailer customers. The "appropriate proportion of the indirect costs" associated with providing drop trailer service must recognize that the indirect costs are capacity driven, and hence caused by core services, not by drop trailer service.[9] The benefit of BCF drop trailer service is that it makes a contribution to overhead for the benefit of core customers without increasing capacity requirements. EES confirmed that true marginal pricing would not add any material indirect costs because they would not change as a result of BCF

[9] See Order 04-01, for instance, in which the Commissioner approved the purchase of new vessels over upgrading existing vessels in part due to capacity constraints and their impact on core service. The Commissioner stated on p.4: "The three vessels provide a significant proportion of the required annual trips on routes 1 and 2. Overload situations are a frequent occurrence, especially in the peak summer months when almost all sailings are in an "overload" situation."

providing the drop trailer service; however, EES has allocated certain costs based on revenue contributed by core and drop trailer services. Applying the revenue allocator to certain costs is consistent with the Route Statement methodology.[10]

A comparison of the results of the COSA to the revenues generated by the drop trailer service demonstrates that the service is priced appropriately and has been since the inception of the service. As per Appendix 2 of this Reply Submission, every drop trailer customer is paying unit prices in excess of the fairly allocated unit costs as determined by EES and BCF.

3.3 Drop Trailer Service as Non-Peak, Lower Value Service

Drop trailer service is limited to certain sailings and is only available during off-peak periods when surplus capacity is available. It is subject to other limitations that are not applicable to live service. The pricing reflects this. Consistent with the non-peak nature of the drop trailer service, and the fact that the core customer classes drive the capacity costs, BCF has allocated capacity-related costs to the core services. In this section, BCF refutes the arguments advanced by Seaspan that seek to re-characterize drop trailer service as (a) a peak service that drives capacity costs, and (b) a premium service that should command a higher price than live trailer service.

Non-Peak Service: The Facts About Excess Capacity

The evidence supports BCF's conclusions that the core customers drive capacity requirements and that drop trailer service is an off-peak service.

The most telling statistic that supports BCF's characterization of the drop trailer service as an off-peak service – a statistic that Seaspan did not acknowledge - is that only 0.2% of BCF's overall traffic has been delayed where there is space on a sailing being occupied by drop trailers.[11] This demonstrates that drop trailer service has a negligible impact on the capacity available for core customers.

Seaspan's first rationale for not accepting BCF's evidence that drop trailer traffic is carried using excess capacity[12] is based on anecdotes of core customer displacement by drop trailers and a misleading interpretation of statistics regarding the drop trailer load profile. In light of the non-material impact cited above, Seaspan's anecdotes about drop trailers being carried while core traffic is left behind are

[10] EES Reply Report, p.2.
[11] Commission's Response to SCIC's Disclosure Request of October 15, 2010; BCF Response to SCIC Question 2.1.
[12] Seaspan Submission, pp.19-20.

misleading.[13] The same is true with Seaspan's reliance only on statistics relating to the number of sailings where one or more vehicles were left in the terminal, without accounting for the number of vehicles impacted. Seaspan has incorrectly equated statistics where drop trailers were carried on a sailing when one or more vehicles were left in the terminal with those vehicles being left behind *because* a drop trailer took its place. BCF identified a number of operational causes of this that have nothing to do with drop trailers.[14] To that end, the 0.2% figure addressed above demonstrates that many of these sailings relied upon by Seaspan involve a minimal number of vehicles that could very easily have been impacted by operational considerations. The pie chart in the response to Seaspan Question 2.1 also shows that there are vehicles delayed when there is no space occupied by drop trailers, emphasizing that other operational factors are in play.

Seaspan's other rationale for portraying drop trailer service as driving capacity requirements is that BCF added Super C Class vessels to Routes 1 and 30.[15] Seaspan suggests this was done to meet drop trailer demand. The fundamental problem with Seaspan's argument is that BCF entered into contracts to have these vessels built in 2004, long before any consideration was being given to providing drop trailer service. They were built to address core peak demand.[16] Moreover, the decision to put larger vessels on Route 30 was part of a plan to:

- divert traffic from the overcrowded Horseshoe Bay terminal by providing the same amenities on Route 30 as Route 2 (Horseshoe Bay – Departure Bay), i.e. making Route 30 a flagship route; and

- anticipate the completion of the South Fraser Perimeter Road.

It is untenable to suggest, as Seaspan does, that BCF had failed to anticipate the drop in demand associated with economic circumstances when it ordered these vessels[17], and is now compensating for this supposed error by expanding drop trailer service. It would have been imprudent for BCF – as it would be for any operator - to undersize vessels, which are long-term capital investments, based on short-term declines in demand. Further, BCF builds to meet peak capacity, not because it is required to do so, but because it is only by having the capacity to meet peak season demand that BCF can generate sufficient revenue to maintain the same low fares in the off-season. Under-

[13] This point applies equally to other anecdotes submitted by various members of the public during this process.
[14] Commission's Response to SCIC's Disclosure Request of October 15, 2010; BCF Response to SCIC Question 2.1.
[15] Seaspan Submission, p.23, lines 15-30.
[16] Order No. 04-01.
[17] The size of which the Commissioner considered reasonable in Order No. 04-01.

sizing vessels means not meeting the summer demand, or having to operate more frequently in the summer if the demand is to be met, resulting in an increase in core customer fares throughout the year.

Value Proposition of BCF Drop Trailer Service

Seaspan argues that drop trailer service is underpriced when discounted below the posted price because, it says, drop trailer service provides greater service, at a greater cost, than live service.[18] This argument, which appears to conflate cost of service-based rates and rates based on value of service, should be rejected for several reasons.

First, Seaspan is correct that there are additional direct costs associated with drop trailer service, but all of the costs it identifies[19] are accounted for in the COSA.

Second, to the extent that Seaspan is advocating a minimum drop trailer price based on "value of service" to the customer, as opposed to cost of service, that would exceed the mandate of the Commissioner under section 45.1(1). The Commissioner is empowered to examine whether (a) rates charged for drop trailer service reflect direct costs and an appropriate allocation of indirect costs, or (b) BCF enjoys an "unfair competitive advantage". The remedies identified in section 45.1(2) result in a cost-based floor price, and do not require a floor price accounting for a higher "value of service".

Third, Seaspan's "value of service" based argument is premised on an incorrect supposition regarding the relative value of service as between live and drop trailer service. Drop trailer service is limited to certain sailings and is only available during off-peak periods when surplus capacity is available. It provides passage within a range of sailing times, but not a guarantee of a specific sailing time. It requires significant lead time to ensure a particular delivery time. It is also secondary to core service in the sense that if the ferry cannot be turned around within 30 minutes, the drop trailers will not be loaded. Live service is not subject to these constraints.

The premise of Seaspan's argument that BCF drop trailer service provides a greater level of service than live service is:

> "One cannot get on and off the ferry any faster with live service. More importantly, with live ferry service, the trucking company provides the driver,

[18] Seaspan Submission, pp.20-22.
[19] Seaspan Submission, p.21, line 32-p.22 line 5.

> the tractor and the trailer, paying full fare for each and BC Ferries does nothing but provide the ferry service."[20]

A key element of the value proposition of live service is its speed relative to drop trailer service. Drop trailer service requires additional lead time as compared to live service. Seaspan's statement above obviously focuses only on transit and unloading time, which is only part of the time required for drop trailer service.[21]

Even considering only transit time once loaded, it is an oversimplification to say that the transit time is the same because "one cannot get on and off the ferry any faster". Drop trailer service always requires additional time. Whereas live trailers drive straight off the vessel, drop trailers are first taken to the drop site and processed for pick up. The time differential is approximately 45 minutes, which is material when one considers that a live trailer could have reached its ultimate destination in Victoria or elsewhere by the time the drop trailer is processed. Ferry traffic adds to the advantage that live service has in avoiding the additional drop trailer processing time, as a drop trailer picked up as soon as processing is complete will follow all of the ferry traffic downtown. In practice, the traffic can add up to half an hour to the trip to downtown Victoria, meaning that the total advantage can be up to an hour and a half. The live trailer could be unloaded and returning to Swartz Bay by the time the drop trailer reaches the same destination. Live trailer service can save many hours in delivery time when multiple trailers are considered over time.

Fourth, Seaspan's assertion that drop trailer service is already priced higher than live service,[22] purportedly evidencing that drop trailer service is a higher valued service, is incorrect. This is illustrated by the following comparison between the published rate for drop trailer service and the rate for live service, complete with other charges:

	Drop Trailer Service	**Live Service**
Tariff Price	$357.75[23]	$378.00[24]
Terminal Fee	$31.00	-
Driver	-	$14.00
Total	**$388.75**	**$392**

Live service, in combination with passenger service, drives BCF's

[20] Seaspan Submission, p.20.

[21] Seaspan suggests on p.20, lines 20-21, that the time estimates BCF provided are inconsistent with "at" and "by" service. The numbers provided by BCF were on an "apples to apples" basis with other providers by focussing on crossing and unloading/processing time, and excluding the lead time requirement associated with drop trailer service.

[22] Seaspan Submission, p.21, lines 5-10.

[23] Based on published price $6.75/ft x average trailer length of 53 ft.

[24] Based on price of $5.25/ft x average length of 72 ft for tractor and trailer.

capacity requirements, and drop trailer service is an off-peak service. Capacity related expenditures, which BCF's COSA allocates to the core customers that drive those costs, represents the much larger portion of costs than the direct costs of drop trailer service that are allocated to drop trailer service. Thus, live service is more expensive to provide notwithstanding the additional direct costs to provide drop trailer service.

3.4 Mr. Linxwiler's Commentary on COSA

Mr. Linxwiler is critical of the COSA performed by BCF in several respects. However, his analysis on matters within his expertise does not withstand scrutiny. Further, BCF submits that Mr. Linxwiler's report strays at times beyond his expertise.

Opinion Beyond Scope of Expertise Should Be Disregarded

While Mr. Linxwiler is qualified to speak to cost allocation matters, at times his report strays beyond his area of expertise. For instance, he offers what amount to legal opinions on how to interpret section 45.1(1),[25] and expresses gratuitous opinions on government policy in what amounts to advocacy on Seaspan's behalf.[26] BCF submits that these aspects of Mr. Linxwiler's report should be disregarded and given no weight. BCF will not address them further.

Overlooks Relevant Considerations

The EES Reply Report identifies a number of instances where Mr. Linxwiler overlooked relevant considerations. This casts doubt on his overall opinion.

Mr. Linxwiler's comparison of the provision of ferry services to electric generation forms a basis for his argument that some fixed costs should be allocated to drop trailer service. EES explains why a more obvious analogy to ferry service is electric transmission. Generation involves the production of a commodity, and there is no easy parallel with BCF's service. However, electric transmission is constructed as transportation infrastructure that moves electricity from point A to point B, just as ferries are constructed to move passengers and vehicles from point A to point B. The costs of electric transmission are typically allocated according to the customers driving capacity (e.g.

[25] Mr. Linxwiler, for instance, proffers an interpretation of the meaning of "unfair competitive advantage". Mr. Linxwiler's relevant expertise is with respect to cost allocation principles, not the interpretation of legislation. While his interpretation of "unfair competitive advantage" is couched in terms of his "experience", Mr. Linxwiler's opinion is unquestionably legal advocacy.

[26] An example of this on p.8 is where Mr. Linxwiler states that BCF should be "held to the even higher standards of fairness and non-discrimination. Pricing by monopolies (including BC Ferries) should not be anticompetitive, even if it is not clearly intended to be predatory."

the wires are sized to meet the coincident firm or non-interruptible requirement at a single point in time), as has been done by BCF in accounting for summer capacity requirements driven by core customers.

