British Columbia Ferry Services Inc.
Response to the
Preliminary Price Cap Decision
for the Third Performance Term

April 30, 2011

Prepared in response to the
March 31, 2011 Preliminary Price Cap Decision
by the British Columbia Ferries Commissioner

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Part I Introduction and Overview

On March 31, 2011, in response to British Columbia Ferry Services Inc.'s ("BCFS" or the "Company") Performance Term Three Submission ("PT3 Submission"), the British Columbia Ferries Commissioner ("Commissioner") released his *Report on the Preliminary Price Cap Decision* (the "Report") and Order 11-02 (collectively, the "Preliminary Decision"). In the Preliminary Decision, the Commissioner reduced the Maximum Allowable Revenues from Fares and Reservations ("MARFR")[1] by $3.5 million annually, consisting of $0.5 million annually for executive compensation expenses, $2.0 million annually for marketing costs, and $1.0 million annually in amortization expenses associated with planned capital spending. The Commissioner also incorporated an annual $15.0 million productivity challenge (or "productivity gain") for Performance Term Three ("PT3"), an amount derived by reference to specific cost items from Performance Term Two ("PT2") identified by BCFS.[2]

The Commissioner provided BCFS with 30 days to file a submission commenting on the Preliminary Decision. The Commissioner specifically sought submissions on:

- whether reductions in executive compensation, marketing costs and amortization of capital expenditures are unreasonable; and/or
- whether it is unreasonable for BCFS to meet the productivity challenge during the third performance term; and,
- whether the preliminary price caps pose a significant risk to the financial sustainability of BCFS during the next performance term relative to its ability to satisfy all of its obligations or covenants to its lenders.[3]

This submission is BCFS' response to the Commissioner's Preliminary Decision (the "Response").[4] BCFS has addressed the three points identified by the Commissioner to assist the Commissioner in his determination of the final price caps for PT3. BCFS has also addressed three other issues that are raised by the Preliminary Decision: (1) the nature of the Commissioner's jurisdiction, which arises because BCFS believes that, in many respects, the Commissioner's Preliminary Decision contravenes the provisions of the *Coastal Ferry Act* ("CFA"); (2) the issue of cross-subsidization, which arises because of the Commissioner's approach to cost allocation; and (3) procedural fairness as it relates to the determination of the final price caps.

***The Commissioner's Jurisdiction*:** The determinations made by the Commissioner regarding price caps must be derived from and adhere to the provisions of the CFA and must not exceed the powers set out therein. As discussed in the subsequent sections of this Response, BCFS respectfully submits that aspects of the Commissioner's preliminary price cap determination must be revised in order to comply with the CFA.

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1 The MARFR is the forecast amount required by BCFS from fares and reservation fees to achieve its return on equity during PT3. The price caps are derived by dividing the MARFR by the anticipated traffic.

2 The Commissioner's "productivity challenge" is expressly a reference to section 41(5) of the CFA, which speaks to a "productivity gain". See Preliminary Decision at p.13. For ease of reference, in this submission BCFS uses the Commissioner's phrase "productivity challenge".

3 Commissioner's Report on Preliminary Price Cap Decision, p.15.

4 This submission contains "forward looking statements". For the purposes of this submission, BCFS repeats and relies on its statement regarding "forward looking statements" found immediately following the Table of Contents to its September 30, 2010, Performance Term Three Submission to the British Columbia Ferries Commissioner.

***Financial Sustainability*:** BCFS respectfully submits that the preliminary price caps pose a risk to BCFS' financial sustainability as the preliminary price caps: (a) incorporate an unreasonable productivity challenge, (b) fail to fully account for financing costs, and (c) do not provide BCFS with an opportunity to earn its allowed return on equity, either annually or in total across the performance term. These issues must be rectified in the final PT3 price caps in order that the price caps comply with the CFA.

Cross-subsidization: BCFS respectfully submits that use of a differential (lower) Weighted Average Cost of Capital (WACC) for the northern and minor route groups amounts to requiring major route fare payers to pay for costs that should be borne by those on the northern and minor routes. Such cross-subsidization is not permitted by the CFA, and PT3 price caps reliant on such cross-subsidization are contrary to the CFA.

***Productivity Challenge*:** The Commissioner identified a $15.0 million productivity challenge solely by reference to specific cost items that BCFS had included in its original PT3 Submission, and which are identified in the Preliminary Decision as cost "reductions" achieved in PT2 that are now being reinstated.[5] The characterization of these costs as PT2 "reductions" is an oversimplification, as the $15.0 million consisted of:

- $5.2 million of non-discretionary costs, including expected increases in pension costs, security/safety expenses and employee benefits that must be incurred in PT3; and,

- $9.8 million for costs, such as professional development and training programs, and risk assessment that should be incurred during PT3 as a matter of prudent governance.

In order to be compliant with the CFA, a productivity challenge incorporated into the price caps must be objectively reasonable, having regard to the evidence. BCFS respectfully submits that establishing a productivity challenge based on non-controllable costs and costs that ought to be incurred in PT3 in the interests of the Company and ferry users alike is unreasonable and contrary to the CFA.

As a demonstration of BCFS' commitment to ferry users to be part of the solution in meeting the challenge of increasing costs of ferry travel, the Company is committing to seek out operating cost savings of $9.8 million annually in PT3, and proposes that the final price caps reflect a productivity challenge in that amount. This productivity challenge represents an amount that is equal to the remaining portion of the Commissioner's productivity challenge after the non-controllable/non-discretionary costs have been deducted. As these remaining items should be incurred during PT3 as a matter of prudent governance, BCFS will exercise its business judgment to attempt to identify cost savings elsewhere across the organization in order to meet the proposed productivity challenge.

During PT2, BCFS was able to meet increased cost pressures brought about by a number of factors, including a global economic downturn, through avoiding and/or reducing certain costs, rather than applying for extraordinary price cap increases under section 42 of the CFA. BCFS is hopeful that it can continue to find ways to reduce costs and meet its proposed productivity challenge in PT3 without resort to section 42 of the CFA. BCFS is mindful, however, that even the revised productivity challenge will be very difficult to meet. BCFS' original forecast for PT3 had already removed all allowances for unforeseen capital expenditures in its capital program, which is a notable departure from previous performance terms, and BCFS only maintained a minimal contingency in its operating forecast. If any unforeseen event occurs during PT3, or if the Company is unable to meet the revised

5 BCFS acknowledges that this erroneous terminology was used by BCFS; however, this was corrected in subsequent meetings in February and March, 2011 with the Commissioner and his consultant, MMK Consulting Inc.

productivity challenge in the face of rising costs occasioned by some event which is outside the control of the Company, such as a change in government regulation, BCFS will be forced to seek an extraordinary price cap increase.

***Executive Compensation, Marketing and Amortization*:** BCFS respectfully submits that the executive compensation, marketing costs and amortization of capital expenditures that form the basis of the $3.5 million annual reduction in the MARFR are prudent expenditures that are beneficial to ferry users and should be accounted for in the final price caps. Nevertheless, BCFS will accept the $0.5 million annual reduction attributable to executive compensation. Since the Commissioner's jurisdiction is over the determination of price caps and does not extend to the management of BCFS' operations, BCFS understands that it retains the flexibility to seek out these savings wherever it is able to do so.

***Procedural Fairness*:** BCFS has responded to the basis identified in the Commissioner's Preliminary Decision for reducing the MARFR and imposing a productivity challenge. BCFS respectfully submits that procedural fairness requires the Commissioner to base the final decision only upon factors to which BCFS has had an opportunity to respond.

The remainder of this submission is organized as follows:

- Part II discusses general legal principles that define the scope of the Commissioner's jurisdiction.
- Part III discusses the impact of the preliminary price caps on the financial sustainability of BCFS in PT3, including aspects of the Commissioner's Preliminary Decision that do not meet the statutory requirements to provide BCFS with an opportunity to earn its allowed return on equity.
- Part IV discusses why the Commissioner's use of a lower WACC in calculating price caps for the minor and northern route groups results in an impermissible cross-subsidization of the minor and northern route groups by the major route group.
- Part V discusses why the Commissioner's productivity challenge must be revised to comply with the CFA.
- Part VI discusses why BCFS' investment in marketing and its amortization expense associated with expenditures on important capital assets during PT3 are reasonable costs and should be accounted for in the final price caps.
- Part VII discusses procedural fairness issues as they relate to the final price caps.
- Part VIII sets out BCFS' conclusions.

Part II The Commissioner's Jurisdiction

The substantive concerns raised by BCFS in this Response are closely tied to the Company's belief that the Commissioner has in certain instances exceeded his jurisdiction in determining the preliminary price caps, and in other instances failed to give effect to his obligations under the CFA. In this Part, BCFS provides the legal principles relevant to identifying the limits of the Commissioner's jurisdiction, and his statutory obligations. BCFS addresses the specific aspects of the CFA in subsequent sections.

The Commissioner derives his authority solely from the CFA. He must exercise his jurisdiction to determine price caps in a manner consistent with the provisions of the CFA. This principle is explained by the Supreme Court of Canada in *Dunsmuir v. New Brunswick*, 2008 SCC 9, as follows:

> [28] By virtue of the rule of law principle, all exercises of public authority must find their source in law. All decision-making powers have legal limits, derived from the enabling statute itself, the common or civil law or the Constitution…
>
> [29] Administrative powers are exercised by decision makers according to statutory regimes that are themselves confined. A decision maker may not exercise authority not specifically assigned to him or her. By acting in the absence of legal authority, the decision maker transgresses the principle of the rule of law.

In *ATCO Gas & Pipelines Ltd. v. Alberta*, 2006 SCC 4, the Supreme Court described this principle as follows:

> Administrative tribunals or agencies are statutory creations: they cannot exceed the powers that were granted to them by their enabling statute; they must "adhere to the confines of their statutory authority or 'jurisdiction'[; and t]hey cannot trespass in areas where the legislature has not assigned them authority"…

Pursuant to *ATCO* and *Dunsmuir*, the determinations made by the Commissioner regarding price caps must be derived from and adhere to the provisions of the CFA and must not exceed the powers set out in the CFA. As discussed in the subsequent sections of this Response, aspects of the Commissioner's preliminary price cap determination must be revised in order to comply with the CFA.

Part III Financial Sustainability of the Company

1. Introduction

The Commissioner asked BCFS to address in this Response whether the preliminary price caps pose a significant risk to the financial sustainability of BCFS during the next performance term relative to its ability to satisfy all of its obligations or covenants to its lenders. In this Part, BCFS addresses the impact of the preliminary price caps on financial sustainability. While the Commissioner has characterized financial sustainability as being a matter exclusively related to the Company's debt obligations, the effect that the price caps have on BCFS' ability to earn its allowed return is also key to the financial sustainability of the Company. BCFS submits that to be consistent with the paramount principle of financial sustainability in the CFA, the level of price caps must be adequate to enable the Company to:

- meet its contractual obligations with current investors (e.g. bond holders) by ensuring that it can meet existing financial covenants;
- earn adequate levels of net earnings as an important source of funding for future capital expenditures; and
- increase equity in order to access financing as a second source of funding for future capital expenditure.

Aspects of the Commissioner's Preliminary Decision do not meet the statutory requirement to provide BCFS with an opportunity to earn its allowed return on equity. This must be addressed in the final price cap determination, in order to comply with the CFA.

The remainder of this Part is organized as follows:

- Section 2 discusses the relevant legal principles regarding financial sustainability.
- Section 3 discusses the issue of financial sustainability in the context of the magnitude of the specified productivity challenge and cost reductions.
- Section 4 discusses the issue of financial sustainability in the context of the failure to allow for the full recovery of financing costs and the allowed return on equity.
- Section 5 discusses the issue of financial sustainability in the context of the constant annual price cap increases provided for in the Preliminary Decision.

2. Relevant Legal Principles

Pursuant to section 38(1)(a) of the CFA, the Commissioner must regulate BCFS with a priority on the Company's financial sustainability. Financial sustainability for BCFS can and should be defined as the ability to deliver core services over the long-term. In order for BCFS to maintain financial sustainability it must be able to meet its current obligations and provide for the replacement and refurbishment of its capital assets. Price cap determinations, which provide for cost recovery and a return on equity, are key components of financial sustainability.

As indicated above, the Commissioner has acknowledged in his Preliminary Decision the relevance to financial sustainability of meeting the Company's contractual obligations to its investors. These obligations include covenants which require the Company to meet tests on an ongoing basis ("maintenance covenants") and prior to issuing any additional debt ("incurrence covenants"). The maintenance covenants include tests which could result in the Company having to increase the level of debt service reserve funds or ultimately default, should the performance of the Company deteriorate. Although the Company does not anticipate that the preliminary PT3 price caps on their own would lead to default or to the inability to raise new debt, the Company is concerned that, in combination with the items addressed herein, they increase the risk of not meeting these tests. At a minimum, the weak financial performance in the early years of PT3 could negatively impact investors' credit assessments of the Company and consequently, the cost of BCFS' future debt.

