



**BACKGROUND TO THE BC FERRY COMMISSION'S
PRELIMINARY DECISION ON PRICE CAPS
FOR PERFORMANCE TERM TWO**

Questions and Answers

March 30, 2007

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1. What is the preliminary decision?

Ferry fares are allowed to rise on the group of **three major routes**:

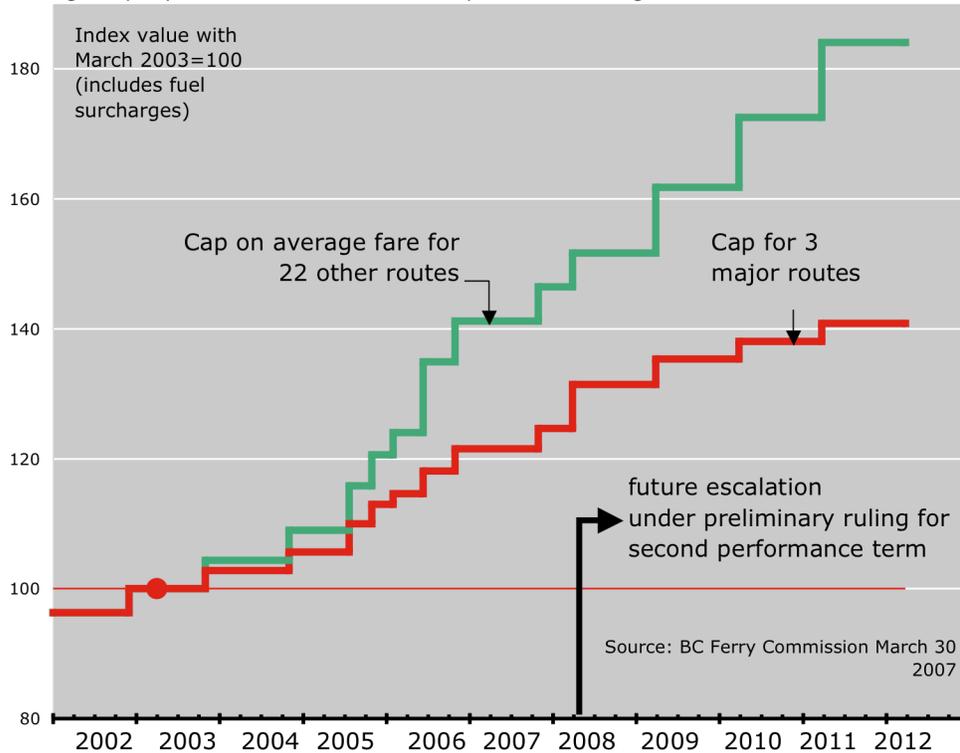
- 5.4%* on April 1 2008
- 3% per year thereafter, assuming the consumer price index increases at 2%: this figure varies depending on future inflation in the BC economy as described in more detail in our report.

For the six groups of **other routes**:

- 3.6%* on April 1, 2008
- 6.7% per year thereafter, again assuming that the consumer price index increases at 2%; this figure also varies depending on future inflation.

BC Ferries fare cap escalation: history and future

following the Commission's March 30, 2007 preliminary decision on price caps
assuming 2% per year increase in the consumer price index through 2012



* These percentage increases start from the fare level reached by March 31 2008, including fuel surcharges. By then, as required in the Coast Ferry Act, on November 1, 2007 there will have been one additional statutory increase of 2.8% for the major routes and 4.4% on other routes. The latter two percentages are increases on the fare level before fuel surcharges.

2. Will fuel surcharges continue?

BC Ferries is permitted to continue charging fuel surcharges through March 31 2008. They will continue at the current level, except for two routes (Horseshoe Bay-Langdale and Mill Bay-Brentwood Bay) where they will be reduced in spring 2007.

We now see the current level of fuel prices as the new norm, and have taken the current fuel surcharges as part of the new base starting in 2008. This means that the percentage fare cap increases in our ruling are calculated from this new, higher base that includes the old fuel surcharge.

Fuel prices through 2012 are unpredictable with considerable uncertainty in forecasts. In setting price caps through to the year 2012 we have assumed that fuel prices will rise from the current level at the rate of general inflation: i.e. we have not incorporated any extraordinary fuel price changes into future price caps.