The other justification that Mr. Linxwiler offers for why incremental pricing should not be applied is the US Federal Energy Regulatory Commission ("FERC") "Or pricing" policy. As EES observes, the "Or pricing" analogy is inapt. The "Or pricing" approach addresses a circumstance where the addition of a new firm (i.e. highest priority, non-interruptible) electric transmission customer requires additional capacity (i.e. the wires would have to be upgraded to permit more electricity to be moved on a firm basis at the peak time). While new core ferry customers could lead to larger vessels being required in a manner akin to the situation contemplated by "Or pricing", it is not possible for drop trailer customers to trigger the need for capacity upgrades. Drop trailer service is a service that, by its terms, only uses surplus capacity. A transmission service with this interruptible or lower priority characteristic could not be subject to "Or pricing" of new capacity built to accommodate that new customer, as the transmission provider simply would not build the capacity.

Mr. Linxwiler states that drop trailer customers are not the only off-peak customers.[27] He characterizes this as discriminatory to have core off-peak customers recover vessel related costs, but not drop trailer customers. The reason core customers continue to pay for vessel related costs in the off-peak times is that they are not paying enough at the peak to recover the capacity costs. They are the customer class driving the vessel capacity requirements, and so the costs are being recovered from that class of customers. Core customers pay a different fare because they are a different class of service reflecting different service attributes.

Recommendation to Institutionalize Unregulated Monopoly Pricing

Mr. Linxwiler states that "The price for a service like drop trailer service offered by a monopoly supplier should not be less than prevailing market prices (that is, prices offered by other suppliers and not distorted by the supplier in question) or long-run incremental costs."[28] The result of the Commissioner setting a minimum price for BCF drop trailer service based on prices offered by Seaspan assuming no competition from BCF, rather than determining a fair, cost-based rate for BCF, would either (a) institutionalize unregulated monopoly pricing, or (b) allow the incumbents to slightly undercut BCF (while still

[27] Linxwiler Report, p.17.
[28] Linxwiler Report, p.3.

enjoying almost all of its unregulated monopoly profits) and drive BCF out of the market. The type of collusion necessary to make this work would be illegal absent the support of an order from the Commissioner. The Commissioner is not mandated by section 45.1(2) to fix a price in this manner.

3.5 Conclusion

The approach used by BCF in the initial Filing, which is supported by the analysis of EES, demonstrated that drop trailer service is properly priced to reflect the fact that fixed costs of vessels and terminals are driven by a need to serve the core customers and not by drop trailer customers. The EES Reply Report demonstrates that Mr. Linxwiler's challenge to EES' methodology is flawed.

Section 4 –Mr. Linxwiler's Methodology Confirms BCF's Position That Drop Trailer Service is Priced Fairly

Seaspan's expert, Mr. Linxwiler, posits a three-part test that he maintains will ensure that the fees charged for drop trailer services are "fair and non-discriminatory and otherwise appropriate".[29] BCF does not accept Mr. Linxwiler's approach, but BCF, with the assistance of EES Consulting, has nonetheless performed a COSA based on Mr. Linxwiler's approach. It is included as Confidential Exhibit "A" to the EES Reply Report. BCF's drop trailer pricing meets Mr. Linxwiler's three-part test for every one of BCF's drop trailer customers. On Mr. Linxwiler's own methodology, the rates BCF charges for drop trailer service are, in the words of Mr. Linxwiler, "fair and non-discriminatory and otherwise appropriate".

In the remainder of this Section, BCF addresses each of Mr. Linxwiler's three criteria in more detail, and summarizes EES' explanation for why the current pricing of drop trailer service meets Mr. Linxwiler's test for an appropriate allocation of costs.

4.1 Mr. Linxwiler's Three-Part Test

Mr. Linxwiler's three-part test that he says renders rates "fair and non-discriminatory and otherwise appropriate" is described in his report as follows:

> "In my opinion, BC Ferries' fees for drop trailer services, if they are to be fair and non-discriminatory and otherwise appropriate, should satisfy three criteria:
>
> (i) First, for the reasons I have described above, BC Ferries' fees for drop trailer services should not be less than the long-run incremental costs of providing the service, including a share of the costs of eventually replacing the ferry vessels and associated terminal facilities. For this purpose, a reasonable (and much higher than zero) share of fixed costs should be allocated on the basis of total through-put for all types of vehicles.
>
> (ii) Second, also for reasons I explain above, in order to be non-discriminatory and to provide a reasonable benefit to other ferry customers, the

[29] Linxwiler Report, p.19.

> normalized rate per foot of transported trailer (taking into account length, width, and height, as well as weight) should not be less than the price charged for transporting other vehicles at the same time. That is, the normalized rate per foot (for vehicle-related ferry costs) should be the same for all customers travelling at the same time.
>
> (iii) Third, in order to provide proper price signals, and also determine a minimum reasonable share of costs reasonably allocated to off-peak customers, the normalized rate or average cost per foot (for vehicle related ferry costs) should not be less than the average cost per foot that would be obtained if the ferry vessels were to be fully utilized. I will explain the basis for this calculation below.[30]

Seaspan included the above passage from Mr. Linxwiler's report in its submission.[31] It endorsed Mr. Linxwiler's approach, saying "Joe Linxwiler's report sets out why BC Ferries' approach is wrong and describes the appropriate regulatory practices and principles to be applied to the BC Ferries Commissioner's determinations in this matter."[32] BCF continues to believe that the EES approach is appropriate. However, Seapan's endorsement of Mr. Linxwiler's test is fatal to its position on BCF's drop trailer pricing, as the application of Mr. Linxwiler's criteria demonstrates and confirms that drop trailer service is priced appropriately.

4.2 BCF Pricing Meets Each Criterion Advocated by Mr. Linxwiler

In this section, BCF summarizes EES' explanation of why drop trailer pricing meets each of the three elements of Mr. Linxwiler's test. Seaspan's assumption that BCF has priced drop trailer service as low as possible is in error. BCF has priced drop trailer service to maximize the revenue to the extent the market will reasonably allow. Hence allocating a proportion of fixed vessel and terminal costs to drop trailer service does not effect the result that drop trailer service is priced above the floor.

Linxwiler Criterion #1: Fees Not Less than LRIC

BCF's pricing of drop trailer service satisfies Mr. Linxwiler's first criterion for appropriate cost-based pricing. Specifically, the fee

[30] Linxwiler Report, p.19.
[31] Seaspan Submissions, p.27.
[32] Seaspan Submissions, p.28.

charged for drop trailer service - whether considering the average fee charged, the posted tariff rate, or the discounted fee charged to individual customers – exceeds “the long-run incremental costs of providing the service, including a share of the costs of eventually replacing the ferry vessels and associated terminal facilities”. The calculations are shown in Confidential Exhibit “A” to the EES Reply Report.

Linxwiler Criterion #2: Normalized Rate Per Foot Not Less Than Price Charged for Other Vehicles at Same Time

BCF’s pricing of drop trailer service satisfies Mr. Linxwiler’s second criterion for appropriate cost-based pricing. Specifically, the normalized rate per foot of transported drop trailer is greater than the price charged for transporting other vehicles at the same time. This suggests that drop trailer service is subsidizing passenger service, not the contrary as Seaspan had expected. The calculations are shown in Confidential Exhibit “A” to the EES Reply Report.

Mr. Linxwiler has included a requirement that this test account for length, width, height and weight.[33] EES’s calculations included in Confidential Exhibit “A” to the EES Reply Report have used length as a factor, and has accounted for the combined length of drop trailer and tractor. However, EES concluded that to include width, height and weight does not make sense in light of the following facts:

- Accounting for width in the Linxwiler calculation implies that there is a variance in capacity depending on the differing width of vehicles. Lanes used by commercial vehicles are a standard width and will accommodate any type of vehicle.

- The ferries employed on Routes 1 and 30 do not accommodate stacking of passenger vehicles on top of each other, and thus the height of vehicles should be irrelevant. Performing calculations based on a fiction that vehicles can be stacked on top of each other is inappropriate.

- The weight of vehicles is also irrelevant because the vessels are designed to operate most efficiently at a weight that exceeds even the typical weight at full capacity and the vessels take on water as ballast as required when the ferry is under the optimal weight to ensure they always operate at maximum efficiency. Specifically, for the Super C's, when traffic is light the ship cannot achieve optimum draught, and more importantly trim, with light loads. The result is an increase in vibration and a

[33] Linxwiler Report, p.19.

decrease in fuel efficiency. To combat that issue, on Friday nights the ship loads 30 to 50 tons of ballast water at each end due to anticipated reduced commercial loads over the weekend. Therefore, heavier vehicles do not cost more to transport.

Linxwiler Criterion #3: Normalized or Average Cost Per Foot Not Less Than Average Cost Per Foot at Full Utilization

BCF's pricing of drop trailer service satisfies Mr. Linxwiler's third criterion for appropriate cost-based pricing. Specifically, the normalized rate or average cost per foot for vehicle related ferry costs (as Mr. Linxwiler defines them) exceeds the average cost per foot that would be obtained if the ferry vessels were to be fully utilized. The calculations are shown in Confidential Exhibit "A" to the EES Reply Report.

It is noteworthy that the result of applying this third element of the test is an *average* floor price. Were the Commissioner to adopt this test as a floor price under section 45.1(2), logic would require BCF's pricing would only have to exceed the floor price when considered on *average*.

4.3 Drop Trailer Service Priced Appropriately on Either Approach

BCF continues to believe that the EES approach reflects a fair cost allocation and demonstrates that drop trailer services are priced appropriately. However, on Mr. Linxwiler's own analysis - which Seaspan endorses - the rates that BCF charges for drop trailer service "are…fair and non-discriminatory and otherwise appropriate".[34] The evidence of both experts support a determination that BCF's drop trailer service is priced above the direct costs and an appropriate proportion of indirect costs.

[34] Mr. Linxwiler's characterization, Linxwiler Report, p.19.

Section 5 – BCF is Competing Fairly

The second aspect of the section 45.1(1) inquiry is whether BCF has an "unfair competitive advantage" in the provision of drop trailer service. BCF outlined in its initial Filing its fair competitive advantages, and also addressed each of the considerations listed in section 45.1(1)(a)-(c). The reasons outlined by Seaspan for why it believes that BCF has an "unfair competitive advantage" in the provision of drop trailer service are without merit. BCF's price for drop trailer service benefits from fair competitive advantages, but the service is otherwise priced to maximize revenues to the extent that the competitive market will reasonably bear.

In this section, BCF will first examine the meaning of "unfair competitive advantage", and then dispose of each of Seaspan's arguments on this point.

5.1 Section 45.1(1) Addresses "Unfair", "Competitive", and "Advantage",

Seaspan's fundamental complaint is: "SCIC takes issue with BC Ferries unfairly competing in the commercial trailer market by utilizing advantages which are unique to BC Ferries and which arise as a result of its, or its predecessor's, relationship with governments."[35] In considering Seaspan's argument, several points with respect to the proper legal interpretation of section 45.1(1) are worth noting.[36]

First, as discussed previously in Section 3, the *Coastal Ferry Act* permits BCF to provide competitive services such as a drop trailer service. Indeed, section 45.1 contemplates that the incumbent provider of a competitive service can continue to face competition from BCF after the Commissioner considers the matter.

Second, the inquiry regarding "<u>unfair</u> competitive advantage" necessarily means that not all competitive advantages are "unfair". BCF can provide competitive services fairly, including relying on fair competitive advantages, without any of the regulatory actions contemplated in 45.1(2).