With respect to the equity component of BCFS' capital structure, BCFS discusses the statutory obligations regarding a fair return on equity in Part VI of this Response. As was recently acknowledged by the Commissioner in Memorandum 41 (setting the preliminary return on equity for PT2), the requirement to enable a pre-tax return on equity, coupled with exemption of BCFS from paying income taxes, was intended by the legislators to enable BCFS to build equity to facilitate financing for its asset renewal program.[6] BCFS submits that the financial sustainability of BCFS is challenged by the combination of: (1) the size of the productivity challenge; (2) the failure to allow full recovery of financing costs and return on equity in accordance with the CFA; and (3) the constant rate of price cap increase that results in lower earnings in the early years of PT3 and relies on higher earnings in the later years when there is greater forecast risk.

3. The Magnitude of Productivity Challenge and Cost Reductions

Parts V and VI review the appropriateness and legality of the cost disallowances and the productivity challenge as identified in the Preliminary Decision. BCFS submits it will be difficult and detrimental to the financial sustainability of the Company to achieve reductions of $18.5 million per annum, especially given the non-discretionary nature of some of the costs. Price caps determined on an assumption of the achievement of these reductions at day one of PT3 do not provide BCFS with an opportunity to earn its allowed return on equity and, as a result, have negative implications for the future financial sustainability of the Company.

4. Failure to Allow for Financing Costs and Return on Equity

BCFS submits that the methodology employed in the preliminary price cap determination does not provide it with the opportunity to earn the allowed return on equity. In an effort to determine whether the return on equity of 12.73% could be achieved with the cost disallowances, productivity challenge and preliminary price cap determinations as set out in the Preliminary Decision, BCFS undertook long-term financial forecasting. This modelling assumed the same cost base as the Commissioner (including a reduction in expenses of $18.5 million per annum[7]) and annual price cap increases of 4.15% for the major route group and 8.23% for the other route groups. The results of this modelling indicated a return on equity over the performance term of less than the allowed pre-tax return on equity of 12.73% set by the Commissioner in Memorandum 41.

Based on subsequent discussions with the Commissioner and MMK Consulting Inc., it is BCFS' understanding that the preliminary price caps were arrived at using a methodology which applied a WACC to the Net Book Value (NBV) of capital assets. As the total capitalization of the Company (debt plus equity) is greater than the NBV of capital assets, the price caps cannot provide for the full recovery of financing costs or the target return on equity.

[6] See Memorandum 41, p.2 and Memorandum 25, p.3.

[7] i.e. the Commissioner's productivity challenge and the $3.5 million in cost reductions.

The CFA requires that the price cap, when combined with all other price caps applicable to all route groups serviced by the ferry operator, must enable the ferry operator to recover all reasonable financing charges and the opportunity to earn the allowed pre-tax return on equity. As the preliminary price cap determinations, including the productivity challenge, do not allow for this, BCFS respectfully submits that the preliminary price caps contravene the CFA.

5. Constant Price Cap Increase

The Commissioner has set the preliminary price cap increases at a constant annual rate of increase for PT3. BCFS submits that this approach is contrary to the CFA as the CFA requires that in regulating BCFS, the Commissioner must place priority on the financial sustainability of ferry operators (section 38(1)(a)). The use of a constant annual rate of increase for price caps creates risk in terms of the Company's ability to meet financial covenants and to produce adequate earnings to fund future capital expenditures.

The constant rate approach compounds the problems previously identified that prevent BCFS from earning the target return on equity over the four year performance term. This is because the constant rate approach leads to a back loading of revenues and net earnings for BCFS over the performance term. The Commissioner's order guarantees that BCFS will earn less than required to meet its target return on equity in the first two years. The Company is forecasted to earn more than required in the last two years of PT3 (although not enough to meet the target return on equity over the four year performance term), but forecast risk increases further out into the future. There is greater risk associated with the earnings in the later years and thereby greater risk that the shortfall to the target return on equity will be even greater. This approach puts financial pressure on the Company for the following reasons.

- The lack of earnings in the early years and the higher risk of lower than forecast earnings in the later years make BCFS' compliance with financial covenants more tenuous should unforeseen costs or unanticipated lower traffic levels occur. This point was observed by DBRS in its recent credit rating report on BCFS, a copy of which has been provided to the Commissioner. Although DBRS has confirmed the long-term rating of BCFS at "A", with a stable trend, it noted that the preliminary price cap order will leave little hope of improvement in financial metrics and will limit BCFS' ability to absorb unforeseen shocks without having recourse to special fare increases.

- The lower earnings in the early years, combined with the higher risk of lower than forecast earnings in the later years increase the overall risk in PT3 of lower than forecast earnings. Lower earnings over PT3 put added risk on the Company's ability to fund future capital expenditures, either internally or externally.

BCFS respectfully submits that the final price cap determination must give priority to avoiding the potential impact on BCFS' ability to meet financial covenants and to achieve the allowed return on equity. Alternative approaches include variable annual increases that allow the Company the opportunity to earn the target return on equity in each and every year or a hybrid approach with an increase in the first year which allows the Company to meet its return on equity and then a constant annual rate of increase over the remaining three years.

Furthermore, BCFS submits that the approach of constant annual price cap increases is not in the interests of ferry users. Under this approach, price caps will end PT3 at higher levels than if alternative approaches are used. Ferry users will have to pay higher fares by the end of PT3 than they otherwise would have to pay if an alternative methodology was used. Effectively, future ferry users will be paying higher fares so those ferry users traveling at the beginning of the performance term can pay less. This outcome is not in the best interests of ferry users.

Part IV Cross-subsidization

In setting the preliminary price caps, the Commissioner has used a lower WACC for the northern and minor route groups than for the major route group. This is the same approach followed by the Commissioner previously when establishing price caps for PT2. However, the experience of the first two years of PT2 indicate that there is no basis for use of a differential WACC, and the continued use of this approach amounts to cross-subsidization of the northern and minor route groups by the major route group and therefore should be eliminated. BCFS raised this concern in an email to the Commissioner dated March 30, 2011 and, by reply, was invited to include the topic of a differential WACC in this report. This section of the Response addresses the issue of cross-subsidization.

The rationale provided in the Commissioner's report for adopting the lower WACC for the northern and minor route groups is that these route groups face less financial risk than the major route group because BCFS receives contract service fees (including the federal subsidy) for operating these routes. Therefore, it is suggested that the northern and minor route groups should pay a lower equity risk premium. BCFS' experience to date in PT2 is that the minor and northern route groups continue to fail to cover their own costs and this strongly suggests that BCFS faces more financial risk in operating the northern and minor route groups. These route groups have historically, significantly underachieved financially as opposed to the major route group which has until recently provided strong earnings. In fact, the Commissioner acknowledged this in his "Remarks to the Board of Directors of British Columbia Ferry Services Inc." of August 18, 2010.

The receipt of service fees which are predominantly fixed in amount results in percentage increases in northern and minor route group price caps that are significantly higher than the percentage increases in BCFS' allowable costs of providing service for those route groups. This situation does not occur on the major routes on which fare payers have paid, and continue to pay, 100% of the costs of providing them service. As the system continues to move towards user pay,[8] this exposes the minor and northern route operations to an increased risk of traffic declines resulting from price elasticity.

Work done to date on the traffic forecast requested by the Commissioner to be delivered by May 31, 2011 indicates that the forecast risk for the minor and northern route groups is high. The minor route group in particular has significant forecast risk.

BCFS submits that use of a differential (lower) WACC for the northern and minor route groups amounts to requiring major route fare-payers to pay for costs that should be borne by those on the northern and minor routes. Such cross-subsidization is not permitted by the CFA and PT3 price caps reliant on such cross-subsidization are contrary to the CFA.

BCFS notes that while the Commissioner's proposed approach mirrors the approach he followed in setting the price caps for PT2, the CFA requires the elimination of cross-subsidization from the major route group to the other route groups by the end of Performance Term One ("PT1").[9] Over the first two years of PT2, BCFS reported net earnings of $12.4 million. Over this period, the major route group contributed net earnings of $17.8 million while the northern and minor route groups incurred net losses of $5.4 million. BCFS submits that the lower cost of capital used in setting PT2 price caps for the northern and minor route groups was a factor contributing to this $5.4 million erosion in BCFS' equity.

[8] See section 38(1)(f) of the CFA.
[9] See section 38(1)(e) of the CFA.

The proposed approach set out in the Preliminary Decision perpetuates the risk of continued cross-subsidization through PT3 and is contrary to the CFA. For this reason, BCFS submits that the use of differential WACCs should not be used in setting the final PT3 price caps.

Part V The Commissioner's Productivity Challenge

1. Introduction

The Commissioner's Report includes a requirement that BCFS meet a productivity challenge over and above specific disallowances discussed in Part VI.[10] The basis for this challenge is set out at p.12 of the Report as follows:

> While the commissioner accepts that BCFS will do well to manage its operating costs such that they will not increase beyond the rate of inflation built into its forecasts, there is no indication of targeted productivity improvements in PT3. On the contrary, BCFS has proposed that the commissioner allow the restoration in PT3 of $15 million in cost reductions made by BCFS in PT2.
>
> The commissioner finds there is insufficient justification for allowing such restoration. Accordingly, in setting the preliminary price caps for the third performance term, the commissioner has not recognized these costs. The commissioner believes BCFS should accept the challenge of maintaining the PT2 cost reductions and will treat the amount of $15 million as the productivity challenge for PT3 in accordance with s 41(5) of the Act.

The basis of the Commissioner's productivity challenge includes a number of cost items that cannot be controlled or avoided in PT3, totalling $5.2 million. BCFS submits that to be compliant with the CFA the productivity challenge can only relate to costs that can be controlled through more productive and efficient management by BCFS. A productivity challenge that is based on non-controllable costs is unreasonable and contrary to the CFA as it precludes BCFS from recovering reasonable forecast costs and from earning its allowed return on equity. BCFS submits that the maximum productivity challenge supported on the evidence is $9.8 million, representing $15.0 million less the non-discretionary costs described below. BCFS accepts an allowance for productivity of that magnitude, although even this amount represents a significant challenge for the Company.

The remainder of this Part is organized as follows:

- Section 2 addresses the relevant legal principles regarding the Commissioner's productivity challenge.
- Section 3 identifies the costs that must be excluded from the productivity challenge to make it reasonable and compliant with the CFA.
- Section 4 provides a summary of the submissions in this section.

2. Relevant Legal Principles

Section 41(5) of the Act provides as follows:

> (5) For the purposes of this section, the commissioner must determine the productivity gain that, in the commissioner's opinion, <u>acting reasonably</u>, the ferry operator should achieve in the following performance term. [Emphasis added.]

[10] The Commissioner's "productivity challenge" is expressly a reference to section 41(5) of the CFA, which speaks to a "productivity gain".

Pursuant to this section, the Commissioner must determine a productivity challenge that BCFS should achieve in the following performance term. The language used in section 41(5) makes clear, however, that the productivity challenge must be one that is “reasonable”. BCFS submits that the requirement of “reasonableness” in section 41(5) means that the amount of the productivity challenge has to be grounded in evidence that BCFS can achieve the gain through reasonable efforts by the Company. Any productivity challenge will be invalid and contrary to the CFA in the absence of such evidence.

At a minimum, it would be unreasonable for a productivity challenge accounted for in price caps to include non-controllable costs. It is implicit in the concept of “productivity” that a productivity challenge can only include controllable costs as BCFS cannot make productivity challenges in respect of costs beyond its control. Even where costs are not, strictly speaking, beyond the control of the Company, there will still be costs that prudent management dictates should be incurred. It would also be unreasonable to account for productivity challenges based on such prudent expenditures.