From 2008 through 2012, there will be a new mechanism for automatic adjustment, such that BC Ferries will be responsible for part of the costs/savings from a limited range of fuel price fluctuation, and customers will see periodic surcharges or rebates if fuel prices move outside that limited range. You will find detail on the mechanism at http://www.bcferrycommission.com/BCFCMemo024_copy.pdf

3. You link increases partly to inflation. Suppose inflation goes from about 2% today to 4%. What happens to fares?

In the first year, 2008, we have determined a price cap increase that does not depend on inflation. Later on it does, though. If general inflation was 4% in 2010, the following year fares would go up by 4% on the major routes and 8.1% on the other routes, as show in the table below.

Price Cap Increases for Performance Term Two			
following the Preliminary Decision of March 30 2007			
	Increase over the price caps (including fuel surcharges) in effect at March 31 2008		
	On April 1 2008	On each of April 1 2009, 2010 and 2011	
		If CPI* is 2% every year	If CPI is 4% every year
Route Group 1: the three major routes	5.4%	3.0%	4.0%
Route Groups 2 through 7: the 22 other designated routes	3.6%	6.7%	8.1%

*CPI means the increase in the consumer price index

Reasons for the Increases

4. *Why will fares rise so fast in future?*

We believe the increases are necessary to keep the ferry services operating and financially healthy. There are several reasons for our conclusion.

- First, underlying costs of ferry service will rise due to general inflation in the cost of labour, fuel and maintenance.
- Second, BC Ferries is in a phase of accelerated renewal of its ships and terminals. The company is starting to replace old ships, which were bought at much lower prices many years ago, with new ships, and upgrading its terminals. Just as car loan payments jump when the old family car is replaced with a new one, so do the payments that BC Ferries has to make on its new ships and terminals. Currently, this applies more to the major routes than to the other routes, though we expect their turn will come.

This catch-up phase is required partly to recover from the lack of steady investment years ago, and partly to meet new and more stringent ship safety requirements imposed by the federal safety regulator. The catch-up phase will last a few more years: when it is over we expect a new phase of lower, regular, capital investment, and a period when fares will rise more slowly.

- A third reason for more rapid fare increases is that the Commission has agreed that the backlog of extra fuel costs paid by BC Ferries should be recovered from ferry customers in future.
- On the 22 taxpayer-supported routes (the routes other than the three major routes), when the amount of taxpayer funding does not rise as quickly as the amount of revenue that BC Ferries requires, there is a magnifying effect on the required fare increases, since fares must make up the difference in the growth rate of these two amounts, as explained in question 7 below.

The fare increases for the 22 taxpayer supported routes would be considerably higher but for increased Provincial funding announced in 2006, through 2012 for northern services and for the indexing of the federal subsidy to inflation (for more on the projection of taxpayer funding, see below).

5. *Why do the major routes face higher increases initially, lower increases later?*

The major routes will see three brand new ships by 2008. Customers should experience better-quality service on these routes. We considered it reasonable to provide BC Ferries with an early boost in fares to provide the revenue needed to finance them, and then level out the increases.

Also, we saw that the alternative—a uniform rate of increase in the fares from 2008 through 2012—would have been excessive since it produces much higher absolute fare levels later on, probably higher than required as the system moves into the third performance term 2012-2016.

6. *My route isn't getting any new ships, so why do I have to pay more?*

During the years 2008-2012, other routes, together, will see one newly built vessel in the south, new vessels in the north, and terminal upgrades throughout.

All routes face inflation-related increases in the cost of labour, fuel and maintenance.

A magnifying effect on fare increases, due to taxpayer funding increasing at less than BC Ferries' costs, continues, as explained in question 7 below

The Province has told us that it intends to redistribute service fees (and also the federal subsidy) among the other routes such that the rate of growth in the price caps is similar across the other routes through 2012. Without this redistribution, the price cap increases decided by the Commission would have been quite different among the 22 routes that comprise the six "other" route groups.

7. *Why have fares risen so quickly in recent years?*

The reasons for the rapid *historical* increases are somewhat different from those for *future* increases. Also, fares on the *three major* routes (the three routes between Vancouver Island and the Lower Mainland) are increasing quickly for somewhat different reasons than fares on the *other 22 routes*.

Since mid-2003, oil prices have doubled. Starting in 2004 the Commission declared this situation to be extraordinary and ruled that BC Ferries could pass on some of the extra cost of fuel to its customers. When fuel surcharges are included, fares then rose at about twice the rate that they would have risen otherwise, for both major and other routes. Even so, partly because fuel surcharges were not started immediately and partly because fuel prices behaved unpredictably, the accumulated surcharges have not covered all BC Ferries' extra costs, leaving BC Ferries with a fuel cost "backlog".

