



BRITISH COLUMBIA
FERRY COMMISSION

ORDER
NUMBER: 05-03

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

<http://www.bcferrycommission.com>
info@bcferrycommission.com

**IN THE MATTER OF
Statutes of British Columbia Bill 18 - 2003
The Coastal Ferry Act Section 55**

And

A Capital Expenditure for an Intermediate Sized Vessel
Proposed by British Columbia Ferry Services Inc ("BC Ferries")

BEFORE: Alan Eastwood, Deputy Commissioner

D E C L A R A T I O N

WHEREAS:

- A. under section 55 of the Act BC Ferries may apply to the commissioner for a declaration as to whether the capital assets proposed to be deployed on, or the capital expenditures proposed to be incurred in connection with a designated ferry route, are reasonably required;
- B. on June 20, 2005, BC Ferries applied for such a declaration respecting \$51 million in capital expenditures for an intermediate sized vessel for the minor route group;
- C. BC Ferries has asked to have these expenditures included in the regular price cap review preceding the performance term starting April 1, 2008;
- D. BC Ferries has stated that the vessel to be acquired would replace the Queen of Tsawwassen which is at or near the end of its economic life;
- E. the commissioner has reviewed the supporting statements and materials supplied by BC Ferries as summarized in the attached Review, and has obtained independent analyses and opinions from qualified persons;
- F. the commissioner is satisfied that:
 - the Queen of Tsawwassen does not meet Transport Canada's revised regulatory requirements, due to come into effect in 2006;
 - while extending the life of this over 40-year old vessel is technically possible, the cost of such an undertaking is not economically justifiable compared to the cost of acquiring a new vessel;
 - it is prudent and timely to acquire a replacement vessel; and
 - BC Ferries has undertaken a competitive bid process, verified by independent technical experts, to determine capital cost estimates for the vessel;

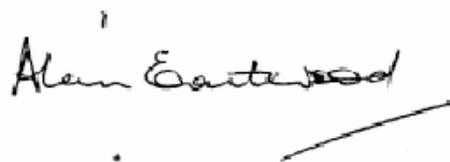
- G. the commissioner is further satisfied that BC Ferries has:
- weighed and carefully considered a number of factors in developing a vessel replacement strategy for routes 7 and 8 within the minor route group, including a redeployment of vessels at a future date to meet traffic growth;
 - applied several best practices in the governance of the capital project;
 - committed to negotiate safeguards against late delivery of the new vessels; and
 - structured the procurement process to be credible and create competition among domestic and international bidders;

NOW THEREFORE the commissioner declares as follows:

- the acquisition of the proposed intermediate sized vessel for deployment on the minor route group is reasonably required;
- of the total estimated capital expenditures of up to \$51 million for both core and ancillary services, that portion needed to provide the core contracted levels of marine transportation service is reasonably required;
- in particular, the commissioner has not ruled on an allocation of the total capital expenditures between core service and ancillary service; accordingly this declaration is not to be construed to mean that the entire \$51 million will be included in the cost base for core services in the price cap review;
- capital amounts may have to be reviewed if extraordinary changes in costs beyond BC Ferries' control occur before construction contracts are signed, such as exchange rates and world steel prices;
- if federal duty is charged in the event that a foreign shipyard is selected, or if a subsidy of any kind is obtained, not previously included in the budget price, the limit on the capital cost is changed accordingly.

DATED in North Saanich, in the Province of British Columbia, this twentieth day of July 2005.

BY ORDER

A handwritten signature in black ink that reads "Alan Eastwood". The signature is written in a cursive style and is positioned above a horizontal line that extends to the right.

Alan Eastwood
Deputy British Columbia Ferries Commissioner

**Review of an Application by BC Ferries
For a Declaration that
A Capital Deployment for an Intermediate Class Vessel
Is Reasonably Required**

CONTENTS

1. Background	2
1.1 Legal Context	2
1.2 Scope of Review	2
2. Summary of Application	2
2.1 Problems with the Queen of Tsawwassen	3
2.2 Safety	3
2.3 Replacement options	3
2.4 Current Status	4
3. Comments of the Commissioner	5
3.1 Handling of Risk	5
4. Outstanding Issues	6
4.1 Negotiation Issues	6
4.2 Federal Duty	6
4.3 Core and Ancillary Costs	6

**Alan Eastwood
Deputy Commissioner
BC Ferry Commission
July 20, 2005**

1. Background

On June 20, 2005 BC Ferries applied to the commissioner requesting a declaration under Section 55 of the Coastal Ferry Act that the proposed replacement of the Queen of Tsawwassen at a capital cost of up to \$51 million was “reasonably required” and would be included in the calculation of the price cap established for the next performance term.