An unreasonable productivity challenge, as defined above, means that BCFS will be compelled to incur non-controllable or other prudent costs required as part of good management beyond those accounted for in the price caps. These costs can only come from equity. Thus, the practical effect of including an unreasonable productivity challenge in the final price caps is to preclude BCFS from being able to achieve its allowed return on equity. The CFA and the common law applicable to rate-regulated entities require that BCFS be provided with an opportunity to earn its allowed return on equity. In setting a price cap applicable to a particular route group and in determining a productivity challenge under section 41(5), the Commissioner must follow the requirement set out in section 41(2) concerning return on equity. Section 41 states in part:

> 41(1) In this section, “equity” includes retained earnings and paid in capital.
>
> (2) In setting a price cap applicable to a route group, the commissioner must be guided by the following principles:
>
> > ...
> >
> > (b) the price cap, when combined with all other price caps applicable to all route groups serviced by the ferry operator, <u>must enable the ferry operator to receive a pre-tax return on equity</u>, which return is to be calculated by adding
> >
> > > (i) an equity risk premium, provided that the equity risk premium is equivalent to that of other regulated businesses with reasonably similar risk characteristics, and
> > >
> > > (ii) a bond yield that is consistent with Government of Canada 30 year bonds or with Government of Canada bonds that in aggregate have a similar duration;
> >
> > (c) the price cap must take into account the anticipated productivity gain determined under subsection (5);

Under the CFA, it is clear that the ferry operator’s statutory right to an opportunity to earn a fair return is absolute and is not subordinate to the productivity challenge. Put another way, to be legally valid, the productivity challenge must be set at an amount that still allows BCFS the opportunity to earn its return on equity. BCFS explains later in this Part why the Commissioner’s $15.0 million annual productivity challenge is unreasonable, and improperly places the productivity challenge ahead of the Company’s right to earn a fair return.

The absolute requirement that BCFS be afforded an opportunity to earn a fair return is common in rate regulation. While BCFS is not a public utility and is regulated under its own distinct regulatory framework, the same elements that underlie price cap setting for ferry operators – cost recovery plus fair return - are present in the legislative framework governing setting just and reasonable public utility rates in British Columbia.[11] In the regulation of public utilities there is similarly an *absolute* requirement to fix regulated rates that allow a regulated entity to achieve its allowed return on equity. As an illustration of this point, the British Columbia Utilities Commission, in its 2006 decision setting the benchmark return on equity applicable to utilities in British Columbia characterized its legal obligation as follows:

> In coming to a conclusion of a fair return, the Commission does not consider the rate impacts of the revenue required to yield the fair return. Once the decision is made as to what is a fair return, the Commission has a duty to approve rates that will provide a reasonable opportunity to earn a fair return on invested capital.[12]

In the above quoted passage, the British Columbia Utilities Commission was applying a decision of the Supreme Court of Canada, *British Columbia Electric Railway Co. Ltd. v. Public Utilities Commission of British Columbia*[13], and the decision of the British Columbia Court of Appeal in *Hemlock Valley Electrical Services v. British Columbia (Utilities Commission)*[14]. In the former decision, Locke J. characterized as “absolute” the obligation on the regulator to approve rates which will produce the fair return to which the utility is entitled.[15] BCFS submits that the same principle applies to the CFA, which incorporates similar requirements in setting price caps as the *Utilities Commission Act* does in setting just and reasonable utility rates. The Commissioner has set an allowed return on equity for BCFS. For that determination to have any meaning, and for the price caps to be compliant with the CFA, price caps must be set at a level sufficient to provide a reasonable opportunity for BCFS to recover its reasonably forecasted costs in PT3 and the stipulated rate of return on equity.

In fact, in *Hemlock Valley*, the Court of Appeal overturned a decision of the British Columbia Utilities Commission that had phased-in rate increases to mitigate the impact on customers. As the phasing-in resulted in a permanent under-recovery of costs the order had reduced the effective return of the utility, and was thus impermissible.[16] The productivity challenge included in the Commissioner’s Report has the same effect on BCFS’ allowed return on equity as does phasing-in public utility rates in the manner attempted in *Hemlock Valley*, and is, therefore, contrary to the CFA. Ultimately, the requirement that BCFS be allowed to earn its return on equity is in the interests of ferry users, as it is an essential component of “financial sustainability” as set out above in Part III.

3. Non-Discretionary Expenditures included in the Productivity Challenge

The Commissioner’s determination that the productivity challenge for PT3 should be $15.0 million relies solely on his assessment that BCFS should maintain the “PT2 reductions” identified by BCFS.[17] The characterization of these costs as “PT2 reductions” is an

[11] See, for example, section 59 of the B.C. *Utilities Commission Act*.

[12] Order G-14-06, March 2, 2006, p.8.

[13] [1960] S.C.R. 837.

[14] (1992), 66 B.C.L.R. (2d) 1 (C.A.).

[15] Locke J., p.848, cited in *Hemlock Valley* at p.19.

[16] *Hemlock Valley*, at p.24.

[17] BCFS acknowledges that this erroneous terminology was used by BCFS; however, this was corrected in subsequent meetings in February and March, 2011 with the Commissioner and his consultant MMK Consulting Inc.

oversimplification, as a significant portion of the $15.0 million represented non-discretionary costs, and the remainder consist of costs that BCFS considers should be incurred during PT3 as a matter of prudent governance. In this section, BCFS identifies the **non-discretionary costs**, and summarizes why BCFS considers the remainder of the $15.0 million annual productivity challenge to be prudent PT3 expenditures. Establishing a productivity challenge based on non-controllable costs and costs that ought to be incurred at this time in the interests of the Company and ferry users alike is, with respect, unreasonable and contrary to the CFA for the reasons described above. As such, BCFS is proposing a productivity challenge representing the amount identified by the Commissioner, less the non-discretionary costs described below.

What follows below is an itemization of the non-discretionary costs included in the $15.0 million annual sum identified by the Commissioner. It is not possible for BCFS to reduce these costs through enhanced productivity.

a. Pension – Anticipated Increase in Pension Contribution Rates ($2.1 million annually)

BCFS anticipates an increase in the order of 10% in the pension contribution rates on April 1, 2012. This would equate to an increase in cost to BCFS of $2.1 million per year. The increase is non-discretionary and driven by two factors:

- First, on July 15, 2010 the Public Service Pension Plan (the "Plan") announced a 25 basis points increase in the employer's contribution rate and a 25 basis points decrease in the employee's contribution rate effective April 1, 2012.

- Second, BCFS anticipates that the March 31, 2011 valuation of the Plan will lead to further significant increases for employer and employee contribution rates.

The Plan is a multi-employer defined benefit plan that has three components: (1) basic pension benefits; (2) inflation adjustments; and (3) non-pension group health benefits. The basic pension benefit is guaranteed by the Plan and is fully pre-funded.

Every three years an independent actuarial valuation is undertaken to assess the health of the Plan. Should an increase in contribution rates be required the increases are non-discretionary and are equal for employee and employer. The last valuation was conducted based on results as of the March 31, 2008 year end. It showed the Plan to be financially sound. Despite a small surplus, a contribution rate increase was required to meet the funding requirements of the *Pension Benefits Standard Act*. The employee and employer contribution rates were increased equally by a modest 0.15% to 7.78% and 8.78%. A 10% increase in the contribution rate would be 0.78% and 0.88% for employee and employers, respectively.

Subsequent to the date of the last valuation, financial markets experienced a dramatic downturn resulting in a negative impact on the market value of the Plan's assets and the associated investment rate of return. The financial markets have somewhat improved. However, the five year annualized return of the Plan at September 30, 2010 was 4.5%,[18] well below the previous valuation's assumed investment return of 6.5%. While there are many other factors that are considered in the valuation of the Plan and the determination of any potential change to the contribution rate, a material financial underperformance of the Plan can be expected to have a significant impact.

[18] The December 7, 2010 Meeting Highlights for the Public Service Pension Plan Board of Trustees.

It should be noted that there have been significant increases in contribution rates in the past. The March 31, 2005 valuation led to a 28% to 33% increase in contribution rates when effective April 1, 2006, and the employee and employer contribution rates were each increased by 1.88% from 5.75%/6.75% to 7.63%/8.63%.

In summary, BCFS believes that an increase in the order of 10% in the employer and employee pension contribution rates on April 1, 2012 is likely. This non-discretionary increase will result in incremental costs to BCFS in PT3 of $2.1 million per year. BCFS submits that it is unreasonable to account for pension costs in the productivity challenge, and they must be excluded so as to ensure that the final price caps for PT3 comply with the CFA.

b. Federal Regulations for Corporate Security ($0.5 million annually)

BCFS is committed to ensuring the safety and security of its employees, customers and assets and complying with applicable legislation and regulatory requirements. Compliance with new federal security regulations will add incremental costs to BCFS in the order of $0.5 million per year in PT3. BCFS explains below why these costs are non-discretionary. BCFS respectfully submits that the Commissioner's productivity challenge is unreasonable to the extent that it accounts for compliance costs. These costs must be excluded from the final productivity challenge so as to ensure that the final price caps for PT3 comply with the CFA.

In 2001, the federal government enacted the *Marine Transportation Security Act* ("MTSA"), Initially the legislation and the associated regulations were limited to international ports and vessels. During 2005, the federal government indicated its intentions to extend the regulations to domestic ferries. Effective January 15, 2010, new regulations came into effect and domestic ferries and facilities are now included within the MTSA framework. As a result, BCFS is required to satisfy a specific level of security on its vessels and at its terminals and, following its corporate security strategy, has completed location-specific enhancements. BCFS has received a security certificate of compliance from Transport Canada for routes servicing its major and certain other routes as required by the regulations.

The federal government has recently indicated that it intends to introduce monetary penalties for failure to comply with the security regulations.

Over the period 2006-2010, and with the knowledge of the pending extension of the security regulations to its operations, BCFS conducted security vulnerability assessments on its terminals and vessels to assist in determining which areas required enhancements. Based on these assessments, a conceptual design report of the desired security system was completed. The significant cost and complexity of implementing all aspects of the desired security system has dictated that such implementation be done over a period of years.

The purpose of the new regulations is to enhance the security of the Canadian ferry transportation system through the establishment of a framework for detecting security threats and taking preventive measures against security incidents. The cost to BCFS of the enhancements required to meet the regulatory requirements is in the order of $0.5 million per year in PT3. The CFA requires the Commissioner to regulate in accordance with the principle that "ferry operators are to be encouraged to minimize expenses <u>without adversely affecting their safe compliance with core ferry services</u>".[19] BCFS submits that this principle requires the Commissioner to allow for these costs. In the post-"9-11" world, security is integral to safe operation of BCFS' core ferry services, and BCFS will not sacrifice security to save costs. This approach is also fully aligned with the interests of ferry users.

[19] CFA section 38(1)(d)

c. Benefit Rates ($2.6 million annually)

BCFS has experienced significant increases in the employee benefit rates for the years 2010 and 2011. These known increases are included as part of the Commissioner's $15.0 million annual productivity challenge.

As the benefit program is largely determined through legislation and the collective agreement, these increases are non-discretionary. The following represents the increases experienced and adjusted for within the $15.0 million:

		$ million
EI	Maximum contribution 5.3% increase (2011)	$0.2
CPP	Maximum contribution 2.0% increase (2010); 2.5% increase (2011)	$0.5
Medical	6% rate increase (2010 and 2011)	$0.5
Dental and Extended Health	5% rate increase (2010 and 2011)	$1.0
Long Term Disability	9% rate increase (2010)	$0.4

4. Other Expenditures Required as Good Commercial Practice

The remaining items that make up the $15.0 million from the Commissioner's productivity challenge consist of a number of cost containment measures that, in PT2, allowed the Company to meet budget requirements in the short term. However, these were short-term reductions that cannot be sustained over the long-term without negative operational consequences.

In the remainder of this section, BCFS sets out the remaining components of the $15.0 million and describes why these costs need to be incurred in PT3 as a matter of prudent management. BCFS will have to find cost reductions necessary to meet these elements of the productivity challenge in other areas of the organization.

a. General Salary Increase ($1.5 million annually)

Exempt staff have not received a general salary increase for two consecutive years while union employees, who make up 85% of the workforce, have received 6% over the same period of time. BCFS monitors the market for managerial and professional staff regularly and notes that there have been salary increases of 2 - 3% in each of the past two years with a similar forecast for 2011. The result is that salaries for managerial and professional staff in the external market have risen 6 – 9% over the last three years, while BCFS salaries have increased by only 2.5% over the same period.

The inequity of salary in BCFS' labour pools has had a significant impact in staff resourcing and is evident in the increase in staff turnover that has been experienced over the last two years. The challenges in recruiting staff occasioned by less competitive salaries and responding to staff turnover bring with them attendant costs. BCFS believes it is reasonable to provide its managerial and professional staff salary increases averaging 3%. This lift of $1.5 million is added to the cost base and therefore included in future years.

b. Vessel Deployment Strategy ($2.0 million annually)

BCFS' standard operating practice involves optimizing vessel utilization by matching vessel size to traffic profiles. In response to the unprecedented traffic decline over the course of PT2, BCFS substituted smaller vessels with lower fuel and crew requirements as the primary vessels on Route 1 (Tsawwassen to Swartz Bay) and Route 2 (Departure Bay to Horseshoe Bay) as one of the cost containment measures that the Company took to avoid the necessity of filing a request for extraordinary price cap increases under section 42 of the CFA. This translated into direct savings in PT2 of $2.0 million annually.