Third, for the Commissioner to find that BCF has an "unfair competitive

[35] Seaspan Submission, p.1.

[36] Parenthetically, Mr. Linxwiler proffers on p.7 an interpretation of the meaning of "unfair competitive advantage". Mr. Linxwiler's relevant expertise is with respect to cost allocation principles, not the interpretation of legislation. While his interpretation of "unfair competitive advantage" is couched in terms of his "experience", Mr. Linxwiler's opinion is a legal one. His legal advocacy should be disregarded and given no weight.

advantage", the Commissioner must identify a factor that results in a "competitive advantage" to BCF *vis-a-vis* BCF's ability to compete in drop trailer service. The fact that the advantage must be one that directly favours drop trailer service follows from the fact that the advantage in question must be a "competitive" one and thus cannot just benefit services over which BCF has a natural monopoly and does not compete with anyone.

Fourth, BCF agrees with Seaspan that the enumerated factors in 45.1(1)(a) to (c) are not exhaustive as to what might be considered to be an "unfair competitive advantage". The important point, however, is that even these enumerated factors do not give rise to an "unfair competitive advantage" unless they convey a competitive advantage *vis-a-vis* drop trailer service. The qualifier "competitive" necessarily limits an "unfair competitive advantage" to an advantage conferred in relation to a service other than the monopoly services. Thus, a "subsidy" paid to BCF, for example, will not represent an "unfair competitive advantage" if the advantage is only to the benefit of core customers and does not assist BCF in competing for drop trailer business.

Fifth, in the case of a factor not enumerated in 45.1(1)(a) to (c), but that the Commissioner determines confers a competitive advantage on BCF *vis-a-vis* BCF's ability to compete on drop trailer service, the Commissioner must still determine whether the competitive advantage conferred upon drop trailer service is "unfair". The Commissioner has discretion to determine what type of competitive advantage affecting drop trailer service does, and does not, constitute an "unfair" competitive advantage. That discretion must be exercised in a manner consistent with the overall purpose of section 45.1. Again, the requirement for an "unfair" competitive advantage necessarily means that not all competitive advantages are captured, even to the extent that they benefit drop trailer service.

As BCF discusses below, neither BC Ferries' history as a Crown corporation, the existence of the CFSC, nor the regulated nature of the company, results in "unfair competitive advantage" as defined by the above test.

5.2 No Unfair Competitive Advantage Due to the CFSC and Regulation

Seaspan contends that the CFSC has three effects that give rise to an "unfair competitive advantage", specifically:

- The CFSC "assures BC Ferries that it will be paid by the core customers, all terminal, ferry, fuel and operation costs";

- Routes 1 and 30 have been included in a single route group, allowing cross subsidization; and

- It "creates excess capacity on Routes 1 and 30, by requiring more sailings than would normally be economic, particularly on route 30."[37]

With respect to the first point, Seaspan is in error regarding the effect of the CFSC. The CFSC is not what "assures" cost recovery on Routes 1 and 30. Rather, it is the demand for ferry service to Vancouver Island, and BCF's natural monopoly, that permits BCF to operate so as to be able to recover its costs on Routes 1 and 30. Neither the CFSC, nor any other legislation or government order, confers or enforces BCF's natural monopoly.[38] Rather, the CFSC is imposed *because* BCF has a natural monopoly. The CFSC precludes BCF from acting as an unregulated natural monopoly might be expected to act by regulating capacity and, in concert with the commercial regulatory construct, price.[39] Put another way, the assurance of cost recovery does not "arise as a result of its, or its predecessor's, relationship with governments", as Seaspan suggests.[40] It is a fair result of the natural monopoly.

Routes 1 and 30 have been included in a single route group under the CFSC. However, this bundling has not facilitated BCF charging lower drop trailer service prices than it would otherwise be able to charge based on a proper cost allocation, i.e. it has not conferred an advantage *vis-a-vis* drop trailer service. The same is true for the additional number of sailings that BCF is required to undertake under the CFSC. Were BCF to apply either of the approaches of BCF (EES Consulting) or Mr. Linxwiler to each of Routes 1 and 30 separately, <u>the allocated cost to drop trailer service by route is still below what BCF is charging for drop trailer service</u>. The supporting calculations for Routes 1 and 30 considered separately under Mr. Linxwiler's approach are included in Confidential Exhibit "A" to the EES Reply Report. In other words, since BCF's drop trailer service is priced in excess of the floor generated by even Mr. Linxwiler's analysis, it is not possible to say that BCF has been able to price drop trailer service lower because of either the bundling of Routes 1 and 30 or having more sailings than

[37] Seaspan Submissions, p.30.
[38] Anyone can contest BCF's market position at any time. In fact, the *Coastal Ferry Act*, s. 27, contemplates government entering into more than one Coastal Ferry Services Contract. The barrier to entry is the high fixed costs of operation, not regulation. The sub-additive cost function where there are high fixed costs results in the emergence of a single provider in the long-run, because it is the most efficient model. This is discussed in more detail on pages 25-28 of BCF's Filing.
[39] This regulation ensures that the single provider of the core service supplies the market demand and passes on the efficiencies of the sub-additive cost function to customers.
[40] Seaspan Submission, p.1.

a private carrier might run.

In arguing that an "unfair competitive advantage" arises from the bundling of Routes 1 and 30 and the excess capacity resulting from an increased number of sailings, Seaspan is really advocating that drop trailer customers bear a portion of operating losses associated with running the required number of sailings under the CFSC, by route, rather than just an allocated portion of overhead/fixed costs. Even Seaspan's own expert, Mr. Linxwiler, does not go that far; he advocates allocating only fixed costs to drop trailer service and holds out the resulting allocation as "fair and non-discriminatory and otherwise appropriate". EES confirmed in the EES Reply Report that the Federal Energy Regulatory Commission ("FERC") "Or pricing" approach that Mr. Linxwiler adopts would preclude the "**and** pricing" (i.e. considering average cost **plus** marginal cost) that Seaspan is advocating.[41] The losses are incurred only because they are required to meet core demand by providing a specified number of sailings, and are not driven by drop trailer customers.

Even if a competitive advantage had been conferred upon BCF with respect to Route 30 as a result of the bundling of Routes 1 and 30 as a Route Group, it would not be an "unfair" advantage. Any unregulated operator has the flexibility to cross subsidize particular aspects of its business in order to capture more business overall.[42] BCF is able to avail itself of this advantage to the degree it has because of its multi-modal business model, which is not available to Seaspan because it has chosen to focus on a particular market niche.[43]

In the end, Seaspan's argument about the CFSC really boils down to whether costs have been allocated properly. If the costs of providing the sailings required under the CFSC are allocated appropriately, then the CFSC cannot be said to confer an "unfair competitive advantage". BCF submits that it has allocated costs appropriately. In addition, under Mr. Linxwiler's approach, drop trailer service is also priced fairly.

5.3 No Unfair Advantage Due to Access to Terminals and Ferries

Section 45.1(1)(a) refers to "use of, or access to or ownership of vessels or terminals that are or had been owned by the government…". Seaspan states that, "Among other advantages and subsidies, it has access to terminals and ownership of a fleet of ferries most of which were acquired by its predecessor during a period of

[41] EES Reply Report, p.11.
[42] As an illustration of this, Seaspan's published prices on its Southern Lane are higher than on its Northern Lane, despite the fact that the distance travelled, and travel time, on the Northern Lane is longer.
[43] This point is addressed in greater detail in the BCF Filing, p.25.

lower costs and high subsidies."[44] BCF addressed this matter in its initial Filing, explaining why this did not give rise to an "unfair competitive advantage".[45]

BCF has already described the treatment of the vessels in detail. With respect to the terminals, BCF sold the 43 terminals and related land to the BC Transportation Financing Authority at their assessed values at the time of the transaction and entered into long term leases for these properties for the same price. The price paid to lease the ferry terminal properties reflected the value of the ferry terminal properties as fee simple land, even though BCF only acquired long term leases. BCF believes that a commercial party would not consider it an "advantage" to pay a price for tenures that reflects the fee simple value if it is only acquiring a long-term lease as BCF obtained. BCF was required by this arrangement, in effect, to overpay for the tenures. Even if mere access to the terminals and vessels is a "competitive advantage" *vis-a-vis* BCF's ability to compete with Seaspan, it is not "unfair" because BCF paid fair value for that access.

5.4 No Unfair Advantage Due to Tax Exemptions

Section 45.1(1)(a) refers to an "unfair competitive advantage, including, without limitation, an advantage resulting from the ferry operator having been provided with (b) any tax exemption". BCF submits that there are no tax exemptions that confer an advantage upon BCF in its ability to compete for drop trailer business. Thus, there can be no "unfair competitive advantage" arising from "any tax exemption".

Income Tax Exempt Status

BCF explained in the Filing that any benefit associated with its income tax exempt status is negated by the high return on equity requirement.[46] Seaspan nonetheless maintains that BCF benefits from improved cash flow. The complete answer to this argument is that even if BCF were subject to income taxes, BCF would not yet have paid income tax primarily due to large capital cost allowance claims available as a result of the significant capital expenditure program BCF has undertaken to serve the core market. BCF's cash flow is the same with the tax exempt status as it would be if BCF were subject to income tax, and would be so for many years to come.

[44] Seaspan Submission, p.3, lines 7-9.
[45] BCF Filing, p.29.
[46] BCF Filing, p.31.

Other Taxes

VIBS asserts that BCF has a "preferential position with regard to municipal tax, transit tax levies, fuel taxes and property taxes".[47] This is inaccurate. BCF pays all such taxes that a private corporation in the same position would pay.

5.5 Drop Trailer Service is Unsubsidized

Section 45.1(1)(b) refers to an "unfair competitive advantage, including, without limitation, an advantage resulting from the ferry operator having been provided with … (b) any subsidy". Seaspan alleges a number of unfair subsidies of drop trailer service. A subsidy paid to BCF must confer a "competitive advantage" to be impugned by section 45.1(1)(b), which by definition means that the benefit must flow to drop trailer service as a "competitive" business, and not just benefit the portion of the business over which BCF has a natural monopoly (and does not compete at all). Below, BCF explains that, while there are a number of benefits provided to BCF, there is no subsidy conferred upon BCF that represents a "competitive advantage" *vis-a-vis* BCF's provision of drop trailer service.

Service Fees

While Seaspan concedes that Service Fees paid by the Province are not allocated to the major routes, Seaspan argues that the Service Fees nonetheless represent an "unfair competitive advantage" because they support "the larger overhead and other fixed costs of the entire business thereby allowing for economies of scale that would otherwise not be available to the major routes on a stand alone basis."[48] Service Fees cannot be considered an "advantage" to BCF in its provision of drop trailer service given that BCF incurs significant costs, including overhead and other fixed costs, to provide service on the non-major routes. The remaining business outside the major routes does not generate the allowed return on equity for this business and in fact often operates at a loss even accounting for the Service Fees.[49]

BCF has previously offered the minor routes to Seaspan for $1, including transferring the right to receive the Service Fees. Seaspan could obtain a CFSC for these routes.[50] Seaspan's silence in response to this offer is telling, and is a tacit acknowledgement that operating the minor routes does not promise a significant benefit in terms of creating economies of scale for the benefit of a drop trailer business.

[47] VIBS submission, October 31, 2010, p.1.
[48] Seaspan Submission, p.33, lines 11-14.
[49] 2009/10 Annual Report to the British Columbia Ferry Commissioner, p. 22.
[50] Seaspan is incorrect when it states on p.18, line 7, that a CFSC is not available to private operators.