At the same time, *major* routes saw slower increases than *other* ones. The main reason is that the other routes are taxpayer-supported through federal subsidy and Provincial service fees. When taxpayer funding increases more slowly than BC Ferries' costs, to make up for this, the **effect is to magnify the required rate of increase of fares**: in fact the federal subsidy is indexed only to general inflation, and the Provincial fee was essentially fixed in dollar terms. Because taxpayer funding did not increase in proportion to BC Ferries' rising fuel costs, the amount left for customers to pay rose, in percentage terms, even more quickly than BC Ferries' costs and more quickly than on the unsubsidized major routes.

8. *BC Ferries has to earn a profit now. Isn't that the real reason for the fare increases?*

It is part of the reason for the increases: making earnings allows BC Ferries to borrow to finance its fleet and terminal renewal program independently from government.

Being allowed to earn a “reasonable” return is a pivotal feature of the financial arrangement under which BC Ferries operates.

In order for lenders to be willing to extend loans to BC Ferries on reasonable terms, which BC Ferries needs to renew its fleet and terminals, they must be confident that BC Ferries will be able to repay the debt principal and interest. Part of that confidence derives from the existence of equity in BC Ferries. The profit, or surplus, that BC Ferries earns, builds up that equity.

Unlike most companies, BC Ferries does not have owners, other than the Province, who receive dividend payments from its earnings, so that all the earnings (except for the small dividend paid to the Province on the preferred shares) are retained to build up equity and, therefore, creditworthiness.

The company is able to raise its own debt outside government, so taxpayers are not “on the hook” by having to guarantee BC Ferries’ debt.

The Commission sets the rates at which BC Ferries is allowed to earn a surplus for this purpose, under rules in the Coastal Ferry Act. Other things being equal, a one percentage point change in the allowed pre-tax return on equity (currently approximately 13 %) would mean fares would be lower by less than one per cent, but could also mean that lenders demand a higher return on BC Ferries’ bonds, which could raise BC Ferries’ financing costs.

In a technical sense, the need to earn a surplus does mean higher fares than if there was no such need. But if there were no earnings, BC Ferries would lose its ability to raise capital and it would move towards financial unsustainability.

Alternatives and Impacts, and Taxpayer Funding

9. *Do you encourage competition for BC Ferries, to keep fares down?*

Under the Act BC Ferries must provide a plan, in each performance term, showing how they intend to seek alternative service providers to operate the ferry routes, either under contract or under other arrangements. More background and the details of this plan are on the commission website at this address:

http://www.bcferrycommission.com/other_ferry_companies.html.

Although the process has been slower than anticipated, at this date a Request for Proposals has been issued for route 12 (Brentwood Bay-Mill Bay) and if an applicant can show that it could operate the route at lower cost than BC Ferries and meet qualifying

financial and safety standards, it could expect to receive a contract. The Northern routes were also at the start of the contractual process before the loss of the Queen of the North, which has caused a delay.

During the second performance term we expect other routes to be considered for possible operation by other operators.

Any firm is free to start a ferry service in head-to-head competition with BC Ferries. But BC Ferries' control of terminals through its leases with the Province, and its access to taxpayer funding through the Coastal Ferry Services Contract with the Province, are two considerable barriers facing such a firm.

10. *Is cross-subsidization no longer allowed inside BC Ferries?*

The Act specifically requires any cross-subsidization from the major (cross-strait) routes to the other routes to be eliminated by the end of the first performance term (March 31, 2008). This has now occurred and the other routes are in a break-even position, after the inclusion of the federal subsidy and the Provincial service fees. Even if the Act permitted it, using the earnings from the major routes to subsidize the other routes would not be beneficial for users or BC Ferries, because without adequate earnings, BC Ferries would not be able to borrow funds at the relatively low rates which it currently pays. The resulting higher cost of borrowing (or inability to borrow sufficient funds) would not permit BC Ferries to renew its fleet and terminal facilities.