While the savings from vessel substitution were significant in PT2, the specific vessel substitutions on Routes 1 and 2 were temporary measures that cannot be sustained economically over the long term. Prolonged use of these smaller, older vessels through PT3 will result in significant investment requirements. In the normal course of business, as vessels age, maintenance requirements increase. Utilizing older vessels as primary vessels will not only incur more frequent maintenance requirements, it will ultimately lead to an increase in unplanned maintenance events which impact both cost and service reliability. In addition, excessive utilization of these older vessels will shorten the economic lives of the vessels and their components, which in turn will lead to higher capital expenditure requirements sooner. The measures taken by BCFS in PT2 were short-term solutions to what was considered, at the time, to be a short-term drop in traffic.

BCFS has strategic operational plans to optimize the vessel mix to create the greatest flexibility to meet service requirements, considering peak and off-peak demands and commercial needs and vessel maintenance requirements. Crews have been trained for all vessels used on Routes 1 and 2 to provide BCFS with the further flexibility in optimizing vessel utilization. Through improved planning, BCFS will optimize the use of its fleet to meet customer service requirements while avoiding significant capital expenditures and service disruptions.

c. Professional Development and Training Programs ($3.1 million annually)

As a Reporting Issuer under Canadian Securities Administrators' regulations, the Company is subject to National Instrument 52-109 ("NI 52-109") certification relating to internal control over financial reporting ("ICOFR"). A foundation element of ICOFR relates to company General Controls, a requirement of which is "management's commitment to competence."

On-going professional development and training programs are essential to the development of a skilled and effective workforce and evidence of management's commitment to competence as required under NI 52-109. BCFS needs to continually develop outstanding leaders and teams dedicated to achieving business success. BCFS strongly believes that its training programs and succession planning strategically positions the Company to recruit and retain the high level of expertise required to operate a sophisticated organization such as BCFS. This translates into a safe, efficient and effective operation where the excellence in service delivery and customer service can continue to be achieved. The need for professional and management development investment is further compounded by the recent arbitration decision to exclude approximately 150 positions that were previously in the bargaining unit.

By the beginning of PT3, professional development and training programs will have been reduced to minimal levels for three years in order to achieve short-term cost savings. This is a not a practical solution for the long-term sustainability of any organization and BCFS recognizes that it is at risk of not being able to continue to achieve the high quality of service it strives to maintain. For these reasons, these costs, which were avoided in PT2, must be incurred in PT3.

d. Enhanced Risk Assessment ($0.8 million annually)

George L. Morfitt's January 2007 Report on Safety in BC Ferries states "*… the company has no formal risk identification and assessment process in place fleet-wide, and risk management is not formally integrated into the Safety Management System (SMS*)." To rectify this significant concern, BCFS made a commitment to a risk management program that has as its foundation a risk assessment process. During the first two years, the investment has contributed to significant improvements in the employee safety index which is measured as employee injury frequency rates times the severity rate divided by 1000. The index improved from 3.4 in 2008 to 1.54 in 2010.

Every business sets goals, outlines strategy and makes day-to-day decisions that create, preserve or erode value. It is good corporate governance to ensure that risks associated with these decisions are known and considered. Without a risk assessment process this cannot be done. Furthermore, under NI 52-109, a foundation element of ICOFR is a requirement for "evidence of a risk assessment framework."

If BCFS is to find additional productivity improvements, the need for risk assessment increases. All productivity improvements have the potential to increase risks associated with the safe operation of ferry services. A strong risk assessment process will ensure the options chosen provide the best value by achieving the maximum benefit with the smallest possible increase in risk. Accordingly, BCFS believes it is reasonable to enhance its risk assessment program.

e. Master Planning and Service Delivery Planning ($2.4 million annually)

BCFS has 35 terminals, many of which consist of structures put in place several decades ago. This, in conjunction with BCFS entering the second phase of its required vessel replacement program, a phase which will replace ten vessels, requires focused planning.

This focused planning takes a long-term approach to capital investment, which incorporates the interrelationship between the service delivery, vessel and terminal requirements, rather than individual components in isolation of one another. It ensures a comprehensive approach to asset acquisition by clearly identifying asset requirements, how they integrate with one another, and how they will meet the demand for an efficient sustainable ferry service over the next 40 years.

It requires up to four years for a new vessel to be brought into service and is a process which occurs in several stages: planning, construction and delivery.

During the planning stage several aspects are assessed and determined. These include:

- Rationalization of service requirements, including exploration of changes
- Determination of vessel requirements
- Determination of terminal modification requirements
- Detailed specifications for the vessel
- Detailed specification for terminal modifications

This stage takes into consideration several factors:

- Demand for service (for the next forty years)
- Technological change
- Regulatory requirements
- Environmental impact
- Asset cost, and corresponding impact on future fares
- Operational cost and corresponding impact on future fares

The magnitude and scope of this work over the next few years dictates the need for several devoted staff positions and expert consultation to properly address long-term needs of ferry users and the sustainability of the Company. The planning work was scaled back over the past few years in response to the drop in traffic and a planned slow-down in the new vessel replacement program. This planning work can no longer be deferred and must be resourced appropriately in the coming years.

5. Summary

BCFS is committed to controlling costs where prudent management allows and is willing to accept a reasonable productivity challenge based on evidence that savings (a) can, and (b) should be pursued. The annual $15.0 million productivity challenge identified by the Commissioner is unreasonable, and thus contrary to the CFA, as it incorporates costs that are non-discretionary and costs that must be in incurred in PT3 as a matter of prudent management for the mutual benefit of the Company and ferry users.

While there is no evidence to support a material productivity challenge being factored into the price caps, BCFS is committed to seek out additional cost savings in PT3 in the amount of $9.8 million annually. This amount represents the $15.0 million productivity challenge, less non-discretionary costs. As the evidence before the Commissioner is that the remainder of the costs that the Commissioner included in his productivity challenge must be incurred as a matter of prudent management, BCFS will exercise its business judgment to identify cost savings across the organization.

As set out above, during PT2, BCFS was able to meet increased cost pressures brought about by a number of factors, including a global economic downturn, through avoiding and/or reducing certain costs, rather than applying for extraordinary price cap increases. BCFS is hopeful that it can continue to find ways to reduce costs and meet its proposed productivity challenge, without the need to seek extraordinary price cap increases during PT3 pursuant to section 42 of the CFA. However, as the Commissioner has recognized in the Preliminary Decision, it will be a challenge to BCFS to even maintain costs below the level of inflation in the current climate. BCFS has absorbed many costs imposed on it by external forces which are completely beyond its control while having significantly reduced its overheads over PT1 and PT2. The Company's ability to absorb any unforeseen and non-discretionary costs has largely been exhausted. Accordingly, if any such unforeseen and/or non-discretionary costs arise, BCFS will likely be forced to rely on the section 42 extraordinary price cap increase provision of the CFA.

Part VI Expenses Related to Executive Compensation, Marketing and Amortization

1. Introduction

In the Preliminary Decision, the Commissioner reduced the MARFR sought by BCFS by $3.5 million annually, comprised of $0.5 million annually for executive compensation expenses, $2.0 million annually for marketing costs, and $1.0 million annually in amortization expenses associated with planned capital spending. As indicated above, BCFS does not challenge the Commissioner's preliminary decision to reduce the price caps to account for a reduction in executive compensation (although BCFS believes that the costs are prudent and the Company will have to find that reduction elsewhere due to existing contractual obligations). In this section, BCFS addresses the Commissioner's $3.0 million annual price cap reduction to account for marketing costs and amortization of capital expenditures. BCFS submits that the marketing costs and amortization of capital expenditures are prudent expenditures and must be accounted for in the final price caps.

The remainder of this Part is organized as follows:

- Section 2 discusses the legal requirement under the CFA for prudent expenditures to be accounted for in price caps.
- Section 3 explains why marketing costs designed to increase ridership and reduce costs to all customers are prudent and recoverable in price caps.
- Section 4 discusses why capital investments designed to replace or extend the life of assets are prudent and recoverable in price caps.

2. Relevant Legal Principles

In order to comply with the provisions of the CFA, the final price caps must account for reasonable forecasted costs and allow BCFS an opportunity to earn its allowed return on equity. As set out above, the ability to earn the allowed return on equity is fundamentally important to BCFS, as it ensures that BCFS meets its contractual obligations with current investors, earns adequate levels of net earnings as an important source of funding for future capital expenditures, and allows BCFS to increase equity in order to access financing as a second source of funding for future capital expenditure.

The provisions of the CFA most directly relevant to cost recovery of expenses are sections 38(1)(a), (b), and (d), and 41(2)(a)(i):

> 38 (1) Without limiting any other power of the commissioner under this Act, the commissioner must, after considering public feedback obtained under this Act, regulate each ferry operator in relation to the core ferry services that are to be provided by that ferry operator and the tariffs, including, without limitation, reservation fees, that may be charged for those core ferry services, and must undertake that regulation in accordance with the following principles:
>
> > (a) priority is to be placed on the financial sustainability of the ferry operators;
> >
> > (b) ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;

...

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

...

41(2) In setting a price cap applicable to a route group, the commissioner must be guided by the following principles:

(a) the price cap must allow for a return sufficient to enable the ferry operator to recover

(i) the portion of operating expenses, including all financing charges, that can reasonably be applied to the route group,

(ii) the portion of administrative expenses that can reasonably be applied to the route group, and

(iii) the reasonable capital costs that are to be

(A) incurred in relation to the route group, and

(B) amortized in accordance with generally accepted accounting principles on a straight line basis;

The use of "must" in section 41(2)(a) makes it mandatory that price caps allow BCFS to recover forecast operating expenses, administrative expenses, and capital costs that are reasonably incurred. The only lawful basis to exclude any of these costs is if they are objectively unreasonable. A determination to exclude recovery of costs must be based on evidence, and not opinions – of the Commissioner or the public - that are unsupported by evidence: *Canadian National Railway Co. v. British Columbia*[20]. This requirement is echoed in the common law requirement for a statutory decision maker like the Commissioner to provide reasons for decision that show why or how or on what evidence he reached his decision.[21]

BCFS observed above that the Commissioner's jurisdiction is to set price caps and does not extend to dictating how BCFS ultimately decides to allocate its costs within the allowed MARFR. However, the fact that BCFS retains the ability to manage its business within the overall price caps and reallocate funding as necessary is not a legally valid basis for the Commissioner to disallow specific costs that are prudent. In circumstances where the price caps are artificially reduced to disallow prudent expenditures, the cost of meeting prudent expenditures comes out of the Company's return on equity. There is a statutory obligation to provide BCFS with an opportunity to earn its allowed return on equity and thus, the disallowance of prudent expenditures necessarily contravenes the CFA. This is also discussed above in Part V in the context of the Commissioner's productivity challenge.

3. Marketing Cost Reductions

The Commissioner's preliminary price cap determination incorporates a reduction of $2.0 million annually for marketing expenses without providing any supporting rationale. The $2.0 million annual reduction represents approximately one-half of BCFS' entire marketing budget for the next four years. In this section, and the accompanying Appendix A, BCFS explains why the Company's marketing efforts are important. This information supplements the information in the original PT3 Submission and provides a more complete evidentiary record on which the Commissioner can base the final price cap decision. Based on the

[20] [1990] B.C.J. No. 570 (C.A.).

[21] *Collard v. British Columbia*, 2011 BCSC 136.

totality of the evidence, BCFS submits that the disallowance of marketing costs will result in unreasonable, and therefore invalid, price caps.

Some of BCFS' high-profile marketing efforts have attracted negative commentary in the media and among ferry users. A theme evident in the negative commentary is that BCFS is a monopoly provider of ferry service to the destinations served, that monopoly providers have captive customers and therefore BCFS does not need to market to attract ridership. This commentary is based on incorrect assumptions about the nature of BCFS' ridership and overlooks the benefits associated with attracting increased ridership.

In most instances, BCFS is the predominant means for members of the public to reach destinations served by BCFS routes. However, what is overlooked is the fact that 66% of BCFS' passengers who use the ferry system for personal travel are travelling for purely discretionary reasons. These individuals, by and large, can choose whether or not to spend their money on ferry travel to visit a destination served by BCFS, not travel at all, or travel to another location that does not require ferry service. To the extent that these discretionary travellers can be encouraged to visit places that require ferry travel, BCFS can increase ridership.