Fall 2008 Government Support

Seaspan cites the fact that BCF received a $20.8 million payment from the Provincial government in 2008 as an "unfair competitive advantage". The Province payed the funds as a measure to address the economic downturn. BCF applied it to a fare reduction of 33% for core customers, including on the major routes, for two months in December 2009 and January 2010. This predated the provision of drop trailer service, and none of those funds were ever applied to reduce the price of drop trailer service. In other words, while the payment conferred an advantage to core customers, the funds did not provide any kind of "competitive advantage" that assisted BCF in attracting drop trailer service business. Thus, it could not, by definition, represent an "unfair competitive advantage" to the drop trailer business.

Interest Relief

Seaspan states that "it appears from BC Ferries' financial statement that it receives millions of dollars in government interest rate support for refurbishment of its vessels".[51] The referenced interest rate support is actually the Structured Financing Facility ("SFF") program sponsored by Industry Canada that, according to the Industry Canada website[52] has been in place since 2001. The fact that the SFF program is made available to BCF cannot be a "competitive advantage" conferred upon BCF when it is open to other private companies as well and does not arise from BCF's relationship with government. Even if it were to be considered a "competitive advantage" that BCF qualified for the SFF program, it cannot be "unfair" for BCF to avail itself of interest relief that is available to other private companies as well.

The federal government website states, "The objective of the Structured Financing Facility (SFF) is to help ensure that shipyard capability exists for federal marine procurement and maintenance requirements in keeping with the Buy Canada procurement policy."[53] BCF is not the only company eligible to participate in this program. Industry Canada has outlined eligibility criteria, which include "new vessels or offshore marine structures and existing vessel and offshore marine structures undergoing major refurbishment, conversion or other major modification and constructed in Canada." According to the publicly available information provided by Industry Canada, approximately 40 other (non-BCF) projects have been supported by

[51] Seaspan Submission, p.32, lines 8-11.
[52] http://www.ic.gc.ca/eic/site/ic1.nsf/eng/02589.html
[53] http://www.ic.gc.ca/eic/site/sim-cnmi.nsf/vwapj/SFF-MFS_eng.pdf/$file/SFF-MFS_eng.pdf

SFF.[54] Seaspan could participate in this program. The only logical explanation for why Seaspan has not accessed SFF funding is that, unlike BCF, Seaspan has not been making investments in its fleet for the several years that the SFF has been available.[55]

If BCF's eligibility for SFF program benefits is a "competitive advantage", then it is a fair "competitive advantage" as SFF is a broadly available program and BCF's eligibility arises only because it is investing in its assets.

Deferred Fuel Costs

Seaspan maintains that BCF has a "significant advantage over private carriers in its ability to defer differences between actual fuel costs and the approved fuel costs which were used to develop the regulated price caps."[56] The mechanism to which Seaspan refers is one that requires BCF to manage differences in actual fuel prices vs. the assumed price in setting the price caps. The mechanism requires BCF to levy fuel surcharges or grant fuel rebates to ensure that real fuel costs are appropriately passed through to its customers. Since price caps are established for a four year time period, the volatility experienced with fuel prices is managed through this mechanism. The basis for Seaspan's position that this mechanism creates an "unfair competitive advantage" is its assertion that "Private carriers cannot go back to their customers for additional money associated with costs which arose after prices were set or contracts entered into."[57] There are several reasons why Seaspan's analysis is flawed and the existence of a fuel price management mechanism does not suggest an "unfair competitive advantage".

- First, Seaspan's premise that private carriers "cannot go back to their customers for additional money" is an oversimplification.[58] This would only be true for long-term fixed price contracts without escalation clauses, in the unlikely event that a private company failed to require such escalation clauses in its customer contracts. Private carriers are not subject to regulatory price restrictions and can change their tariffs within market constraints. Even where longer-term contracts are considered, private carriers can, for instance, recover

[54] http://www.ic.gc.ca/eic/site/sim-cnmi.nsf/eng/uv00033.html
[55] There are, in fact, related-entities to Seaspan that have benefited from the SFF program. Of the SFF funding received by BCF, Washington Marine Group companies, Vancouver Drydock Company Ltd. and Vancouver Shipyards Company Ltd, represent 88% of the total (~$20 million). BCF has been eligible for six completed SFF supported projects of which four have been undertaken at these two shipyards at a value of almost $160 million, resulting in direct benefits to Seaspan's owner. Seaspan itself has received other Federal Government grants. This is further evidence that Seaspan is savvy regarding capitalizing on government programs.
[56] Seaspan Submission, p.32, lines 13-15.
[57] Seaspan Submission, p.32, lines 15-18.
[58] There are many examples where unregulated businesses add fuel surcharges to their normal pricing.

unfavourable variances over time by raising prices for other customers or at the conclusion of a contract term. In the absence of a fuel price management mechanism, BCF would be precluded from taking such steps to recover costs. Losses would remain within the four year Performance Term, and the price cap for the next Performance Term would still only reflect the costs of that new Performance Term. In effect, the deferral account is a regulatory mechanism that addresses what could, depending on the way prices are moving, be a significant disadvantage for BCF that it would not be exposed to but for the regulatory framework.

- Second, there is a converse obligation on BCF to return favourable variances to customers. There is unlikely to be any such obligation on a private carrier like Seaspan to return windfall gains resulting from favourable variances to its customers that paid too much for fuel.

- Third, the Seaspan submission focuses on deferred fuel costs as a benefit to BCF generally, but has not explained how the existence of a deferral account that manages fuel costs for core customers enhances BCF's ability to offer drop trailer service.

Thus, deferral of fuel costs is properly characterized as a means of counteracting a potentially detrimental result of regulation, not as a competitive advantage *vis-a-vis* the ability to compete on drop trailer service. If it is a competitive advantage, the fact that the mechanism is reciprocal and the fact that it mirrors the result in the private industry make it a fair advantage.

The Seaspan submission also refers to the $1.7 million provided by the provincial government to defray fuel costs.[59] The government specifically directs these funds toward defraying fuel costs on the Northern and Minor Route Groups, and not to the Major Route Group.

Duty Remission

BCF's ability to apply for duty remission has not affected BCF's drop trailer pricing, or BCF's ability to compete with Seaspan, in any way. There are two reasons why duty remission has not conferred a "competitive advantage" on BCF *vis-a-vis* its ability to compete for drop trailer customers.

First, the "across the board fare reduction of about two percent" referred to by Seaspan[60] was not passed through to drop trailer

[59] Seaspan Submission, p.32, lines 23-25.
[60] Seaspan Submission, p.32, lines 32-33.

customers, or accounted for in drop trailer pricing as the capital costs associated with the purchased vessels are driven by the core customer peak demand, not drop trailer service.

Second, BCF's COSA, as well as the COSA based on Mr. Linxwiler's approach, were performed based on costs prior to duty remission. Thus, the determination of the COSA that drop trailer service is priced to account for direct costs and an appropriate portion of indirect costs stands irrespective of duty remission.

Moreover, even had there been a "competitive advantage" conferred on BCF relative to Seaspan through BCF's access to duty remission, it is dubious to suggest that this is the type of program intended to be captured by section 45.1(1)(c). This is a program that is open to other companies that meet program requirements.[61] BCF submits that more is required to establish an "unfair competitive advantage" than the fact that BCF is able to apply for and qualify for duty remission that is broadly available; a "competitive advantage" is a fair one unless it has been conferred on BCF as a result of its history or ownership. BCF's access to duty remission was not a product of its history and has had no impact on BCF's competitive position on drop trailer service. Therefore, it has not conferred an "unfair competitive advantage".

Under section 45.1(2)(b), the remedy where the Commissioner identifies an "unfair competitive advantage" is to account for the effect of an "unfair competitive advantage" in the COSA used to generate the minimum price for the competitive service. Since both allocation methodologies advanced by the experts in this process (EES and Mr. Linxwiler) already back out the impact of the duty remission, any determination under section 45.1(2)(b) would not require an adjustment.

1977 Coastal Ferry Subsidy Agreement

The Province receives payments from the Government of Canada pursuant to a contract between the federal and provincial governments for the provision of ferry, coastal freight and passenger services in the waters of British Columbia. The annual payment increases with the Consumer Price Index (Vancouver). Pursuant to Section 5 of the CFSC, the Province agreed to make the proceeds of this agreement available to BCF. These amounts are directly assigned to routes as specified by the Province. The major routes, which include Routes 1 and 30, do not receive the benefit of any of these payments.

[61] The duty remissions granted conformed with changes to the Excise Tax Act that were concurrently announced. In the same announcement, Algoma Central Corporation was granted duty remission in respect of a vessel it procured offshore.

As in the case of Service Fees, Seaspan argues that these payments nonetheless represent an “unfair competitive advantage” because they support “the larger overhead and other fixed costs of the entire business thereby allowing for economies of scale that would otherwise not be available to the major routes on a stand alone basis.”[62] Again, these payments cannot be considered an “advantage” benefitting BCF’s ability to compete for drop trailer customers given that BCF incurs significant costs to provide service on the non-major routes and the remaining business outside the major routes does not generate the allowed return on equity for this business, and in fact often operates at a loss even with these payments. To reiterate, BCF has offered to sell the minor routes, including the attendant Service Fees and payments to Seaspan for $1, which to date Seaspan has not accepted.

Cost of Capital

Seaspan expresses the view that government support for BCF gives rise to a subsidy in the form of lower cost debt:

> “BC Ferries’ privileged relationship with government (as both ‘owner’ and major long-term financial supporter under the CF contract and as a beneficiary of a state sponsored monopoly) gives it an artificially low cost of debt with interest rates well below the risk premium that would be assigned to a standalone company with similar financial statements.”[63]

BCF submits that Seaspan’s argument is based on an incorrect premise regarding the nature of BCF’s competitive advantages. Government has not conferred any advantage on BCF *vis-a-vis* BCF’s ability to compete in the drop trailer market through a more favourable cost of debt.

BCF is treated as a stand alone entity for debt rating purposes. BCF’s debt is not guaranteed by the Province. Issuers make the decision to purchase BCF’s bonds with this awareness and will purchase the bond at a given spread taking into account the absence of such a guarantee. BCF is subject to the same market forces as any other company when arranging and negotiating financings. These forces include:

- Investors’ risk appetite;

- Supply of funds available to investors for deployment;

[62] Seaspan Submission, p.33, lines 11-14.
[63] Seaspan Submission, p. 34.

- Relative returns compared to other investment opportunities (by sector/country/type); and

- Other investment options concurrently being offered to investors.

BC Ferries has credit ratings provided by DBRS and S&P. In the determination of the rating, the credit rating agencies consider multiple factors in their overall assessment of an entity's creditworthiness. Seaspan is correct in so far as it states that BCF's monopoly position has a favourable impact on BCF's credit rating. For instance, S&P's recent assessment report for BCF (provided in Confidential Appendix "C") emphasizes that "BCFS' status as a near-monopoly provider of an essential service gives it considerable credit strength."[64] Seaspan's argument falls down, however, because government does not confer the monopoly. The monopoly arises from the nature of the service and the financial barriers facing other potential market participants. BCF has discussed previously in Section 5.2 of this Reply Submission that any competitive advantage arising from the existence of a monopoly (and the associated multi-modal business model) is a *fair* competitive advantage.