11. *BC Ferries earned \$50 million in 2005/6: why not just force them to absorb their higher costs and restrict them to inflation-level increases?*

The Commission does have the authority to deny all fare increases to BC Ferries and to force the company to absorb all costs. To do so might be expedient, but would violate important principles and compromise the long-term health of ferry service. In particular:

- under the Act we regulate BC Ferries performance in four year terms, on a set timetable. For a given term, BC Ferries knows in advance what ferry services it must deliver and what its allowed fare levels are. It is then accountable for its performance and is able to retain its earnings from one term to the next. Those earnings are the foundation for its borrowing in order to renew its vessels and terminals. If we deliberately force BC Ferries to operate at a loss for any extended period, this would not only ignore the principle of financial sustainability, but also put at risk its ability to provide service. This is not in the long term interest of the ferry system.
- during our current price cap review, we have adjusted BC Ferries allowed fare levels (incorporating fuel surcharges) against all their costs (including fuel), and have set the fare caps for the following term. While fares will not go down, we will capture for ferry customers, through fares lower than they would otherwise be, the benefits of productivity gains achieved in the current term—and build in a target for future cost-efficiencies. Limiting uncertainties through a consistent, non-arbitrary regulatory regime, and maintaining incentives, are key to realizing those gains.

12. Has BC Ferries been required to look at revenues and potential savings in other areas of its operation to absorb the higher costs?

In determining fare caps for the years 2008 to 2012 we have:

- taken into account the current level of revenues that BC Ferries receive from their non-core services, such as cafeteria and parking revenues.
- received a report from our consultants who examined BC Ferries' projections of their expected costs for the next two years.
- used the year ending March 2008 as a starting point and allowed for increases in BC Ferries' costs that are close to the expected increase in the consumer price index.
- set a requirement that BC Ferries achieve a higher gain in productivity than has been recorded in recent years. They will need to cut costs and/or increase traffic beyond their current expectations if they are to meet our target.
- taken into account the expected efficiencies in operations that will result from the introduction of new ships.

13. Ferries are becoming unaffordable for some families. Ever-higher fares are having an economic impact on the islands. Fewer people travel as fares go up. Do you take this into account?

We have no statutory or contractual duty to consider affordability of the fare-paying travelers, or the broad social and economic impacts on communities, when making our decisions.

Section 38 of the Coastal Ferry Act instructs us to regulate ferry services in accordance with six listed principles, starting with "priority is to be placed on the financial sustainability of the ferry operators" and ending with .. "the designated ferry routes are to move towards a greater reliance on a user pay system. There is no mention of the consideration of the effect of our decisions on the fare paying passengers or on economic activity. You will find the six principles on our website at:

http://www.bcferrycommission.com/public_interest.html

However, that does not mean that we ignore the effect on the traveling public of the Commission's decisions. There are several ways in which we track the public response to ferry services and to fare increases:

- Article 6 of the Coastal Ferry Services Contract requires BC Ferries to make a customer satisfaction survey each year through an independent polling firm. This survey is provided to the Commissioner. Over the last few years the survey has shown a high degree of satisfaction, including value for money;

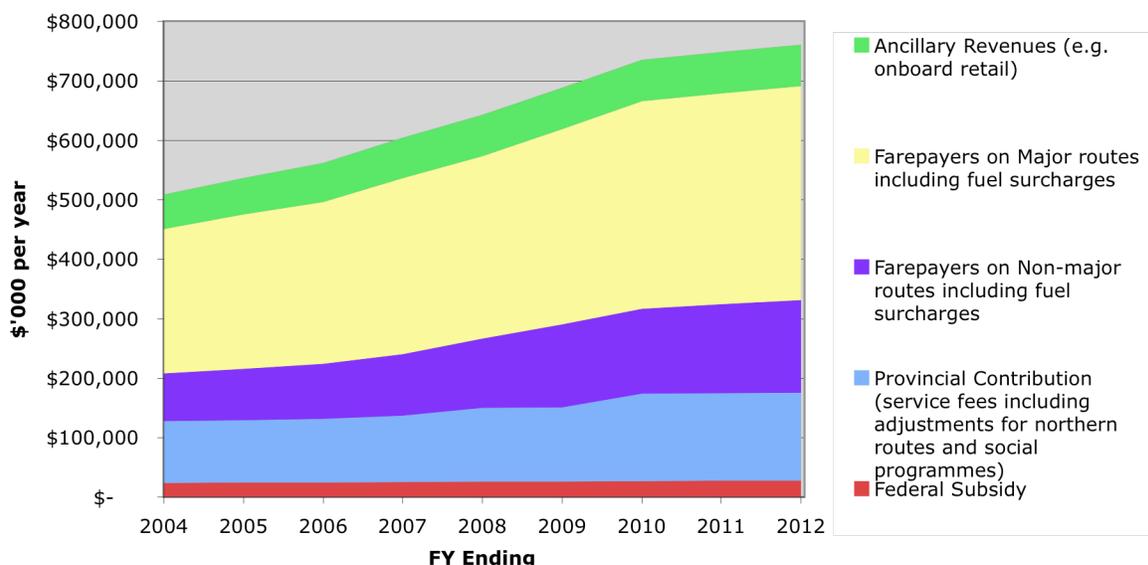
- Before fuel surcharges, or other extraordinary charges, are put into effect the public has an opportunity to comment on the proposed increases. In the case of the fuel surcharges we did receive comments from the public, but from only a fraction of one per cent of the traveling public;
- If there were significant public objection to the level of fares we would expect to see a reduction in the numbers of people traveling. This has not occurred. Although there has been a significant increase in fares since 2003, mainly due to much higher fuel prices, there has not been a reduction in the number of people using the ferry system.
- Which communities receive ferry service, its frequency and capacity, and who pays for it (ferry travelers vs. taxpayers) are matters of public policy which the Province decides. Under the Act, during the fare-setting timetable for periodic re-setting of maximum fares, the Province has a three-month opportunity to (a) adjust taxpayer contributions and (b) change the minimum amount of ferry service that BC Ferries must provide, before the Commission finalizes the maximum fares that can be charged. In the current cycle, this three-month opportunity is April 1, 2007 through June 30, 2007.