Increasing ridership among discretionary ferry users delivers material benefits to all ferry users, including the 34% of ferry users that are best characterized as non-discretionary users. The majority of BCFS' operating costs are fixed as the Company is required to provide a level of service which is mandated by the Coastal Ferry Services Contract within Transport Canada regulations. Adding additional ridership means that there are more customers available to share the fixed costs.

The marketing initiatives described in Appendix A, which are accounted for in the PT3 forecast, are cost-effective means of mitigating rising ferry fares. A reduction of approximately one-half of BCFS' marketing budget for the four years of PT3 is, with respect, short-sighted and not in the long-term interests of ferry users or the Company. BCFS believes that these initiatives are sufficiently important that it would have to maintain them regardless of the final price caps and the cost would, in effect, come out of the Company's equity. However, as indicated above, it would be contrary to the CFA for the Commissioner to disallow prudent marketing costs in the expectation that ferry users can obtain the benefits at the expense of precluding BCFS from earning its allowed return on equity.

BCFS further submits that the Commissioner's reduction of approximately one-half of BCFS' marketing budget for the next four years is inconsistent with the principles in section 38(1) of the CFA, and in particular 38(1)(b), which requires the Commissioner to regulate ferry operators in such a way as to encourage a "commercial approach to ferry service delivery". BCFS's approach to marketing is a "commercial approach" aimed at increasing ridership in order to spread costs through innovative and strategic initiatives. The Commissioner's significant cost reductions will frustrate this approach, and are therefore inconsistent with the principles set out in the CFA.

BCFS also observes that regulated public utilities such as FortisBC (formerly Terasen Gas), who are the sole providers of natural gas within their service territories, advertise and market extensively in this jurisdiction in a variety of media. They are permitted by the British Columbia Utilities Commission to recover such costs from customers in rates. The reason those costs are recoverable in natural gas delivery rates is because the purpose of much of their marketing is to retain and attract customers to share in the fixed costs of operations and reduce natural gas delivery rates for all customers. Although a gas utility has an effective monopoly on the provision of natural gas within its service area (thus requiring it to be regulated) some people within the service area have the ability to choose something other than natural gas as an energy source (e.g. electric heating, geothermal, solar etc.). The target of the marketing is those individuals with a choice of energy suppliers. The analogy is apt in the present circumstances, as BCFS has an effective monopoly on ferry service but does not enjoy a monopoly on possible destinations for discretionary travellers.

4. Amortization of Capital Expenses for PT3

The Commissioner made an adjustment to reduce BCFS' amortization expense estimate by $1.0 million annually in PT3. In this section, BCFS explains:

- why the costs set out in the PT3 Submission will be reasonably incurred and should not be disallowed in the price cap setting process;
- why the option of deferring capital projects as a means of realizing reductions in amortization expense is significantly restricted; and
- why the contemplated level of capital expenditures for PT3 is necessary and reasonable and should be reflected in the price caps.

BCFS submits that the Commissioner must restore the amortization expense in full in the final price cap determination in order for the final price caps to comply with the CFA.

a. Priorities Identified Through Robust Capital Planning Process

BCFS' first submission regarding this issue is that its capital planning process is sound, and there is no basis for reducing planned capital expenditures in PT3.

BCFS' business is capital intensive. Accordingly, well planned capital expenditures are required in order to continue to provide safe, reliable and efficient marine transportation services. In point of fact, the Company was established in its current form to address the capital requirements which had been neglected by the former crown corporation. BCFS has a rigorous capital planning process that has been recently reviewed and determined to be appropriate by the Office of the Comptroller General.[22] This is the process that was followed in developing the PT3 capital plan, a portion of which has been disallowed in the Preliminary Decision.

On an ongoing basis, BCFS assesses its capital investment requirements through condition surveys, maintenance plans, deployment plans, and master plans. This information is collected and analyzed, and forms the basis for the capital requests which are submitted annually for review and approval, in the form of project charters and detailed business cases. All of the requests, along with their scope, schedule and budget, are assessed as individual items and as part of the group.

The Office of the Comptroller General reviewed BCFS in September 2009, and found that the Company has:

> *... appropriate financial and management controls and processes established including planning, budgeting, monitoring, reporting, internal controls, a capital asset management framework, procurement policies, and an active internal audit function. The company demonstrated that cost containment strategies, revenue generating efforts and customer service quality systems were in place.*[23]

[22] Office of the Comptroller General, Report on Transportation Governance Models, October 2009. This report is found at http://www.fin.gov.bc.ca/OCG/ias/pdf_Docs/transportation_governance.pdf.

[23] Office of the Comptroller General, Report on Transportation Governance Models, October 2009, p.2.

The Office of the Comptroller General also recognized in its recent report that practical constraints limit BCFS' ability to control major cost drivers, such as capital costs, including amortization.[24]

The capital plan for PT3 submitted to the Commissioner consists of the following broad categories of projects:

Table 1 - Capital Plan for PT3
($ millions)*

	FY2013	FY2014	FY2015	FY2016	TOTAL
Terminals					
Marine Structures	7.0	7.1	17.3	20.6	**52.1**
Land Structures	13.1	5.2	19.2	25.2	**62.7**
Vessels					
New Vessels	35.2	39.3	79.5	71.5	**225.5**
Vessel Upgrades	18.5	11.6	50.1	32.0	**112.3**
Vessel Components	4.1	1.7	1.0	1.0	**7.8**
Other	18.3	35.3	17.1	14.1	**84.8**
TOTAL	96.2	100.2	184.2	164.4	**545.1**

**Note: may not add due to rounding.*

This plan was based on the fiscal year 2011 Board approved plan, which was the result of extensive review and rationalization of an initial list of projects totalling in excess of $675.0 million. BCFS notes that, in its financial analysis, MMK Consulting Inc. stated:

> *On balance, our assessment is that the $545 million of forecast PT3 capital expenditures, as contained in BC Ferries' September 2010 submission to the Commission, is reasonable.*[25]

BCFS submits that MMK Consulting Inc. supports BCFS' position that the capital expenditure level set out in the PT3 Submission will be reasonably incurred and should not be disallowed in the price cap setting process.

BCFS understands the cost impacts of capital expenditures on ferry users and is committed to controlling costs where prudent management allows. The four key reasons why a disallowance of amortization expense of the magnitude contemplated in the preliminary decision is unreasonable, and thus contrary to the interests of the Company and ferry users are set out in the following sections (b) through (e).

b. Amortization Expense for PT3 Largely Attributable to PT2 Capital Expenditures

There is no evidentiary basis for the Commissioner to disallow recovery in price caps of the amortization expense associated with capital expenditures budgeted and incurred in PT2. This is supported in the Commissioner's Preliminary Decision itself, which states on page 8 that for PT2, it was reasonable for BCFS to have incurred its capital expenditures. This leaves the amortization expense associated with capital expenditures budgeted to incur in PT3.

[24] Office of the Comptroller General, Report on Transportation Governance Models, October 2009, p.30.

[25] MMK Consulting Inc.'s Financial Analysis for BC Ferry Commission's Price Cap Review – Third Performance Term, p.6

Table 2: Amortization Expense Schedule
($ millions)

	FY2013		FY2014		FY2015		FY2016		Total	
Capital investments in service prior to April 1, 2012	$ 110.5	90%	$ 105.9	84%	$ 101.3	80%	$ 95.4	74%	$ 413.1	82%
Capital investments in service April 1, 2012 to March 31, 2016	$ 12.3	10%	$ 20.0	16.%	$ 26.0	20%	$ 33.9	26%	$ 92.2	18%
Total	$ 122.8	100%	$ 125.9	100%	$ 127.3	100%	$ 129.3	100%	$ 505.3	100%

As noted in Table 2, 82% of the total amortization expense for PT3 is a result of capital investments put into service prior to April 1, 2012, the start of PT3. Most of these investments are already either in service or are in progress currently. This leaves only 18% of the amortization expense for PT3, meaning the ability to defer capital projects as a means of realizing reductions in amortization expense is therefore significantly restricted.

Only 18% of the amortization expense reflected in the PT3 Submission is from capital expenditures for assets entering service during PT3, some of which have commenced in PT2 and were adjudicated as reasonable by the Commissioner. Due to the long life of many of BCFS' assets (many being 40 years), significant capital expenditure reductions are required to reduce amortization expense in the magnitude of $4.0 million for PT3. For example, deferring a theoretical $10.0 million asset replacement capital project with a 40 year life would only reduce amortization by $0.25 million per year. As illustrated in the capital plan and resulting amortization schedule above, a significant portion of the work occurs in the latter years of PT3 with a limited impact on amortization, which further limits how a reduction of $4.0 million may be achieved. BCFS would be required to reduce an already conservative capital plan anywhere from $30.0 to $50.0 million in order to achieve a $1.0 million per year reduction in amortization over PT3.

c. The PT3 Capital Plan is Already Very Conservative

The PT3 capital plan covers the last four years of a six year forecast, the length of which results in uncertainty and risk. Several things may change within this time period: pricing above core inflation; changes in law, including environmental and safety regulations; unforeseen capital expenditures due to emergencies or asset condition; and technological change.

The PT3 capital plan is already conservative as described below.

- It has no allowance for necessary capital expenditures that may arise due to unforeseen circumstances, where, for example, emergency asset replacements may be required. The independent financial review of the PT3 submission conducted for the Commissioner by MMK Consulting Inc. supports this assessment. With respect to BCFS' PT3 capital plan, MMK Consulting Inc. found that:

  > *BC Ferries has not provided an allowance for unforeseen capital expenditures for PT3. If these are significant, then BC Ferries may face a decision whether to exceed its forecast expenditure levels, or whether to defer some of its planned PT3 terminal capital expenditures to PT4.*[26]

[26] MMK Consulting Inc.'s Financial Analysis for BC Ferry Commission's Price Cap Review – Third Performance Term, p.6

- It has no inflation over 2010/11 pricing (efficiencies gained through procurement were assumed to offset inflation during the six year period). The review by MMK Consulting Inc. supports this assessment:

> *Our preliminary assessment is that the proposed PT3 vessel and terminal-related expenditure levels appear low in relation to the average long-run capital expenditure requirements for long-run sustainability. At the same time, this does not necessarily mean that the capital schedule for PT3 is too low, given the cyclical nature of BC Ferries' capital expenditures patterns. For example, higher capital expenditures are expected in PT4, when many of BC Ferries' smaller vessels are scheduled to be replaced.*[27]

By reducing an already conservative plan, which has no allowances for unforeseen capital expenditures, the risks associated with the Company's aged assets will increase.

d. The PT3 Capital Plan Focuses on Replacing Assets Which Have Exceeded Their Economic Life Expectancy

In PT3, BCFS will enter the second phase of required vessel replacements. During PT3 BCFS will incur expenditures of $225.5 million to replace several vessels over 50 years of age and $112.3 million to upgrade several vessels to ensure safe, reliable service for the remainder of their expected lives. These vessel replacements and upgrades account for 62% of the total capital plan for PT3. Furthermore, several of BCFS' information systems are antiquated and require replacement. All of the assets are beyond their reasonable economic life for assets in their respective categories.

The technological advancements over the past twenty years allow the opportunity to make needed capital investments which will create stability, reduce service failures and allow for significant future efficiency gains.

The following are the major planned vessel and information system replacements and their ages upon replacement.

	Age when replaced	**Planned in service date**
Vessel Replacements		
Queen of Burnaby	52 years	2017
Queen of Nanaimo	53 years	2017
North Island Princess	60 years	2016
Tenaka	53 years	2014
Information Systems		
Reservation system	22 years	2016
Point of Sale system	16 years	2016

[27] MMK Consulting Inc.'s Financial Analysis for BC Ferry Commission's Price Cap Review – Third Performance Term, p.5.

e. Harmful to the Interests of Ferry Users

Deferring capital replacements will lead to increased maintenance costs, lost efficiencies, and decreased reliability. The cost of steel replacement, asbestos and lead paint containment, marine structure decay repairs, and required safety equipment replacements combined with the limited life of this work, will result in amortization and repair expenses which may exceed the amortization which would be associated with a new asset. Much of the technology and equipment of these aged assets are out of date and no longer available. This results in failed components needing to be built at a much higher cost in order to keep the assets in service, increasing risk and repair times, and overall impacting reliability and customer service.