1.1 Legal Context

Under the Coastal Ferry Act the BC Ferry Commissioner is empowered to regulate the core ferry services provided by ferry operators. The commissioner determines the price cap (weighted average tariff) applicable to ferry routes (in route groups) for four-year performance terms. In calculating the price caps the commissioner includes those capital expenses that are determined to be reasonable in relation to a route group, including capital expenses that have received prior approval under Section 55.

Section 55 states:

“Before deploying capital assets on, or incurring capital expenditures in connection with, a designated ferry route or terminal, the ferry operator may apply to the commissioner and the commissioner must, within one month after the application, declare whether the capital assets proposed to be deployed on, or the capital expenditures proposed to be incurred in connection with, the designated ferry route or terminal are reasonably required”.

In December 2004 the commissioner provided BC Ferries with Revised Guidelines for Section 55 which set out the requirements that ferry operators would be required to meet in submitting applications under this section.

1.2 Scope of Review

This review relies on documents and representations of BC Ferries management and staff. It does not constitute a review of the financial viability of the replacement of the vessel Queen of Tsawwassen or the affordability of a new vessel to BC Ferries with or without increases in price caps. Nor does the review involve a detailed assessment of technical specifications or ship design. It is also outside the scope of the commission’s work to perform due diligence on the procurement process (e.g. by reviewing contract bid documents).

2. Summary of Application

BC Ferries supplied a number of documents with its application. Opinions from outside technical experts were included to the submission, which contained reasons for upgrading or replacing the Queen of Tsawwassen, including building a new vessel.

The commissioner provided all the documents received from BC Ferries to a consulting firm—PricewaterhouseCoopers LLP—hired by the commissioner for the purpose of this review. The firm was asked to give its opinion as to whether the vessel replacement and capital costs were reasonably required and whether BC Ferries had responded adequately in its application to the commission’s Section 55 Revised Guidelines.

In preparing this review the commissioner has carefully considered the opinions of the consulting firm in reaching his own conclusions regarding the application and has included their opinions in this review, where appropriate.

2.1 *Problems with the Queen of Tsawwassen*

The Queen of Tsawwassen, constructed in 1960, originally operated on the major routes and currently operates on route 7 (Saltery Bay-Earl’s Cove), a more sheltered route. Independent consultants have confirmed that it has reached the end of its useful service life and needs to be replaced.

2.2 *Safety*

The vessel has had significant regulatory issues. It operates under conditional certificates issued by Transport Canada with respect to its lifesaving and fire protection equipment and engines. It will not meet the requirements of the Canada Shipping Act to be introduced in 2006 with a sunset clause bringing them into effect by 2009 or the requirements of the International Agreement on Safety of Life at Sea. BC Ferries has made a commitment to Transport Canada to retire the vessel by the end of 2007.

The option of extending the life of the vessel was considered by internal and external consultants and was rejected. The cost of a major upgrade, estimated at over \$50 million, would not provide any certainty concerning the length of life extension or its ability to meet Transport Canada regulations.

2.3 *Replacement options*

The vessel replacement strategy stresses “interoperability” on the minor routes. The proposal is for the new vessel to replace the Queen of Tsawwassen on route 7 (Saltery Bay-Earl’s Cove) initially before being redeployed to route 8 (Horseshoe Bay-Bowen Island) several years later. The Queen of Capilano, currently operating on route 8, would be moved to route 7, for which it is more suited. The rapid growth in traffic on route 8 would be met by the option, for the new vessel, of expanding its capacity.

Terminal upgrades at Snug Cove on Bowen Island, are dependent on land use planning decisions for the Snug Cove village area, which are the responsibility of the Municipality.

Used Vessel Option

Replacement of the Queen of Tsawwassen with a used vessel was considered and several vessels were reviewed but rejected for the following reasons:

- there are few double-ended intermediate class vessels in the marketplace;
- significant modifications would be required to meet Transport Canada standards, especially safety standards;
- the ability to move vessels among routes is required but difficult to attain with a non-standard vessel;
- a non-standard used vessel would create problems in maintenance, spare parts and effective operation on the different routes in a route group; and
- most vessels available for purchase have not been constructed to a 40-year life standard.