The significance of BCF's relationship with government in the context of credit rating is primarily the fact that, in the unlikely event of a crisis, government would intervene to avoid a disruption of service. Again, this points to BCF's monopoly over an essential service, rather than the company having the monopoly conferred by government or BCF receiving ongoing credit support. S&P states, for instance:

> "In accordance with our criteria for government-related entities, our view of a "moderately high" likelihood of timely and sufficient extraordinary government support reflects our assessment of BCFS' "very important" role and "limited link" with the province of British Columbia. The "moderately high" assessment supports a one notch uplift to BCFS' 'A' stand-alone credit profile. We had previously had assessed the stand-alone rating as 'A-'". While BCFS does receive continuing support from the Province of British Columbia (AAA/Stable/A-1+), it is not extraordinary; rather, credit support is "limited"[65] and is through the ongoing contractual payment of an annual service fee from the province to guarantee a minimum level of service on the smaller, less economically viable

[64] Global Credit Portal, BCF, March 1, 2010, p.5. This document has been provided to the Commissioner previously in confidence, but BCF's contract with S&P precludes releasing it publicly. It is available for purchase from S&P.

[65] S&P defines "limited" to mean "The government has limited interference with the GRE [government related entity] and has a policy/track record and/or capacity of providing very limited credit support" and the definition also provides illustrations of this.

routes. Nevertheless, we believe the company plays a "very important" role for the province through the provision of what is considered an essential service."[66]

As indicated above, S&P concluded that the impact on the credit rating due to BCF being considered a "government related entity" is only one notch uplift. BCF's fixed rate financing since 2004 has all occurred while BCF was rated "A-" by S&P and "A (low)" by DBRS (i.e. prior to the improved credit ratings)[67, 68]. BCF expects not to issue new bonds in the next several years, and thus will not be relying on lower cost of debt associated with the improved bond rating.

Parenthetically, Seaspan has referred to a unique financing for one specific vessel as evidence of how BCF's drop trailer service has benefitted from a low cost of debt. This is misleading because the referenced loan was available to BCF as a result of acquiring a specific asset, which is not even operated on the major routes. This rate would not be available to BCF for a financing for general corporate purposes, such as financing drop trailer operations.[69] Excluding single purpose loans and the credit facility (which has a variable rate) the average cost of BCF's debt is significantly higher.

The other element in determining BCF's Weighted Average Cost of Capital ("WACC"), which Seaspan has not addressed, is the cost of equity. BCF's cost of capital is negatively impacted by the company's inability to raise equity, and this is a direct result of regulatory constructs imposed by government. The B.C. Ferry Authority holds the single voting common share ("Class B Share") in BCF. The Authority is prohibited from accepting capital in addition to that contributed by the Province. As BCF cannot raise equity, the company is limited by the amount of Retained Earnings. Furthermore, BCF's contractually obligated servicing of the minor routes has a negative, eroding impact on retained earnings, as these routes are not profitable. The CFSC puts BCF at a financial disadvantage by reducing financial flexibility.

[66] Standard & Poor's, Global Credit Portal, British Columbia Ferry Services Inc., March 1, 2010, p.3-4.
[67] As at March 31, 2010, BC Ferries had approximately two percent of total debt in variable rate instruments.
[68] DBRS upgraded BC Ferries' long-term rating to "A" from "A (low)" on December 11, 2009.
[69] In January 2009, BC Ferries entered into a $108 million loan agreement with KfW IPEX-Bank GmbH, a subsidiary of KfW Bankengruppe – a German export credit bank. It is a 12 year amortizing loan, repayable in 24 equal, semi-annual payments, at an interest rate of 2.95%. The proceeds were used to partially finance the purchase of the *Northern Expedition*, which is exclusively in service in the Northern Route Group. KfW IPEX Bank undertakes Export and Project Finance, acting as Germany's Export Bank. The fixed rate offered is an internationally set rate as published by the Organisation for Economic Co-operation and Development (OECD). The interest rate is available to any entity that qualifies, and we assume that a standalone company with similar financial statements would qualify – this is not exclusively available to BCF. The rate is relatively low as the rate is subsidized by the German government. By contrast, the last bond issue undertaken by BCF was in December 2008 – a month before the 2.95% KfW loan cited by Seaspan was funded. The interest rate for that bond issue was 6.214%.

Overall, while BCF's WACC is presumably lower than Seaspan's, it is reasonably comparable to other large institutions with a monopoly over an essential service.

In summary, government has not conferred any advantage on BCF *vis-a-vis* BCF's ability to compete in the drop trailer market through a more favourable cost of debt. The cost of debt available to BCF is the product of BCF's business model and the favourable cost of debt represents a fair competitive advantage.

5.6 Conclusion Regarding Competitive Advantage

The fundamental premise upon which Seaspan's argument is based is that BCF is using advantages not available to all when entering into the competitive drop trailer service market "to reduce costs and prices".[70] The "competitive advantages" Seaspan identifies are, in actual fact, no such thing as they either do not facilitate BCF's ability to compete for drop trailer business or do so in a manner that is fair. BCF has priced its drop trailer service to maximize revenues to the extent permitted by the market, and as such the factors identified do not translate in a lower price being charged for drop trailer service. BCF is competing on a fair basis.

[70] Seaspan submission, p.34, line 20.

Section 6 – Other Matters

In this Section, BCF addresses some miscellaneous points raised by Seaspan and other commenting parties.

6.1 Factual Issues With Seaspan's Submission

There are a number of factual issues with Seaspan's submission, among which are those discussed below.

Service Quality and Unmet Demand

Seaspan appears to have misinterpreted BCF's evidence explaining the differentiating attributes of BCF's drop trailer service as an attempt to disparage Seaspan's service.[71] Further, Seaspan has misinterpreted BCF's evidence regarding "unmet demand" as relating to the overall size of the transportation market to Vancouver Island.[72] BCF's point was to demonstrate that there was unmet demand for a service that offered service attributes such as greater flexibility in sailing times and faster transit.

Seaspan states that "None of the customers who have migrated to BC Ferries have advised SCIC that they did so because of SCIC scheduling issues. To the best of SCIC's knowledge all shifts were due to BC Ferries offering low discounted prices which SCIC could not match."[73] Despite Seaspan's assertion, Summit Logistics, a customer that migrated to BCF, filed a letter of comment with the Commission explaining that they changed for reasons related to the nature of the service that Seaspan provides: "Our move was not an easy one as Seaspan had always serviced us well. However our problem with Seaspan was that the time of their sailings didn't always work best for us." The customer went on to note:

> "Our drivers now regularly can start their shift at 3pm and finish their work by around 1am, 7 days a week. This is much better for our drivers' work schedules, as well as for the Safeway stores in more accurately estimating load arrival times so they can efficiently staff for restocking."[74]

[71] Seaspan Submission, p.14, lines 30-37.
[72] Seaspan Submission, p.15, lines 20-25.
[73] Seaspan Submission, p.14.
[74] Public Comments Received, Submission #23.

Service attributes are a legitimate and fair competitive advantage for BCF.

Erosion of Seaspan's Business is Attributable to Multiple Factors

Seaspan has implied throughout its submission that it has lost business to BCF's drop trailer service. Although this is accurate as a general statement, the statistics that Seaspan is putting forward to demonstrate significant erosion of its business at the hands of BCF are misleading. While Seaspan's evidence is not directly relevant to the nature of the inquiry under section 45.1(1), which is focussed on how BCF prices its service and the existence of any "unfair competitive advantage", the record should be clarified.

Seaspan states that "prior to the entry of BC Ferries into the drop-trailer business" Seaspan operated more vessels, more frequently, with a total capacity of approximately 225,000 units.[75] It says that "today" it has experienced a 14% decrease in volume, and that BCF's drop trailer service has "also" put downward pressure on rates in addition to reducing volume.[76] It is obvious that this evidence was intended to leave the impression that the drop trailer service is causing these declines. It is, with respect, disingenuous for Seaspan to attribute this entire loss of business to BCF launching its drop trailer service because the time period they are addressing coincides with a poor economic climate. To illustrate this point:

- The amount of lost volume Seaspan has identified[77] is well in excess of the entire drop trailer traffic carried by BCF since the inception of the service; and

- BCF has experienced significant lost overall commercial volumes in this same period due to the economic conditions.

Seaspan acknowledged elsewhere in its submissions the drop in commercial freight to Vancouver Island due to prevailing economic circumstances,[78] but this is not reflected anywhere in its calculations of business lost to drop trailer service.

[75] Seaspan Submission, p.16, line 6.
[76] Seaspan Submission, p.16, lines 11-20.
[77] Which BCF understands to be 153,000 "pre BCF drop trailer" (225,000 capacity x 68% utilization) decreased to 135,000 (200,000 capacity x 68% utilization), which would equal the 14% decline asserted by Seaspan. This represents a 18,000 decline. In other recent communication to its customers, (Seaspan letter to Canadian Council of Grocery Distributors – October 12, 2010) Seaspan has cited a larger figure of 20,000: "SCIC has lost 20,000 trailer trips per year from volumes carried before BC Ferries entry into the market, and has been forced to reduce its average rates while costs are rising". In either case, these numbers exceed the amount of drop trailer traffic carried by BCF.
[78] Seaspan Submission p.23, line 27, where Seaspan was asserting that BCF had not foreseen the drop in demand when BCF ordered "massive vessels".

VIBS

Seaspan challenges BCF's statement that VIBS is limited to the Nanaimo market. BCF notes that VIBS only sails to Nanaimo, and is presumably not directly involved in the trucking business. While Seaspan's comments regarding VIBS "transiting further up the Fraser River than any other daily shipping service" and its corresponding inference that VIBS bundles its services with a trucking partner to provide low-cost drayage into Langford is interesting considering the additional costs of a longer marine transit and additional trucking costs to drive from Nanaimo to Langford, it does not change the fact that from a marine - drop trailer provider perspective, Seaspan had an unregulated monopoly on the Southern Island market until BCF entered the market. Seaspan's own actions speak to the value of having access to a more direct route to the Victoria/Langford market. If no such advantage into Swartz Bay exists or is mitigated by low-cost trucking, Seaspan would have presumably not renewed its lease on its Swartz Bay location a few years ago given it provides a similar service out of Nanaimo. Given the costs associated with running multiple terminals one would assume Seaspan sees some benefit in maintaining its monopoly position in the Southern Lane.[79]

6.2 Preferred Shipping Arrangements

Seaspan has raised the matter of whether a company affiliated with BCF is acting as a freight forwarder, although Seaspan admits that the nature and purpose of the relationship between BCF and this company is not clear to Seaspan. A similar point was referenced by VIBS, in point 3 on their list where it mentions a company called Four Square Solutions. Although BCF does not believe that this is at all relevant to the matter at hand, BCF can confirm that no such affiliation or service as described exists. There is no merit to the point raised by Seaspan and VIBS.[80]

6.3 Letter of Ralph Sultan, M.L.A.

Mr. Sultan's letter contains unsupported speculation regarding the intention of BCF in offering drop trailer service.[81] Predatory pricing, which Mr. Sultan appears to allege, is illegal in Canada under the *Competition Act*, and BCF does not engage in it for the reasons previously addressed in the Filing. BCF's involvement in the drop trailer business is an appropriate means of making more efficient use of existing assets and to contribute incremental revenue to the benefit of all ferry users. Further, BCF's involvement in the drop trailer

[79] Which is further evidenced by Seaspan's published higher rates on the Southern Lane.
[80] Commission's Response to SCIC's Disclosure Request of October 15, 2010; BCF Response to SCIC Question 4.11.
[81] Mr. Sultan's letter of November 5, 2010, p.2.

business ended Seaspan's effective unregulated monopoly on the service. The market is best served by BCF offering a competing service.