Reducing capital investment in PT3 will create a backlog in capital projects that must be addressed in Performance Term Four (“PT4”) adding to overall cost pressures in subsequent performance terms. The aged infrastructure of BCFS is an issue which extends into PT4. In the absence of dealing with this backlog, there is already steep upward pressure in terms of the required capital expenditures in PT4 and beyond to address vessel replacements and other non-discretionary capital expenditures, as noted by MMK Consulting Inc. (see above quote). Due to vessel substitution and berth limitations, there are restrictions in what can be accomplished within a four year period while still meeting the contractual service levels with the Province. Thus, deferring work from PT3 will likely result in identified work for PT4 being deferred into Performance Term Five. This will further compound the risk and associated expense for the aged assets which will be required to provide contractual service. BCFS submits that deferring capital expenditures is thus ultimately harmful to the interests of ferry users.

f. Summary

BCFS submits that the PT3 capital plan is reasonable and in the long-term best interests of the Company and ferry users. The disallowance of a total of $4.0 million in amortization expense attributable to these PT3 expenditures over four years is unjustified based on the evidence, and the amount should be restored in full in the final price caps.

The Commissioner’s proposed reduction of $1.0 million annually in amortization expense does not appear to BCFS to be based on anything other than the Commissioner’s opinion, without an evidentiary foundation. The Commissioner acknowledges that if this reduction is made it will be necessary to reduce or defer expenditures for assets that were planned to be brought into service during PT3. However, the Commissioner does not point to any of the planned expenditures that he feels can be avoided in PT3. BCFS submits that as this determination is not based in evidence it cannot be sustained.

BCFS’ evidence is that its capital planning process is sound, and that the amortization expenses that the Commissioner proposes to reduce are reasonably required. BCFS submits that the Commissioner is required, by section 41 the CFA, to allow these reasonable expenses as part of his price cap determination.

Part VII Procedural Fairness

In this submission, BCFS has responded to the determinations set out in the Preliminary Decision. BCFS respectfully submits that the Commissioner may not consider any further reductions not set out in the Preliminary Decision without giving BCFS notice of any such proposed determinations, and an opportunity to comment on them before they are made.[28]

[28] *Baker v. Canada*, [1999] 2 S.C.R. 817

Part VIII Conclusion

In response to the three items that the Commissioner invited BCFS to comment on in his Preliminary Decision, and with respect to other issues that are raised by the Preliminary Decision, BCFS respectfully submits that:

- Certain aspects of the Commissioner's preliminary price cap determination must be revised in order to comply with the CFA.
- The preliminary price caps, as set out in the Preliminary Decision, pose a significant risk to the financial sustainability of BCFS during the next performance term.
- The use of a differential (lower) WACC for the northern and minor route groups amounts to cross subsidization, which is not permitted by the CFA, and should not be used.
- It is unreasonable for BCFS to meet the productivity challenge for PT3 in the amount of $15.0 million, and there is no evidence to support any material productivity challenge, but BCFS accepts a productivity challenge in the amount of $9.8 million.
- The reductions in marketing costs and amortization of capital expenditures are unreasonable.

BCFS' Response reflects its desire to be a part of the solution in addressing the challenges that increasing ferry fares represents for many British Columbians. BCFS believes that its proposed productivity challenge is significant and reflects the maximum extent to which BCFS can cut costs for PT3 in the face of increasing cost pressures following years of fiscal restraint. Deeper cuts would result in BCFS having to reduce its return on equity well below the allowed level to avoid compromising safety or service, or vessel maintenance that is required to avoid even greater costs in the long-term. This scenario is contrary to the CFA, which requires the Commissioner to set fair price caps that allow the Company a legitimate opportunity to recover its reasonable forecasted costs and to earn its allowed return on equity. BCFS therefore respectfully requests that the final price caps reflect only the reduction of $0.5 million annually in respect of executive compensation (subject to the caveat that the Company will have to find these costs elsewhere), and a productivity challenge of $9.8 million for PT3.

Appendix A

Marketing and BC Ferries Vacations

I. Introduction

This appendix provides an overview of the primary activities undertaken by the Marketing and Travel Services departments of British Columbia Ferry Services Inc. ("BCFS" or "BC Ferries") over the past fiscal year. It represents a summary of activities and is not inclusive of all areas of responsibility. It demonstrates the delivery of a new key strategic growth initiative that supports the organization's corporate vision and the direction set out in the *Coastal Ferry Act* ("CFA") to act in a commercial manner. This appendix has been prepared by BCFS in support of its April 30, 2011 submission to the British Columbia Ferries Commissioner in response to his *Report on the Preliminary Price Cap Decision* and Order 11-02.

II. Overview

In 2007, Travel Services was identified by the Executive and Board of BCFS as one of the key strategic growth initiatives for BC Ferries over the next five years. The creation of a Travel Services division and a 'ferry-centric' destination marketing approach presented BC Ferries with the opportunity to earn incremental revenue by leveraging the existing customer base of 21 million annual passengers and capturing incremental and discretionary travel dollars while strengthening the BC Ferries brand.

The tourism market is particularly attractive for earning incremental revenue for BC Ferries as evidenced by the sales results from vacation packages and *a la carte* products. It provides the opportunity to up-sell to existing customers (BC Ferries passengers) as well as attracting new customers to the core business with the lure of a complete vacation experience. The success of this initiative will ultimately lead to lower fares paid by ferry users than would otherwise be the case.

Tourism is not one of life's necessities; it is pure discretionary spending. In British Columbia, tourism brings in revenues in excess of $13.0 billion dollars a year with tourism returns totalling approximately $1.0 billion for the provincial treasury in the form of taxes and fees every year. The province's tourism sector is greatly influenced by local as well as external economic conditions. When times are good, spending on these goods and services tends to increase. However, as witnessed in the last several years, tourism spending dries up quickly in a soft or declining economy.

From 2001 to 2009, the volume of visitor entries into British Columbia from the United States and overseas dropped by approximately one-third (32.5%). In 2010, the number of international travelers entering Canada via British Columbia increased (+3.5%) for the first time since 2004, however, this growth is directly attributable to increased visitation during the 2010 Olympic & Paralympic Winter Games in February. Conversely, the number of passengers travelling on BC Ferries remained virtually unchanged in 2010, and continues to stagnate at levels below the peak reached in fiscal year 2005.

Multiple factors continue to negatively influence travel into British Columbia for 2011, including a continued weak global economy, rising fuel prices (which influence transportation costs to consumers across all travel sectors), HST implementation and a strong Canadian dollar. In particular, a strong Canadian dollar makes international travel more attractive to BC Ferries' primary domestic target markets and Canada as a destination less affordable to key international markets. Consumers are also experiencing unprecedented travel deals offered on a global level by destinations that are looking to recapture previous business levels. Adding to this, consumers are better educated and have access to real-time information and rate transparency via the internet. This forces businesses to adapt quickly to a changing market and offer the best value to close the sale.

Competitors in the marketplace include travel agencies offering British Columbia West Coast and Pacific Northwest destination itineraries, as well as other travel agencies, tour operators and vacations companies offering packaged British Columbia vacation experiences. Other British Columbia regions, such as the interior, compete for visitors as well, with established wine country tours, abundant golf resorts and warmer climate. Sport and outdoor adventure destinations such as Whistler, Banff and Jasper also offer competition for discretionary travel spending. BC Ferries is well positioned to compete against these markets as it operates the only marine transportation service accessible to British Columbia residents and visitors looking to explore British Columbia's coastal regions and islands. The challenge is for BC Ferries to market aggressively to influence consumers to choose a travel destination serviced by BC Ferries over another British Columbia destination. With 66% of passengers surveyed traveling for discretionary personal reasons, BC Ferries' goal is to influence these customers to take additional trips that they may not have considered otherwise.

A 2010 industry paper by Scott C. Margenau, founder and CEO of ImageWorks Studio, an award-winning web design and branding firm, discusses the appropriate level of marketing investment for small to medium size businesses. His research shows companies with gross revenues greater than $300 million spend approximately 3% - 4% of their gross revenue on marketing.

The following is an excerpt from Margenau's paper outlining important considerations when setting a marketing budget:

> *"For most [small businesses], the percentage of revenue dedicated to a marketing budget is determined by industry and size. But, in general terms, here is some information we have put together based on several creditable sources.*

Revenue	***Marketing Budget***
Less than $5 million	*7–8%*
$5–10 million	*6–7%*
$10–100 million	*5–6%*
$100–300 million	*3–5%*
More than $300 million	*3-4%*

> *An important consideration, adjust for industry. Every industry is different, so companies that sell to specific government branches or one that has an ultra-specialized niche may be able to deduct 1–2% from the above figures. If your company is B2B or B2C, you may need to raise your budget by 1–3% to see solid results. Retail and pharmaceuticals lead the spending, with many of these companies spending more than 20% of net sales. The overall average is reported to be 4–6%."*

Greg Stine, CEO and President of Polaris, also found in his 2008 research that successful companies had annual marketing budgets that fell between 4% (conservative, market is very strong or the company has little or no growth aspirations) and 6% (strong growth aspirations) of their gross margin. Given that marketing budgets need to be adjusted for each industry and given BC Ferries' unique position in the marine transportation industry, the organization's marketing budget should conservatively fall between 1% and 3% of gross sales.

BC Ferries' total "marketing" budget, which includes corporate branding and marketing, consumer research, partnerships, community investments, marketing of both travel and ancillary services, the Vancouver downtown retail space and BC Ferries Vacations is less than one percent (0.65%) of total customer based revenue.

The following outlines BC Ferries' key marketing and sales activities and how they contribute to the growth of incremental revenues and positively support BC Ferries' brand.

III. Marketing Objectives

Department Vision: To build and leverage the BC Ferries brand and to provide an integrated brand experience while developing and executing marketing programs that grow incremental revenue and strengthen the brand.

> *"It was fortuitous that I noticed a mention of the BC Ferries package in the Vancouver Sun, and thus was able to take advantage of the package. In future, I'd welcome notification of such packages by email if possible, as I am not usually a careful reader of the newspaper. Thanks again,"*
> Amy, Vancouver BC, BC Ferries Vacations customer

> *"Thanks for recommending this vacation package, it was almost perfect! Rest assured we will always use your service and will let our friends, relatives and acquaintances know of your vacation offers/packages. Probably you can advertise and promote your services aggressively emphasizing to travel BC first rather than going to the US, Mexico etc. Explore Beautiful BC first rather than other places!!! Thanks again."*
> BC Ferries Vacations customer

Today's consumers are inundated with travel deals, many of which are much more affordable than traveling to coastal destinations in British Columbia. Marketing plays a key role in creating awareness of BC Ferries' unique product, generating interest with relevant/timely offers that deliver exceptional value and communicating an experience that consumers can not get anywhere else.

According to the 2010 Customer Satisfaction Tracking (CST) survey conducted for BC Ferries by Mustel Group, 66% of all passengers surveyed travel for purely discretionary personal reasons, with 41% residing in the Greater Vancouver Region. With this in mind, BC Ferries developed a strategy to influence this important market segment. Over the last 12 months, the marketing vision has been executed with initiatives to build and leverage the BC Ferries Vacations brand, supporting an integrated brand experience while developing and executing marketing programs that grow incremental revenue and evolve the Company to become more destination marketing focused.

Key Objectives:

- Drive discretionary ferry travel
  Develop and execute integrated marketing campaigns for specific products like CoastSaver, seasonal packages and unique destinations which appeal to a broad range of consumers over multiple channels, creating interest and offering value to the consumer.

- Strengthen BC Ferries brand and image
  Consumers equate service with value. Through the BC Ferries Vacations division BC Ferries provides a one-stop-shop concept with a vacations offer, up-selling additional services and connecting the customer with unique offerings, ultimately influencing the overall brand perception in a positive way.

- Build destination travel business
  Work with tourism/business associations to provide education and support in developing market-ready product that BC Ferries can promote for sale to key markets, thus supporting the communities BC Ferries serves.

- Leverage positive media coverage
  Execute a comprehensive media relations program that will attract sustained positive attention and stories related to BC Ferries and BC Ferries Vacations.

- Maximize onboard profitability
  Continue to create an on-board experience that enhances the brand through
  - Vessel renovations;
  - Retail expansion and merchandise standards;
  - Continuous menu development;
  - Product development including Sea West Lounge and C-Spa; and,
  - Exceptional on-board customer services standards.

- Generate non-tariff revenue
  Leverage onboard and terminal assets to promote BC Ferries' and partner products/programs creating new and/or enhanced revenue opportunities.

The success of these initiatives ultimately serves to reduce fares from the level that would otherwise be required.

IV. BC Ferries Vacations Division

Department Vision: To be the leading sales and distribution channel for British Columbia west coast travel experiences.