14. Where does BC Ferries get its revenue?

As shown in the chart, fare payers on the three major routes, which are unsubsidized, contribute almost half of BC Ferries' total revenues in fares and fuel surcharges. Fare payers on the 22 taxpayer supported routes contribute about one fifth, but this share is increasing as the share of taxpayer funds declines. The Provincial taxpayer also currently pays a fifth of BC Ferries revenue. The balance of BC Ferries' revenue is made up of ancillary revenue from its retail and other unregulated activities, and the federal subsidy.

Who Pays BC Ferries?

Sources of Revenue for BC Ferries for Performance Terms One and Two
(Actual to 2006, BC Ferries est. for 2007 and 2008, Commission projected using preliminary decision with 2% inflation for 2009-2012)



15. How Does the Province Decide on Its Contribution, and is it increasing?

The decision making framework for fares and Provincial taxpayer funding for ferries can be condensed as follows:

The PROVINCIAL GOVERNMENT decides....	The FERRY COMMISSION decides....
<p style="text-align: center;">(A)</p> <ul style="list-style-type: none"> • what communities will get government-supported ferry service (by designating routes), and • how much service (by defining core service on them); 	<p style="text-align: center;">(B)</p> <ul style="list-style-type: none"> • the (preliminary) level of ferry fare caps that BC Ferries reasonably requires to operate the services defined by the government
<p style="text-align: center;">(C)</p> <ul style="list-style-type: none"> • how much public money to inject in order to “buy down” the commission’s preliminary fares to a level it considers in the public interest, i.e. the degree of user-pay. 	<p style="text-align: center;">(D)</p> <ul style="list-style-type: none"> • the (final) fare cap level to reflect the government’s commitment of public money. <p><i>The commission also:</i></p> <ul style="list-style-type: none"> • monitors BC Ferries to ensure they do not overcharge or compromise service quality • incentivizes BC Ferries to be efficient in delivering service.

The commission cannot speak for the government’s decisions, i.e. (A) and (C) above and any associated public processes. For its own decisions (B) and (D), the commission’s job is essentially a technical one.

The Province provides its subsidy, in the form of per-sailing “service fees” to BC Ferries. In the case of new ships for the northern routes, in 2006 the Province agreed with BC Ferries to increase its service fees. After accounting for the insurance proceeds from last year’s loss of the Queen of the North, this contribution shields ferry customers from the higher cost of new ships and related terminal modifications in the north.

The Province also reimburses BC Ferries for passengers it is required to carry at zero or reduced fares under Provincial social programmes (e.g. seniors’ free midweek travel).

These reimbursements represent about 4% of BC Ferries' revenue from fares, and rise with fares and traffic growth. In FY2007/8 we expect these reimbursements to total some \$16 million.

The price caps for the 22 taxpayer-supported routes would be greater had not the Province formally indicated this month to the Commission that it will pay off from taxpayer funds the fuel cost backlog for the north, which we have estimated at \$5 million.

In FY 2003/4, the start of BC Ferries' performance term one, Provincial taxpayers contributed some \$104 million in service fees (\$92 million) and social programme reimbursements (\$12 million). In FY 2007/8, the end of performance term one, that is expected to increase to some \$124 million, and to some \$150 million by the end of performance term two.