6.4 Letter of 3PLOGIX (VIBS)

VIBS, in item 4 of its submission, poses the question: "Given that more costs for the drop service and more space is occupied with non-paying tractor footage for each customer's trailer, is the pricing relative and reasonable?" There are additional direct costs associated with providing drop trailer service, and all of these costs have been allocated to drop trailer service in the BCF methodology endorsed by EES. Both live and drop trailer services require accommodating a tractor. The COSA performed by BCF and EES account for this. While there are additional direct costs associated with drop trailer service, it is appropriate to allocate more indirect costs to live trailer service because the costs are driven by capacity requirements associated with the provision of core services.

6.5 Live Traffic

BCF's live trailer service, whether discounted or at the tariff rate, is priced to recover the long run incremental cost of service together with passenger vehicles. The analysis performed by BCF in conjunction with EES based on Mr. Linxwiler's methodology demonstrates that live service is actually priced in excess of the cost of service and is subsidizing the passenger and passenger vehicle classes. In any event, live service is not the proper subject of this process.

Section 7 – Requested Findings and Next Steps

7.1 BCF's Requested Findings Supported by Evidence

BCF submits that the information provided to the Commissioner supports the two findings requested by BC Ferries, namely that:

- BC Ferries' drop trailer service is priced in a manner that reflects BC Ferries' direct costs and an appropriate proportion of indirect costs associated with providing drop trailer service; and

- BC Ferries is competing on a fair basis with the incumbent providers of drop trailer service.

BCF also submits that the Commissioner should reject Seaspan's requested findings. The evidence of Mr. Linxwiler, put forward by Seaspan, supports BCF's position.

7.2 Alternative Scenario

In this Section, BCF addresses what should occur in the event that the Commissioner makes a finding adverse to BCF.

BCF believes that there is sufficient evidence on the record for the Commissioner to make any necessary determination pursuant to section 45.1(2)(b), which requires the Commission to calculate the appropriate amount to be charged by BCF based on BCF's cost of service and adjusting for any "unfair competitive advantage" identified by the Commissioner. BCF believes that any decision intending to set a minimum price for BCF drop trailer service should approach that objective by identifying in the decision the applicable cost inputs that must be included in the COSA, and leaving the specific drop trailer rate unspecified in the decision. This approach has two benefits:

- First, it will allow flexibility for the minimum price to be updated periodically as cost inputs change materially; and

- Second, it will protect confidential information (see below).

However, an order under section 45.1(2)(a) (alternative service provider) would represent a fundamental change of course for BCF, with significant ramifications for the company and its customers. BCF respectfully submits that BCF should be given the opportunity to provide further submissions on the application of 45.1(2)(a) before any order is made under 45.1(2)(a).

The Commissioner Should Deny Interim Order Request

Seaspan is requesting, in the event that the Commission finds in its favour, that BCF's rates be adjusted on an interim basis to the published tariff rate "notwithstanding any existing long or short term contracts". BCF submits that these types of orders would be inappropriate and prejudicial to BCF and its customers. The reasons for this include:

- There is no express statutory power for the Commissioner to make interim orders of this nature.

- The Commissioner is mandated by section 45.1(2) to fix a minimum price based on BCF's costs of service assuming that none of the factors in 45.1(1) are present. The mere fact of an unfavourable determination under section 45.1(1) does not mean that the appropriate cost-based rate charged for drop trailer service cannot be less than the current published rate.

- Customers have existing agreements with BCF and have made commercial arrangements based on those agreements.

Commissioner Should Maintain Confidentiality

Seaspan also argues that confidential information will have to be disclosed as part of a section 45.1(2) process. BCF submits that the Commissioner has decided the issue of confidentiality, and the decision on confidentiality should remain in place. Seaspan is, in effect, seeking a further reconsideration of that order under the guise of characterizing the determination of a remedy as a different phase of proceeding. Both remedies contemplated in section 45.1(2) will result in Seaspan continuing to face competition on drop trailer service. Disclosure of the confidential cost information, or publication of a minimum price[82], in the context of determining the remedy would be just as detrimental as it would be in the current phase of the proceeding.

[82] BCF discussed the impacts of publishing a minimum price for drop trailer service on p.40 of the Filing.

Section 8 – Conclusion

BC Ferries respectfully submits that BC Ferries' drop trailer service is priced in a manner that reflects BC Ferries' direct costs and an appropriate proportion of indirect costs associated with providing drop trailer service. BC Ferries is also competing on a fair basis with the incumbent providers of drop trailer service. The core customers are benefitting from the revenues earned by BCF's fair competition on drop trailer service, and users of drop trailer service are benefitting from the end of the incumbents' unregulated monopoly. BCF should be free to maintain healthy competition with the incumbent providers of drop trailer service, based on fair prices, to generate the maximum possible revenues for the benefit of customers.

Appendix 1: EES Reply Report

(Exhibit "A" to the EES Reply Report has been redacted consistent with Commissioner Order No. 10-01. An unredacted version has been filed confidentially)

December 8, 2010

Mr. Rob Clarke
Executive Vice President and Chief Financial Officer
British Columbia Ferry Services Inc.
1321 Blanshard Street
Victoria, BC V8W 0B7

SUBJECT: Reply to Mr. Linxwiler's Review of BC Ferries Submission regarding DT Ferry Service

Dear Mr. Clarke:

BC Ferries requested that EES Consulting (EES) reply to a submission from Mr. Joe Linxwiler on behalf of Seaspan Coastal Intermodal Company (Seaspan). Mr. Linxwiler's submission provides review and comments on the cost allocation methodology developed by EES in determining the direct cost and an appropriate proportion of indirect costs associated with providing Drop Trailer (DT) service by BC Ferries. The EES methodology yields a fair and equitable cost allocation methodology based on generally accepted allocation principles. Mr. Linxwiler takes exception with part of the EES methodology and analysis. This letter first outlines why the proposed EES methodology is appropriate, and secondly it addresses specific comments made by Mr. Linxwiler. The last section of this letter describes the application of Mr. Linxwiler's proposed tests and confirms that actual prices charged to the DT service customers exceed these overly stringent tests.

EES's Approach to Determine DT Rates is Appropriate

The overall objective of BC Ferries in this undertaking is to maximize the utilization of surplus ferry capacity and to generate additional revenue to offset fixed costs thereby keeping Core customer ferry rates at a minimum. This objective must be met within the letter and spirit of the appropriate regulatory guidelines applicable to BC Ferries.

BC Ferries' offering of DT service is regulated by Section 45.1 of the *Coastal Ferry Act* ("Act"). Based on the requirements in the Act, BC Ferries requested that EES determine a minimum rate for DT service that is priced in a manner that reflects BC Ferries' ***direct costs and an appropriate proportion of indirect costs associated with providing the DT service***. The actual prices charged for DT service are all above this minimum threshold calculated by EES. As such,

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it is EES' opinion that the current BC Ferries charges for DT services are appropriate and in keeping with this requirement of the Act.

Cost causation lays the foundation for just, reasonable, and not unduly discriminatory or preferential rate setting. This basic tenet serves as primary guideline for rate design, and is used by most utility regulators and administrative agencies[1]. This "price-equals-cost" concept provides the basis for the development of just and reasonable rates.

Calculation of the Direct Costs and an Appropriate Proportion of Indirect Costs Associated with Providing the DT Service

The Act calls for an allocation of direct costs and an appropriate proportion of indirect costs to DT service. EES first directly assigned costs that would not have been incurred "but for" the DT service. Mr. Linxwiler did not appear to take objection to the methodology applied in determining the direct costs associated with the DT service. The appropriate allocation of costs directly assigned to the DT service includes:

- Direct labour and associated benefits,
- Expenses related to the hostling units, such as lease costs, fuel, maintenance and insurance,
- Expenses related to terminals, such as property tax, property lease, utilities and outside services and security services,
- General office and administration costs, and
- Amortization, financing costs and ROE on assets including IT, terminals and hostling units.

In addition to these directly assigned costs, EES also allocated certain costs based on revenue contributed by Core and DT services. Applying the revenue allocator to certain costs is consistent with the Route Statement methodology previously approved by the commissioner and for consistency purposes was carried through to the cost allocation step. Strictly speaking, only the direct costs of the DT service would be included in the calculation of marginal costs. However, the revenue-related allocation ensures that the DT service is allocated an appropriate proportion, or a fair and equitable share, of indirect costs even though these costs do not change

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[1] See for example a recent decision by FERC "Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities" Issued June 17, 2010. "Under sections 205 and 206 of the FPA, the Commission is responsible for ensuring that the rates, terms, and conditions for transmission of electricity in interstate commerce are just, reasonable, and not unduly discriminatory or preferential. With respect to this responsibility, the Commission and the courts have found that the costs of jurisdictional transmission facilities must be allocated in a manner that satisfies the "cost causation" principle. The U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) has defined the cost causation principle as follows: "[I]t has been traditionally required that all approved rates reflect to some degree the costs actually caused by the customer who must pay them". pages 77-78.
See also BCUC's October 26, 2007 Decision in "BC Hydro 2007 Rate Design Application – Phase 1" http://www.bcuc.com/Documents/Proceedings/2007/DOC_17004_10-26_BCHydro-Rate-Design-Phase-1-Decision.pdf

as a result of BC Ferries providing the DT service. This allocation also ensures that the DT service contributes towards the fixed costs of vessel and terminals.

Based on the direct and indirect cost information above, EES determined a minimum rate for DT service which meets the rate requirement of the Act.

DT Service Level is Not the Same as Core Service Level

As Mr. Linxwiler states on page 5 “a fair rate is a rate that reflects the costs of providing service.” He further states that a rate that is too high relative to costs is unfair. In BC Ferries’ case, for example, rate differences exist between passenger vehicles and commercial services due to differences in the services provided to each of these customer classes.

As stated in BC Ferries’ initial Filing, the DT service is unique and different from the Core service in the following ways:

- DT service is limited only to certain sailings and off-peak periods when surplus capacity is available,
- DT service is guaranteed passage within a range of sailing times, not guaranteed a specific sailing time,
- DT service requires significant lead time to guarantee delivery time,
- DT service is not available for all commercial loads. For example, BC Ferries cannot transport hazardous materials, and
- DT service is secondary to Core service, i.e. if the ferry cannot be turned around within 30 minutes, the DTs will not be loaded.

Because of these different characteristics, the services provided to the DT customers and the Core customers are different. Consequently, there should also be differences in the rates charged for DT service and Core services. As costs are the foundation for determining fair and equitable rates, the result is that different services have different rates. One of the reasons why the minimum rate established for the DT Service is below the Core service rate, is that the rate for Core service reflects the higher and more flexible service level provided to the Core customers.

BC Ferries is Utilizing Existing Capacity, Not Expanding Due to the DT Service

BC Ferries’ assets and resources are planned and operated around peak period travel. Ferries, terminals and operations are planned around meeting peak usage by vehicles. This is the main reason why there is excess capacity on the ferries during off-peak periods and why BC Ferries can offer the DT service and the lower DT service rate.[2]

One concern of other parties is that BC Ferries will increase future ferry capacity to serve additional DT demands. Even with an optimistic projection of BC Ferries’ DT market, the

[2] Please refer to 2010 11 19 Information Request Response to Commissioner pages 10 and 11.

market projections are far below the surplus capacity of existing ferries on both routes 1 and 30 as explained in BC Ferries' initial submission.

In light of the fact that excess capacity exists on off-peak sailings and that the DT service utilizes this excess capacity, there is no cost allocation basis for treating the DT service as a Core service.

Minimum Rate Estimated

According to the Act, the Commissioner must determine that actual rates paid for the DT service are at or above the direct costs and an appropriate proportion of indirect costs. As such, an appropriate cost allocation methodology must establish a minimum rate applicable to the DT service.