> *"The trip to Victoria was great! My experience using the BC Ferries Vacations link was fantastic - so easy to use, helpful agents on the phone, documents ready within a matter of minutes. It was perfect for a last minute getaway. Not to mention how easy it was to use the vouchers. Thanks for making it so easy!"*
> Jeff Duerr, Seattle WA, BC Ferries Vacations customer

> *"It (BC Ferries Vacations) is a significant step in building BC Ferries as an important support to tourism in island and coastal communities. The exposure has been so important for our business; the referral of guests is a significant off-season opportunity for us. I hope that it will continue to grow. These are difficult, challenging times for small business in British Columbia. I hope BC Ferries will expand its reach significantly and, most importantly, continue to grow markets on our behalf particularly in our quiet times (which seem to be all the time now unfortunately). Hopefully you can assist us even more with 'short term' specials to respond to immediate inventory needs. I also must compliment you on your staff and your support: you all have been great. I look forward to doing even more business with you this year."*
> Conny Nordin, Galiano Oceanfront Inn and Spa, BC Ferries Vacations partner

> *"We booked a BC Ferries vacation by telephone and it was perfect. The reservation process was easy and the representative was very helpful. We booked the ferry from Tsawwassen to Victoria and we stayed at the Chateau Victoria. A complicated process for out of towners was made simple. The room at the Chateau Victoria was excellent and the location of the hotel was near everything we wanted to do. And we could walk from the hotel to most everything we wanted to see. We will recommend this service and package to all our friends."*
> The Tyes, BC Ferries Vacations customer

As previously stated, the tourism market is particularly attractive for earning incremental revenue for BC Ferries. It provides opportunities to up-sell to existing customers as well as attracts new customers to core business with targeted, relevant vacation options. Using the strength of BC Ferries brand recognition, the Travel Services Division/BC Ferries Vacations was developed to capitalize on demand from their primary market, British Columbia, and regional fully independent travelers.[1] With over half of the population of British Columbia residing within a one and a half hour drive of Tsawwassen or Horseshoe Bay terminals, demand for a West Coast get-away or adventure has been well received, with 1 and 2 night stays to Victoria currently representing 80% of sales. Other destinations that have seen significant results are the North and West Coasts. Consumer feedback indicates that in many cases, British Columbians had no idea that the option of traveling by ferry to the North and specifically the Inside Passage was available until BC Ferries Vacations brought it to their attention through marketing and storefront advertising. While BC Ferries marketing has been more strategic and robust than ever, clearly there is still work to do to increase awareness around the extensive Coastal British Columbia vacation offerings.

The following table illustrates the number of vacation packages sold through BC Ferries Vacations in fiscal year 2011. Package sales are grouped by geographic region to illustrate sales distribution. Data is not representative of number of people travelling as one package and may include multiple travellers. On average, 99.9% of all packages have two or more travellers.

[1] Fully independent travelers: Individual travel in which a tour operator has previously arranged rooms and transportation at various destinations in advance for use by individual travelers. These travelers travel independent, not in a group, usually by rental car or public transportation.

Vacation Packages Booked in the Past Year

Region	Number of Packages
Vancouver Island	1931
North Coast	375
Metro Vancouver	257
Northern British Columbia	55
Southern Gulf Islands	50
Sunshine Coast	37
Thompson Okanagan	30
Northern Gulf Islands	16
Cariboo Chilcotin Coast	6
Coast Mountains (Whistler/Squamish)	5
Total	**2762**

Vacation packages were developed to include a comprehensive mix of vacation experiences that combine BC Ferries' products in key destinations which represent each route group, major port of call and/or high demand routes. Packages are comprised of short get-away trips ranging from 1 to 3 nights, to longer vacations that include multiple destinations throughout the province with multiple activities and accommodation offerings.

With over 50 preset packages currently being offered, the consumer can easily find a package that meets their needs; however they can also customize any of the options by calling BC Ferries' travel consultants who are industry trained on the array of vacation options. By packaging travel products (including accommodations, attractions, sightseeing and other transportation services) which include passage on BC Ferries, BC Ferries Vacations stimulates demand for the ports of call by promoting and selling these offers through several vehicles:

- Vancouver Vacations Centre
- BC Ferries Vacations portal on the BCFS website
- Trade Shows, Destination Marketing Organizations (DMOs) and other partner relationships
- Travel Media
- General Mass Advertising
- Social Media

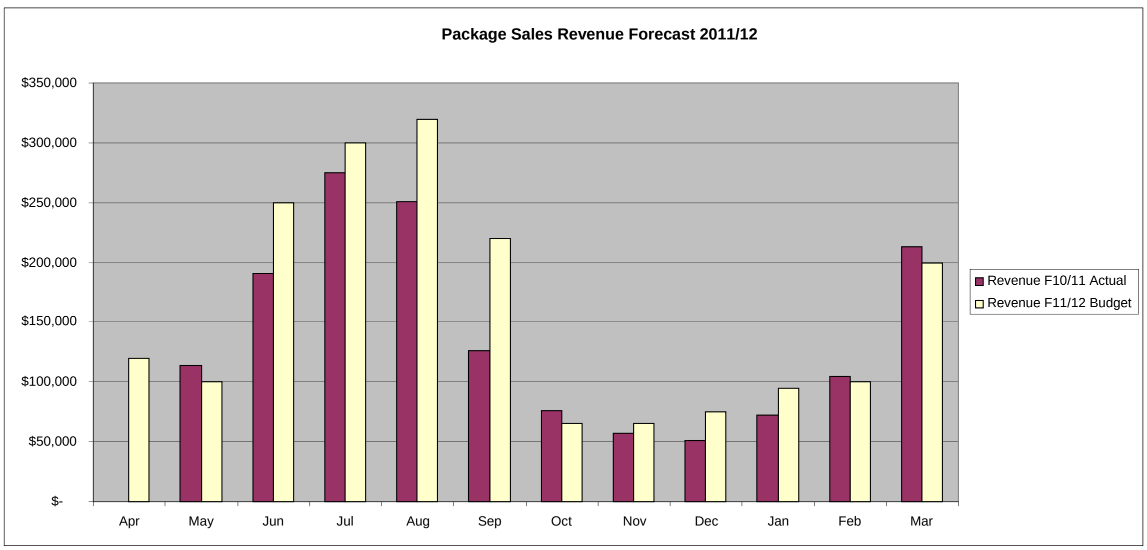
The focus is to utilize pricing strategies that are built on offering a discount on the retail component price to generate volume and higher yield. By utilizing product margins, package pricing is set so that the overall package price is less than the sum of the parts. The consumer ultimately pays less than they would if they purchased each component separately, but profit is built into the price to generate a margin for the company. In addition, product suppliers have added additional incentives for the consumer with "value add-ons" like automatic room upgrades and restaurant credits, further enhancing the overall experience and value proposition to the consumer.

Sales targets for fiscal year 2011 were achieved, even though a number of operational and technological challenges resulted in a delayed web site launch and BC Ferries Vacations Centre opening. Despite these challenges, BC Ferries Vacations' gross sales target of $1.2

million was achieved. Forward gross sales of $0.326 million for fiscal year 2012 were also realized in fiscal year 2011.

To achieve these results existing internal sales distribution channels were utilized, such as on-line requests via www.bcferries.com/vacations, phone sales through 1-888-BCFERRY and in-person consultations through the BC Ferries Vacations Centre. Operational changes and efficiencies were made throughout the year to maximize labour and improve sales conversions[2], which finished at 34% for fiscal year 2011. Standards are between 25% and 30% for the travel booking industry.

Most economic indices now suggest that demand for travel services will recover somewhat in the year ahead, but consumers will still demand exceptional travel deals. Value remains top-of-mind as travelers are still focused on finding the best fares and rates when planning and purchasing travel. Despite this, sales growth is anticipated at 46% over the previous year, with targeted gross sales set at $1.85 million. While this is aggressive, it is predicated on the following factors: (1) that investment in marketing BC Ferries Vacations is made at the same or greater level as last year; and (2) the economy recovers to predicted levels.



"We are delighted to be part of BC Ferries Vacations planning program. Being part of the gulf islands, with numerous ferries passing by our island every day, we had long wondered how to work with them.

Since meeting with them last summer, we have taken part in a couple of presentations to the ferries personnel responsible for administering the program and are very excited. Our 2011 year is already shaping up to be a good one with many new visitors finding Poets Cove thanks in large part to partnering with BC Ferries Vacations.

The BC Ferries Vacations website, their outstanding collateral, the images at the Vancouver office and on board the ships as well as the new joint venture program to target the Alberta marketplace are all adding to the potential for much business, not only in the summer, but all year round.

[2] The ratio of converting a quoted package price to an actual sale

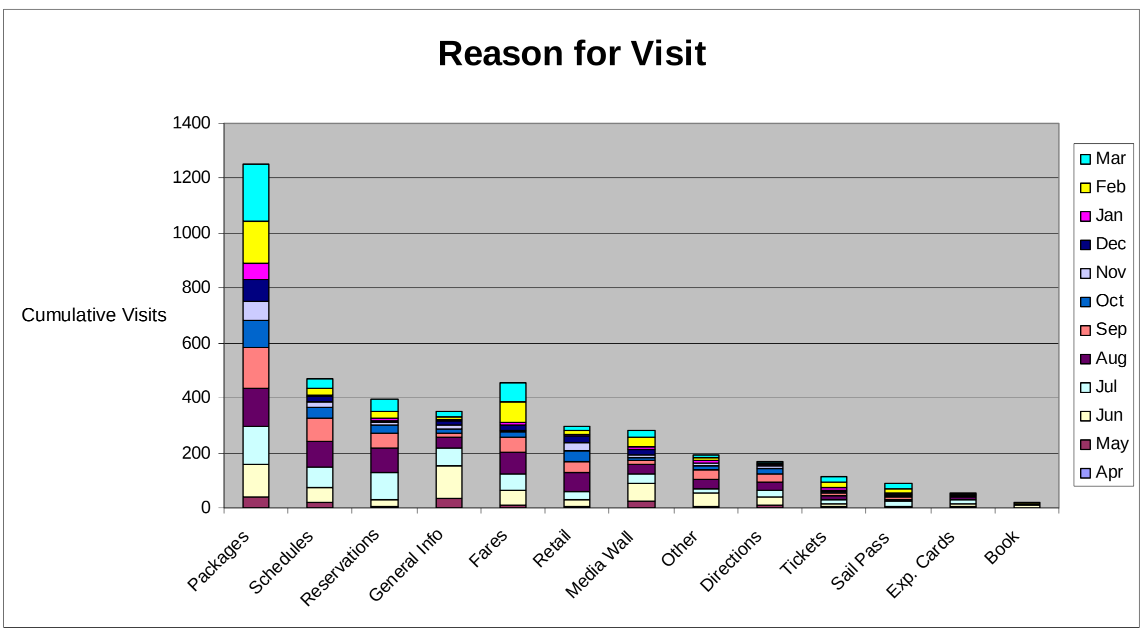
Thank you so very much for this opportunity and for your excellent program. Whatever we can do to further our relationship, we would be more than happy to do. Sincerely,"
Ina Timmer, Director of Marketing, Poets Cove Resort & Spa, BC Ferries Vacations partner

NBCTA has formed a strong working partnership with BC Ferries Vacations during the past few seasons. We have had the opportunity to stage large-scale co-operative marketing campaigns together, along with our northern BC communities, to promote travel to our region. Having such a strong partner, with resources to effectively raise consumer's awareness of northern BC, as well as book travel packages, has been instrumental in the success of our campaigns.
Anthony Everett, CEO, Northern British Columbia Tourism Association

V. Vacations Centre

"…I was very happy with the service, prices and efficiency of BC Ferries Vacations. I appreciated the reservation on the ferry in both directions and they got my friend and I an amazing rate on our hotel room at the Fairmont Empress. The deal and service of BC Ferries Vacations far exceeded my expectations. Best,"
Tracy Houston, BC Ferries Vacation customer