16. Will the Federal government increase its subsidy?

Under a 1977 agreement with the Province of BC, the Federal government pays a subsidy, which is passed on to BC Ferries by the Province. The subsidy inflates according to consumer prices and is expected to be some \$26 million in FY 2007/8.

Process

17. Why are you making this ruling now?

We are required, under the Act, to provide our preliminary decision on fare caps by March 31, 2007. We provide it to the Province and to BC Ferries, who will consider changes to the Coastal Ferry Services Contract over the next three months, including service changes. By June 30, we will be informed of any changes to the Contract and, if BC Ferries' costs are affected by the changes, or if the Province decides to change the Provincial service fees, we will take those changes into account in making our final decision by September 30, 2007. The new fare caps will go into effect April 1, 2008.

18. Are "price caps" the same thing as fares?

No, they are not the same but there is a close relationship. We speak of "price caps" or "fare caps" which are the maximum allowed fares, as measured by the average weighted (by revenue) fares charged by BC Ferries in each three month period. It is in BC Ferries' interest to structure its tariff so that its weighted average fare is as close as possible to, but not over, the price cap. For more information, visit "Regulation of Fares" on the commission's website at

http://www.bcferrycommission.com/regulation_of_fares.html

19. How are route groups established?

There are six route groups which were set by the Coastal Ferry Services Contract. Each route group includes routes that have similar characteristics, for example the major route group includes the three cross-strait routes and the minor route group comprises 16 routes

to, and among the smaller islands. The purpose was to avoid situations where, for example, if one route required a new vessel, that cost would be borne by just one route. Vessels are also moved from one route to another, usually within the same group, and, in this way costs are spread over the entire group. The Northern route group, comprising three routes, has vessels specifically built for service on longer routes.

20. *Are you publishing background information for more depth on the preliminary ruling?*

We expect to publish shortly a review that will explain how we made the decisions required to reach our overall conclusions on the price caps.

21. *Have you done a full audit of BC Ferries and do you believe their figures?*

We have not done an audit of BC Ferries submission dated September 30, 2006 to us, which included forecasts of their revenues and costs for the two years ending March 2007 and 2008. We have received a report from a large consulting firm whom we hired to review the forecast and they have determined that BC Ferries' forecast is, for all significant issues, reasonable.

Based on the review by the consultants and ourselves, we are satisfied with the accuracy of the information given to us.

22. *Can the public apply for a reduction on ferry fares, or appeal this increase?*

There is no appeal mechanism in the Coastal Ferry Act. Should a political decision be taken to increase public funding to the ferry system, then the Commission would lower the price cap in its final decision due September 30, causing a fare reduction as provided for in the Act.

Comments from the Public

23. *How can I give feedback and to whom? Is there a deadline?*

We shall be pleased to receive comments on our preliminary decision from the public by e-mail, fax or Canada Post by June 30 2007.

Please contact us by email at the [BC Ferry Commission](#), by fax at (250) 285-3740 or by regular mail at BC Ferry Commission, P.O. Box 1497, Comox, B.C.

To comment on any aspect of Provincial government policy, please contact Minister Kevin Falcon at the address below.

To provide comments on taxpayer funding, the frequency and capacity of sailings on any route, and any other aspect of the Coastal Ferry Services Contract, please contact:

BC Ferries via	Minister Kevin Falcon via
Email: www.bcferrries.com/contact_us or Phone: 1-888-223-3779	Email: Minister.Transportation@gov.bc.ca or Mail: PO Box 9055, Stn Prov Govt Victoria, BC V8W 9E2

24. Are you holding public meetings where people can ask questions and provide input?

The Act requires us to make the preliminary decision on price caps by March 31, 2007 (for the second performance term) and to issue a report, which includes the decision, to the “ferry operator and the government”. We are also required to publish the report to bring it to the attention of the public and that is why it is on the website. We have met with representatives of the ferry advisory committees to inform them of the process and expect to have further meetings over the next few months before our final decision is made.

We shall be pleased to receive comments from the public by e-mail, fax or Canada Post within the next three months through e-mail, fax or Canada Post (see above).

The Commission will not be hosting public meetings but we look forward to invitations from representative groups.

25. Will you do anything with my feedback?

All responses from the public will be carefully reviewed and, if we consider that the final decision will benefit from adopting any proposals, we shall adjust our decision to reflect them.

BC Ferry Commission
March 30, 2007