New Vessel Option

In developing its statement of technical requirements for the new vessel BC Ferries reports that among its considerations were:

- the capacity required for route 7—slightly less than that provided by the Queen of Tsawwassen—because of lower utilization on the route and low growth;
- ability to expand capacity when moved to route 8 to meet the growth in traffic on that route;
- sufficient speed to meet the schedule but with increased fuel efficiency;
- strategies to lower maintenance and refit costs;
- double-ended propulsion which is more efficient for the shorter routes; and
- interoperability with other routes.

The specifications derived from the technical requirements were based on “proven technology” with minimal risk, the expectation of a 40-year life and the best features of minor route vessels.

2.4 Current Status

At this date BC Ferries has carried out the following steps in the procurement process:

- requested shipyards in Canada and internationally to respond to a Request for Pre-Qualification;
- identified three shipyards, Canadian and international, to be in compliance with the requirements;
- issued a Request for Proposals to the three shipyards; and
- commenced technical discussions with the aim of refining the individual proposals to be more in line with BC Ferries requirements.

Independent technical experts confirmed the process and the three shipyards were ranked in the same order by internal and external evaluations. The next steps are expected to be negotiations with the shipyards, followed by selection and contract signing with an expected delivery date in 2007.

3. Comments of the Commissioner

The identification of the need to replace the Queen of Tsawwassen, the vessel replacement strategy, integration with other future requirements in the minor route group, specifications for the new vessel, and the process for evaluating the shipyards bidding on the work has been confirmed as satisfactory by the consultants to the commissioner. They report again, as in the case of the proposal to acquire the “Super C” vessels in 2004, that BC Ferries has employed a number of best practices in the governance of the project and in the procurement process.

The consultants examined BC Ferries responses to the commissioner’s revised Section 55 guidelines and report that the information provided by the company is satisfactory, subject to the issues discussed below.

After reviewing the actions taken by BC Ferries in its efforts to locate a used vessel that would meet BC Ferries needs for the route, the requirements for the route group and meet Transport Canada’s standards, the consultants concur with BC Ferries that the cost of acquiring and retrofitting a used vessel was too high and the length of the remaining life uncertain. In addition, none of the used vessels could meet Transport Canada’s new safety requirements. The consultants agree with BC Ferries conclusion that acquiring a new intermediate class vessel is the most appropriate procurement option.

In its specifications for the new vessel BC Ferries has met the requirements for route 7—including a slight reduction in capacity, improved fuel efficiency, and expected lower maintenance costs—with the flexibility to increase capacity for the expected redeployment to route 8 after several years.

The consultants state that the capital cost estimates, based on the shipyard prices quoted by the three shipyards, do not appear unreasonable, but they have a concern over the initial capital cost estimate. Because of rapid cost escalation and variations in the proposals received from the shipyards, it was difficult to compare the initial cost estimate directly with the proposals. The consultants found the procurement process had been structured to be credible and create competition among shipbuilders but expressed a concern at the length of the procurement process. The consultants had a minor concern that the discount rate used in the business case analysis was not appropriate, however, the use of their preferred rate would not have changed any conclusions.

3.1 Handling of Risk

The consultants commended the thoroughness of the risk identification and mitigation procedures and agree with BC Ferries that the project does not carry the same magnitude of risk as the acquisition of the three “Super C” vessels.

The major remaining risks and their mitigation, where possible, are:

- cost inflation, especially for steel and other material costs, which could be reduced by a fixed price contract;
- limited design-build experience of two out of three shipyards will be offset by strengthening BC Ferries project management team and more detailed supervision;
- technical problems to be minimized by use of existing, up-to-date technology.

The commissioner is satisfied that BC Ferries has followed a process that will minimize the risk involved in this capital project.

4. Outstanding Issues

The procurement process is currently at the stage of negotiations with the shipyards and some issues remain outstanding.

4.1 *Negotiation Issues*

Several important issues concerning the design of the vessel remain to be negotiated with the shipyards, including engine propulsion, overall configuration of the vessel and payment terms. BC Ferries will need to ensure that their detailed specifications are met.

4.2 *Federal Duty*

If the foreign-based shipyard is chosen, the Government of Canada is expected to levy a duty of 25% on the value of the vessel imported into Canada, together with Goods and Services Tax on the duty. These amounts have been included in the bid comparison in the evaluation.

4.3 *Core and Ancillary Costs*

The amount of the ancillary costs, incurred to support non-core services of BC Ferries, and calculated as costs of providing non-core services incremental to costs of core services, will be excluded from the cost of the vessel for purposes of determining future price caps. The ancillary costs, to be determined after construction is completed, are estimated to be approximately one per cent of total vessel costs.