Because current DT customers actually pay more than the minimum rate calculated by EES, they contribute to the costs otherwise paid by the Core customers and contribute to the other fixed costs associated with the ferries and terminals. This contribution to ferry and terminal fixed cost by the DT customers reduces rates for other Core services. The revenues collected from the DT customers in excess of the direct costs of the service do not benefit BC Ferries.[3] BC Ferries' earnings are regulated and any benefit from the additional revenues from DT service is used to offset the cost of passage for the Core customers.

Summary of EES Cost Allocation to DT Service

BC Ferries provides DT service to maximize the utilization of surplus capacity. The DT service is limited to off-peak periods in order to utilize surplus capacity and not interfere with Core customers' service. The unique level of service and utilization of existing assets was considered in determining the minimum rate for the DT Service.

It is the opinion of EES that the calculated minimum rate for DT service recovers the direct cost and an appropriate proportion of indirect costs associated with providing the DT service.

Response to Specific Comments made by Mr. Linxwiler

This section of the letter will address a few of the specific comments made by Mr. Linxwiler related to general cost allocation and rate setting principles, as well as the EES report. Given the short timeframe for this matter, EES has not addressed all of Mr. Linxwiler's specific comments, but has focused on the material issues within Mr. Linxwiler's submission. EES's silence on certain comments made by Mr. Linxwiler should not be interpreted as agreement.

[3] Mr. Linxwiler appears to suggest the contrary in his submission to the Commissioner. See for example page 17.

Unfair vs. Fair Competition

On page 7 of his report, Mr. Linxwiler discusses unfair competition. The first concern voiced by Mr. Linxwiler is the concept that the rates charged to the Core customers are increased to pay for the services provided to the DT customers. Mr. Linxwiler states that the Core customers therefore subsidize the DT service. He voices this concern repeatedly throughout the submission.[4]

The fact is that, as a regulated entity, BC Ferries is limited in what it can earn from its business. The revenues collected from the DT service, in excess of the direct costs of the service, go to offset rates to Core customers. Therefore, the addition and /or expansion of the DT service by BC Ferries benefits Core customers and not BC Ferries itself.

BC Ferries' interest in providing the DT service is to efficiently utilize existing resources. As excess capacity is available on many sailings, BC Ferries has taken the opportunity to provide DT services on those sailing, and charge a just and reasonable rate for the DT service commensurate with the service provided. This is not unfair competition – this is smart business.

While Mr. Linxwiler does not specifically state that BC Ferries is setting predatory prices, he does discuss this notion related to BC Ferries.[5] It is traditionally accepted that prices set above marginal cost are not predatory.[6] [7] In the case of DT service, the marginal cost equals the directly assigned costs. No other costs could be avoided if the DT service was not provided. As the calculated minimum rate includes both marginal (or direct) cost and a share of indirect costs, the pricing cannot be predatory.

There are many reasons why cost structures differ between competitors. Company size, location, the mix of products or services and service levels all influence the cost structure of companies. Having lower operating costs does not necessarily equal predatory pricing, but can be a result of these many other factors.

The fact remains that BC Ferries' actual pricing of the DT service is far above the marginal (or avoidable) cost of that service.

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[4] See for example, page 10, page 15, page 17 and page 18.
[5] Mr. Linxwiler, page 7
[6] L. Goodman, The Process of Ratemaking, Part 5, p.180 (1998).
[7] From the Competition Bureau's Guidelines: "Ordinarily, a multi-product firm incurs costs that are common for the production of all its products or for a particular group of products. When the Bureau conducts a price/cost analysis for only one of the firm's products, any common costs will ordinarily be excluded from the calculation of avoidable costs. This reflects the fact that the firm still needs to incur these costs in order to produce other products not subject to the predatory pricing allegation." http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/02713.html

BC Ferries Rate Should Not be Set at the Prevailing Market Price

Mr. Linxwiler suggests that one method of setting the DT rate would be to set the rate based on prevailing market price, which is defined as the historic market price (i.e. Seaspan's historic rate)[8], rather than price the DT service based on the direct cost and an appropriate proportion of indirect costs of providing the service.

Without commenting on whether the Act allows the Commissioner to determine a floor price based on the costs (including significant profit) of another firm, the concept is quite suspect from a regulatory policy perspective. This methodology for setting a minimum rate will certainly remove any competition in the DT market. If the minimum rate that BC Ferries can charge is based on the historic rate charged by Seaspan, there is nothing to prohibit Seaspan from setting their rates just below those they know will be offered by BC Ferries. This will drive BC Ferries out of the DT service business. EES cannot think of an example in which a regulating agency has set a rate higher than cost to foster competition. In EES' opinion this approach is unwarranted particularly in an industry with very few participants.

Incremental Cost Allocation

Mr. Linxwiler suggests that "incremental service" is not a standard term in the area of pricing or cost allocation.[9] It is EES' opinion that the concept of incremental customers is a widely used term in many regulatory settings. Common examples of incremental types of service are surplus energy sales[10], capacity release on pipelines[11] or the addition of a new rate class. For example, a small utility may see a large industrial customer as an incremental service if no other industrial customers exist. The incremental concept has also been used by FERC in the "or pricing" example provided by Mr. Linxwiler, which allows incremental pricing for new (or incremental) transmission customers on a constrained transmission system.[12] Of course, the example given in the initial Filing describing the off-peak service provided to the DT customers (new, different and in addition to the existing Core service) is another instance of an incremental (or new) customer.[13]

Ferry Service is Not Similar to Electric Production

Beginning on page 8, Mr. Linxwiler offers a comparison between ferry services and electric utilities. Specifically, on page 13 Mr. Linxwiler suggests that ferry service is akin to electric generation. He further suggests that since a portion of fixed costs for electric generation service

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[8] Mr. Linxwiler, page 13
[9] Mr. Linxwiler, page 15.
[10] Energy generated that is beyond the immediate needs of the producing system. This energy may be sold on an interruptible basis so that if it is required by the Core customers, the utility will retain priority to the energy.
[11] Refers to surplus gas pipeline capacity which is released and sold in the market
[12] *FERC in 1994 adopted its so-called "Or Pricing" policy, whereby the charges to each new transmission customer should be the* higher *of average cost or incremental cost. Page 3.*
[13] BC Ferries initial Filing, Appendix C pages 7-8

are sometimes allocated based on demand and commodity, the cost allocation methodology for ferry service should allocate some fixed costs to the DT Service. While it is difficult to compare ferry service and electric utility service, a more appropriate comparison to ferry transportation service than electric generation is electric transmission (or transportation) service. The ferries move people or cars from point A to point B and transmission companies move electrons from point A to point B. This is in contrast to producing a commodity, as is the case with an electric generation utility (generation of electrons).

FERC, which is the regulator of transmission pricing in the US, allocates transmission costs based on peak capacity. Regardless of the actual methodology (e.g. 12 Coincident Peak, 1 Coincident Peak or 2 Coincident Peaks[14]) all of the approved methodologies examine the monthly transmission system ***capacity*** usage at the time of the peak of the system (this is denoted by the "peak" in the Coincident Peak allocator terminology). Therefore, customer classes that only use the system during off-peak periods are not allocated any fixed costs. In addition, transmission customers that rely on non-firm access to the transmission system are treated differently than the firm (or Core) customer classes. The revenues from non-firm access to the transmission are used to offset the total cost of service allocated to and recovered from firm service customers. The DT service is analogous to non-firm transmission service, while the Core service is analogous to firm transmission service, which has priority. In EES' opinion, the cost allocation analysis performed by EES is supported by cost allocation principles and regulatory practice.

"Or Pricing" Concept

EES agree with Mr. Linxwiler that the *"'Or Pricing' policy is well-founded"*[15]. However, EES disagrees with Mr. Linxwiler's interpretation of FERC's "Or Pricing" construct. Specifically, Mr. Linxwiler incorrectly summarizes FERC's "Or Pricing" option as follows:

> *FERC in 1994 adopted its so-called "Or Pricing" policy, whereby the charges to each new transmission customer should be the higher of average cost or incremental cost.*

There are two incorrect assumptions in the above statement. First, FERC has *allowed* the higher of average or incremental cost to be used for new transmission customers, but does not require it.[16] Allowing a utility to charge either embedded or marginal cost is different than requiring a

[14] The 1 Coincident Peak (1CP) method determines the maximum monthly peak of the year (e.g. January) and allocates costs based on each customer class' contribution to that one-time hourly peak. The 12 Coincident Peak (12 CP) determines the 12 monthly peaks and allocates costs based on each customer class' contribution to the twelve hourly peaks. In determining which method to use, an examination of the planning criteria and the relationship between the monthly peaks is performed.

[15] Mr. Linxwiler, page 16

[16] "In the Policy Statement, the Commission explained that when the transmission grid is constrained and a utility chooses not to expand its system, we have allowed the utility to charge transmission-only customers the higher of embedded costs or legitimate and verifiable opportunity costs, but not the sum of the two ("or" pricing). The opportunity costs are capped by incremental expansion costs." *Inquiry Concerning the Commission's Pricing Policy for Transmission Services Provided by Public*

utility to charge the higher of embedded or marginal cost as stated by Mr. Linxwiler. "Or pricing" also supports the cost allocation methodology utilized by EES and the pricing set by BC Ferries.

Secondly, FERC's "Or Pricing" policy applies when "the transmission grid is constrained and a utility chooses not to expand its system."[17] In FERC's scenario, the marginal cost is likely higher than average embedded cost due to the needed system expansion. The transportation of DTs to Vancouver Island is not a constrained system. To encourage the expansion of the transmission grid, FERC has allowed, but does not require, the regulated utilities to pass through the additional expansion costs to customers via marginal cost pricing. As stated in BC Ferries' initial Filing significant unused capacity exists on both routes and the nature of the DT service will therefore not trigger an upgrade to the ferry system.

Mr. Linxwiler states on page 16:

> *This [Or Pricing] applies to both on-peak and off-peak service, although the incremental cost for service that is completely off-peak in nature will usually be much less than the average.*

Mr. Linxwiler's assumption that his definition of "Or Pricing" is appropriate for DT service is ungrounded; Mr. Linxwiler admits that the *cost* for service that is off-peak in nature will be significantly less than average cost. The lower cost of serving DTs on BC Ferries is accordingly reflected and calculated in EES cost of service study.

As a final point, FERC's "Or Pricing" is named such since it allows for pricing at *either average cost or marginal cost*. It is an important distinction to make that "Or Pricing" does not allow for pricing equal to average cost plus marginal cost. The 1994 FERC policy statement Mr. Linxwiler references specifically states that this so-called "and" pricing is an example of unacceptable transmission pricing.[18] Thus, the rate set should never be higher than the maximum of average embedded cost or marginal cost.

Matching Principle

Mr. Linxwiler presents his case on pages 6 and 12 for the use of the matching principle for allocating costs to the DT service rate class. While the "matching principle" is theoretically interesting, in practice, it does not work well for rate setting. EES is not commenting on whether the Act allows BC Ferries to set a rate not based on direct costs and an appropriate proportion of indirect costs. However, setting rates based on the benefit received by customers is very difficult

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Utilities Under the Federal Power Act, Policy Statement, *FERC Statutes and Regulations* ¶31,005 (1994); 59 Fed. Reg. 55031, Nov. 3, 1994. (Policy Statement).

[17] See 16.

[18] *Inquiry Concerning the Commission's Pricing Policy for Transmission Services Provided by Public Utilities Under the Federal Power Act*, Policy Statement, *FERC Statutes and Regulations* ¶31,005 (1994); 59 Fed. Reg. 55031, Nov. 3, 1994. (Policy Statement).

and impractical. For example, to incorporate benefits received by the ferry riders, capacity on the ferry might be auctioned to the highest bidders or rates could be based on the urgency of travel needed. This would be very difficult to implement and, it is therefore standard practice to set rates based on costs, not benefits.

The British Columbia Utilities Commission traditionally reviews revenue to cost ratios to determine if rates need to increase or decrease by rate class, examining the relationship between rates and costs rather than examining if rates match benefits received by the rate class[19].

It is important to recognize, once again, that the actual rates paid by the DT customers do incorporate the benefit component based on DT customer's preferences. The DT service rate identified by EES is a *minimum* rate based on appropriate costs. This floor is equal to BC Ferry's willingness to accept price. A DT service customer must have a willingness to pay equal to or greater than the price floor in order to receive service. The actual price charged for the service is based on direct negotiations with the DT customers and is in part dependent on the perceived benefit of the service.

The Application of Mr. Linxwiler's Proposed Pricing Tests

Mr. Linxwiler concludes his report by listing three pricing tests which BC Ferries DT service should exceed. According to Mr. Linxwiler, the following criteria should be met:

> *In my opinion, BC Ferries' fees for DT services, if they are to be fair and nondiscriminatory and otherwise appropriate, should satisfy three criteria:*
>
> *i)* *First, for the reasons I have described above, BC Ferries' fees for DT service should not be* ***less than the long-run incremental costs of providing the service, including a share of the costs of eventually replacing the ferry vessels and associated terminal facilities.*** *For this purpose, a reasonable (and much higher than zero) share of fixed costs should be allocated on the basis of total through-put for all types of vehicles.*
>
> *ii)* *Second, also for reasons I explain above, in order to be nondiscriminatory and to provide a reasonable benefit to other ferry customers, the* ***normalized rate per foot of transported trailer (taking into account length, width, and height, as well as weight) should not be less than the price charged for transporting other vehicles at the same time.*** *That is, the normalized rate per foot (for vehicle-related ferry costs) should be the same for all customers traveling at the same time.*
>
> *iii)* *Third, in order to provide proper price signals, and also determine a minimum reasonable share of costs reasonably allocated to off-peak customers,* ***the normalized rate or average cost per foot (for vehicle-related ferry costs) should not be less than the***

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[19] BCUC's October 26, 2007 Decision in "BC Hydro 2007 Rate Design Application – Phase 1" http://www.bcuc.com/Documents/Proceedings/2007/DOC_17004_10-26_BCHydro-Rate-Design-Phase-1-Decision.pdf

> ***average cost per foot that would be obtained if the ferry vessels were to be fully utilized****.* *I will explain the basis for this calculation below.*[20]*(emphasis added)*

EES considers its own approach to be the most appropriate methodology for determining the minimum rate. However, while EES has material theoretical and technical issues with Mr. Linxwiler's three tests, we have calculated the three rate thresholds proposed by Mr. Linxwiler to determine if the actual prices paid by BC Ferries' DT customers meet or exceed Mr. Linxwiler's stringent requirements.

The first test determines the direct (marginal or avoidable) cost due to the DT service and adds a share of costs to eventually replace the ferry vessels and associated terminal facilities. The cost of eventually replacing the ferry vessels and associated terminal facilities is interpreted as adding a share of the financing, amortization and return components associated with vehicle-related terminal and vessel assets. This share is determined based the DT services share of total throughput. Exhibit A provides the resulting calculation and minimum rate for this calculation. This calculation overestimated the cost of providing the DT service as the service utilize the excess capacity on board the ferries during off-peak periods but allocates all fixed costs as if DT service utilized capacity during peak periods. If this rate was implemented the DT customers should be able to utilize capacity at peak times similar to other Core customers.

The second test requires that the normalized rate per foot for DT service should not be less than the price charged for transporting other vehicles at the same time. As BC Ferries does not have time differentiated rates, the price charged for transporting other vehicles is the average vehicle-related revenues divided by actual throughput for each route. Mr. Linxwiler suggests normalizing based on width, weight and height in addition to length. Based on discussion with BC Ferries staff, width, weight and height differences between DT customers and Core customers do not effect the costs or capacity available. A normalized foot is therefore calculated based on length only (including hostling unit) as the width, weight and height do not impact the utilization of the vessel capacity. This threshold rate suggested by Mr. Linxwiler does not take into account that the DT service is limited to certain runs and has significant contractual and operational limitations. Thus this rate is calculated by treating the DT service as any other Core service. In addition, it is important to recognize that the rate calculated using this test is overstated, as BC Ferries does not have time differentiated rates. In fact, if BC Ferries had time differentiated rates, the off-peak rate would be lower than the current average rate, while the on-peak rate would be higher. Thus the time differentiated average rate calculated from this methodology would be less that the average rate without time differentiation. If this third test rate was implemented the DT customers should also be able to utilize capacity at peak times, similar to the first test. Exhibit A provides the minimum rate for this calculation.

Finally, test three states that the rate should not be less than the average cost per foot that would be obtained if the ferry vessels were to be fully utilized. This test determines the total vehicle related costs (including direct cost of DTs) and divides the total cost by total capacity. This test

[20] Mr. Linxwiler, page 19

is the only test that attempts to correct for the non-Core characteristics of the DT service by utilizing the 100% load factor concept, however it does not go far enough. This test still inappropriately requires the DT customers to pay for a significant share of vessel capacity, which is available whether or not BC Ferries operates the DT service. From a cost causation perspective this methodology does not result in a fair and equitable rate. Exhibit A provides the resulting calculation and minimum rate for this calculation.

As demonstrated by Exhibit A, BC Ferries' actual average rates charged for DT service meet or exceed all three test requirements. In fact, BC Ferries meets the most stringent requirement that *all* individual contract prices exceed the three criteria.

In addition to supporting the three tests provided by Mr. Linxwiler, Seaspan goes even further in their own filing. On page 9, Seaspan states: "*An "appropriate" contribution to indirect costs would be a contribution based on full long term cost including the costs of terminals, ferries, fuel, crews and overheads*". This statement is interpreted by EES to mean that Seaspan suggests that the minimum rate should be calculated by adding the direct costs plus the average of all other costs, i.e. marginal cost plus average embedded cost. As mentioned earlier in this letter, this type of "and pricing" is not supported by other regulatory entities and is also not supported by Seaspan's own expert.

Conclusion

In EES' opinion, the following conclusions can be reached:

- The methodology that EES used calculates a minimum rate based on direct cost and an appropriate proportion of indirect cost,
- Additional margin from DT customers contributes to vessel and terminal fixed costs,
- BC Ferries pricing is non-discriminatory,
- Actual DT service rates charged are greater than Mr. Linxwiler's three tests either on an average or individual basis,
- If DT service were to be priced as a Core service, there would be no reason to limit DT trailer service to the off-peak sailings.

Therefore, it is the opinion of EES that the calculated rate for DT service recovers the direct cost and an appropriate proportion of indirect costs associated with providing the DT service.

Very truly yours,

Gary S. Saleba

Gary Saleba
President

Appendix 1 - Exhibit "A"

Exhibit A-1

Fiscal 2010
$/Foot

Linxwiler's 3 Criteria	Route 1	Route 30	Combined
(i) BC Ferries' fees for drop trailer services should not be less than the long-run incremental costs of providing the service, including a share of the costs of eventually replacing the ferry vessels and associated terminal facilities			
(ii) the normalized rate per foot of transported trailer (taking into account length, width, and height, as wll as weight) should not be less than the price charged for transporting other vehicles at the same time. That is, the normalized rate per foot (for vehicle-related ferry costs, should be the same for all customers traveling at the			
(iii) the normalized rate or average cost per foot (for vehicle-related ferry costs) should not be less thant the average cost per foot that would be obtained if the ferry vessels were to be fully utilized.			

Exhibit A - 2

Mr. Linxwiler Criteria 1 - First test

Direct Assigned plus a reasonable share of the fixed costs allocated based on total thru-put for all vehicles

Fixed costs - further defined as the costs of eventually replacing the vessel and terminals (Amortization, Financing costs and ROE)

Route 1	**Allocated Costs**	**Unit Cost/ft**	**Source**
Direct Assigned Costs			Initial Filing, Appendix C, Exhibit C-1
Fixed Costs			Vehicle Related Amortization, Financing Expense and ROE divided by total thruput times DT service capacity available
Total Allocated			
Route 1 Drop Trailer Capacity (Feet) Available			
Route 1 Total Thruput (Feet)			

Route 30	**Allocated Costs**	**Unit Cost/ft**	
Direct Assigned Costs			Initial Filing, Appendix C, Exhibit C-2
Fixed Costs			Vehicle Related Amortization, Financing Expense and ROE divided by total thruput times DT service capacity available
Total Allocated			
Route 30 Drop Trailer Capacity (Feet) Available			
Route 30 Total Thruput (Feet)			

Combined	**Allocated Costs**	**Unit Cost/ft**
Direct Assigned Costs		
Fixed Costs		
Total Allocated		
Combined Drop Trailer Capacity (Feet) Available		
Combined Total Thruput (Feet)		

Exhibit A - 3

Mr. Linxwiler Criteria 2 - Second test

Normalized rate per foot should not be less than the price charged for transporting other vehicles at the same time

Route 1	**Total Revenues**	**Unit Cost/ft**
Total Vehicle Related Revenues Collected		
Less DT Service Revenues		
Total Revenues from other vehicle services		
Other Vehicle - total feet carried in Fiscal 2010		

Route 30	**Total Revenues**	**Unit Cost/ft**
Total Vehicle Related Revenues Collected		
Less DT Service Revenues		
Total Revenues from other vehicle services		
Other Vehicle - total feet carried in Fiscal 2010		

Combined	**Total Revenues**	**Unit Cost/ft**
Total Vehicle Related Revenues Collected		
Less DT Service Revenues		
Total Revenues from other vehicle services		
Other Vehicle - total feet carried in Fiscal 2010		

Exhibit A - 4

Mr. Linxwiler Criteria 3 - Third test

Average cost (for vehicle related ferry costs) divided by fully utilized capacity in ft.

Route 1
Average Cost for Vehicle Related Costs
Vehicle-related
Revenue-related
Direct Assigned
Total Vehicle Related Costs for all vehicles
Total Capacity Available
Average Vehicle Related cost at 100% utilization
Route 30
Average Cost for Vehicle Related Costs
Vehicle-related
Revenue-related
Direct Assigned
Total Vehicle Related Costs for all vehicles
Total Capacity Available
Average Vehicle Related cost at 100% utilization
Combined
Average Cost for Vehicle Related Costs
Vehicle-related
Revenue-related
Direct Assigned
Total Vehicle Related Costs for all vehicles
Total Capacity Available
Average Vehicle Related cost at 100% utilization

Appendix 2: Current Rates Per Foot

(Redacted consistent with Commissioner Order No. 10-01. An unredacted version has been filed confidentially)

Appendix 2

Commercially Sensitive and Confidential

BC Ferries current rates (per foot)	Route 1	Route 30
Passenger Vehicle	**$2.29**	**$2.29**
Bus	**$3.70**	**$3.70**
Commercial Vehicle	**$5.15**	**$5.15**
Minimum Drop Trailer Charge (including Terminal charge)		
Adjusted to include feet for hostling unit		

Appendix 3: S&P and DBRS Reports

(Filed Confidentially Due to Contractual Requirements of S&P and DBRS. Available for a Fee from those companies)