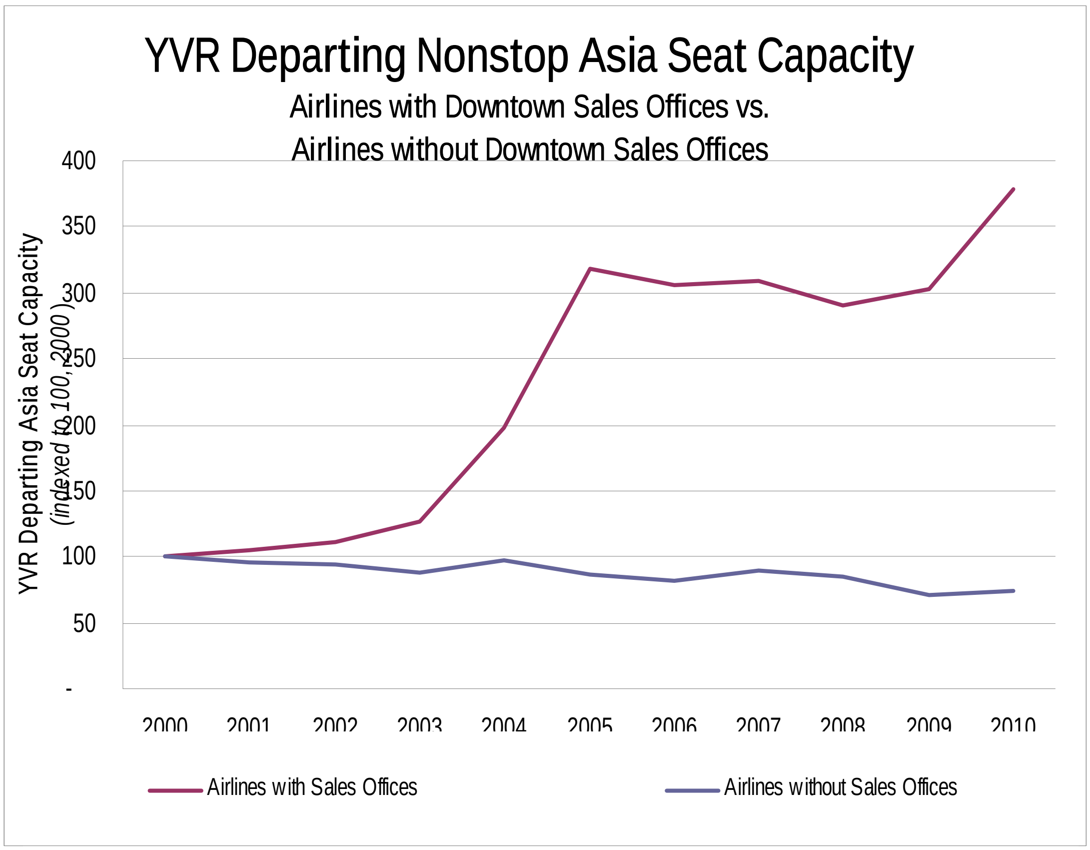
"We had a wonderful trip to Prince Rupert and Haida Gwaii which you arranged. Would recommend your services highly. Thanks again," Mrs. Joy Henderson, BC Ferries Vacations customer



The BC Ferries Vacations Centre opened to the public on May 11, 2010, with the grand opening attended by over 500 people representing influential industry partners, stakeholders and media. Since then, thousands of people have visited the Centre to find out more about the vacation options available. While most of the visitors to the Centre are local Vancouverites, 40% are visitors from Europe, the United States and Asia. The Centre is located directly across from the newly expanded Vancouver Convention Centre and the cruise ship terminal, which attracts thousands of visitors each month, many of whom are interested in extending their city stay to discover more about British Columbia's unique coastal experiences. Consumer shows like the Vancouver Home and Garden Show and the Vancouver Auto Show share BC Ferries' target demographic, resulting in spikes to daily walk-in traffic which have generated higher sales conversions. As a result, visitors are introduced to unique West Coast experiences by viewing products and services on a 90 sq ft interactive media wall, which is unique to Vancouver as a dynamic sales tool. While in the Centre, visitors can also purchase hand-made artisan products in our retail area, which both enhances their vacation and further supports the coastal communities served by BC Ferries.

There are many different factors that create consumer awareness and management must judge which of these are the most cost effective – dollars of expenditure versus dollars of incremental revenue. Therefore ongoing efforts are made to develop new, innovative and highly productive marketing programs. In doing so, BC Ferries is guided by the best practices of others in the transportation and tourism sectors.

It is well known that in spite of the development of the internet, downtown sales offices have been a highly successful marketing strategy for tourism related transportation businesses, both for increasing overall awareness and improving sales conversions. For example, the chart below highlights the relationship with respect to airlines operating to/from Asia in the Vancouver market with a customer facing store front.



InterVISTAS Consulting Inc.

BC Ferries' management examined this potential marketing strategy and decided to pursue a downtown Vancouver travel centre as part of its marketing innovation program to promote incremental traffic. This was a carefully considered decision. Research conducted by InterVISTAS Consulting Inc. on the effects of storefront operations suggests that a location in close proximity to the highest visitor traffic location in the downtown core is the most productive.

In Vancouver, this is the area near Canada Place, the two convention centres and Jack Poole Plaza. This location continues to be a tourism draw and point of gathering for many local celebrations, including Canada Day in July, and Grey Cup Central in November 2011. In addition, it is also located across from the cruise ship terminal and the rapid transit station servicing the lower mainland.

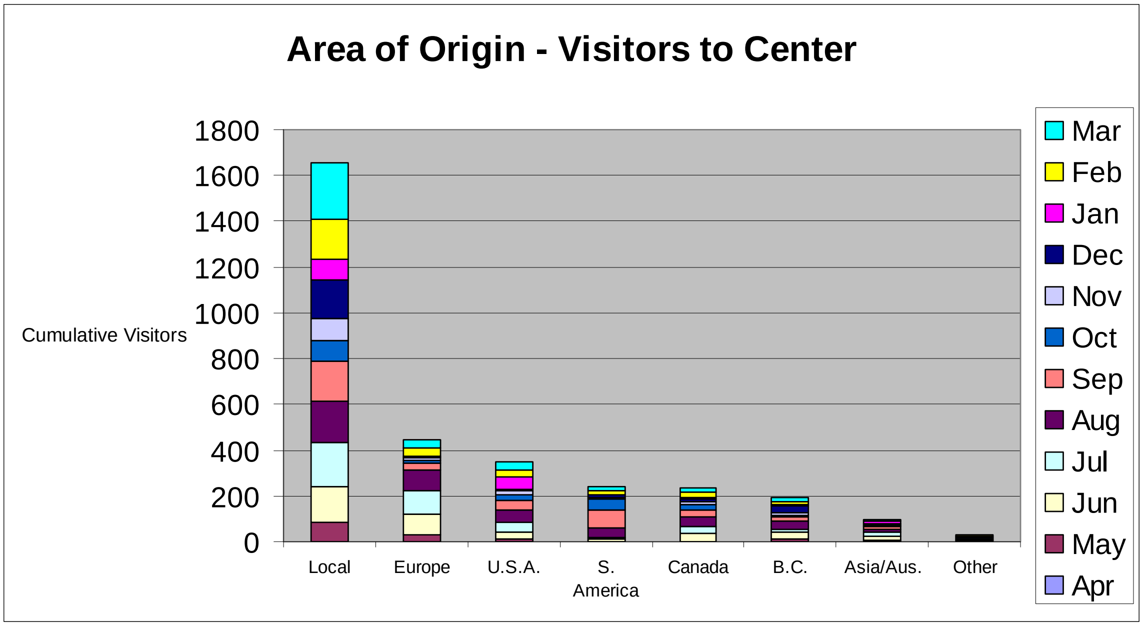
Lastly, the area is surrounded by major hotels with inter-city and tour bus services to Vancouver Island. BC Ferries Vacations works closely with hotels and transportation companies to create awareness and drive visitation to the Centre. As well, the location is in close proximity to the Tourism Vancouver Information Centre, enabling cross referrals. The downtown location also has the advantage of creating awareness of BC Ferries products and experiences with visitors who are visibly exposed to alternative transportation options (harbour float planes and helicopter services).

Travel Centres are also important to the tourism industry in building repeat business from visitors already in-market. The Province of British Columbia knows this well - there are currently 134 Visitor Centres around British Columbia which are supported by Tourism BC with various levels of funding, training and resources. Of these, there are 6 'gateway' centers which are owned by the province. These include centres at Golden, Merritt, Mount Robson, Osoyoos, Vancouver International Airport and at the Peace Arch Border Crossing. Recently, the province completed construction on the Peace Arch Visitor Center for a total investment of $4.6 million. The purpose of creating and operating these centers is to drive awareness, provide visitor information and assistance, and enhance the overall guest experience while generating economic benefits through direct sales and referrals.

During its first year in operation, the BC Ferries Vacations Center has had a successful opening, drawing in thousands of visitors both local and international alike who are interested in finding out more about BC Ferries' unique vacation packages.

Key Customer Data:

- 60% of visitors are local Vancouverites, 40% are from Europe, the United States and Asia
- 85% Adults, 8% Seniors, 7% Children
- 52% Male, 48% Female
- 98% of all vacations include travel by car
- Major routes make up 78% of volume
- Northern routes account for 19% of volume
- All other routes represent remaining 3% of volume
- Contests and promotions are ongoing and designed to drive visitors to the center, garner awareness for BC Ferries Vacations as well drive sales
- Customer feedback has been extremely positive about the new service attaining a satisfaction score of 87% average year to date



VI. BC Ferries Vacations Marketing

> *"I came across your "Vacations" section then clicked on the link and was amazed at the deals you provided… The price was $300 for an upgraded room at The Empress, ferry ride both ways, discounts on breakfast, scavenger hunt with toys and high-tea…Thanks BC Ferries Vacations! Now that I know about you and the great deals you offer, I've told so many people. If you guys have anymore up coming deals, I'd love to hear about them."*
> Christine MacDonald, BC Ferries Vacations customer

> *"Since the beginning of our BC Ferries partnership (now just over a year) we have seen incredible growth in our mainland visitors. The guests that come to Black Rock through BC Ferries are well informed and very appreciative of the services and packages available through BC Ferries."*
> Adele Larkin, General Manager, Black Rock Oceanfront Resort, BC Ferries Vacations partner

BC Ferries Vacations offers a comprehensive suite of vacation products representing key destinations and high yield products. The focus is on vacation packages that represent each route group, major ports of call destinations and/or high demand routes. In just under one year BC Ferries has expanded from offering 25 unique vacation packages to over 50, plus over 100 supplier products and services. BC Ferries Vacations products fulfill a recent consumer demand trend for affordable, short-haul, local vacations; positioning BC Ferries to drive regional and overall tourism.

It is essential to plan and execute strategic, direct-to-consumer marketing campaigns for BC Ferries to compete in today's tourism climate. BC Ferries competes for consumer discretionary travel dollars with other popular regional destinations such as the Okanagan and Whistler. In addition to local competition, with the strong Canadian dollar, consumers are also spending their discretionary travel dollars outside of our domestic market in destinations like Las Vegas, California and Mexico.

BC Ferries Vacations marketing programs are developed to influence discretionary travel to the communities BC Ferries serves, targeting British Columbia residents as well as building awareness and demand in other regional and domestic markets such as the Pacific Northwest and Alberta. Multi-media marketing campaigns include mass media-print, TV and radio, as well as online web advertising, social media and co-operative partnerships, that play a key role in delivering increased business to our coastal partners.

Leading with a destination-oriented marketing strategy, BC Ferries Vacations' marketing programs deliver an integrated brand experience for customers, and grow incremental travel and revenue. Marketing activities highlight British Columbia's spectacular coastal destinations and a strong value proposition.

BC Ferries provides customers with unique vacation experiences in beautiful British Columbia that begins with their ferry travel. The British Columbia coastal experience delivers stunning scenery, diverse landscapes and magnificent wildlife in remote wilderness to cosmopolitan cities offering a vast array of cuisine and cultural experiences.

BC Ferries also invests in tourism marketing programs that build capacity and demand in communities that do not have the resources to market themselves. In successfully marketing BC Ferries Vacations destinations such as Quadra Island, Salt Spring Island, Pender Island, the Inside Passage and the Discovery Coast, among others, BC Ferries is growing demand for and traffic to these minor routes. In the first year of operations, close to 1,200 room night bookings were delivered to Northern British Columbia alone through sales of the Inside Passage Wilderness Circle Tour on the Northern Expedition. For many British Columbians this offering represents a new and exciting vacation product not previously marketed to this audience.

To leverage marketing resources, BC Ferries Vacations partners with destination marketing organizations such as Northern British Columbia Tourism and Tourism Vancouver Island, and individual supplier partners like Black Rock Oceanfront Resort, Tigh-Na-Mara, Kingfisher Resort and Poets Cove to gain further marketing reach at reduced cost to BC Ferries. For example, with minimal investment of $5,000 in the summer of 2010 BC Ferries Vacations garnered over $0.25 million in marketing campaign value targeting Alberta and British Columbia consumers by partnering with Northern British Columbia Tourism and its communities.

More recently, BC Ferries Vacations successfully executed a "March Break Family Getaways" promotion targeted at British Columbian families, with accommodation partners at Tigh-Na-Mara, the Fairmont Empress and Vancouver Coast Hotels. This promotion generated 75 vacation package bookings during this brief program.

Looking ahead, BC Ferries has partnered with Tourism Vancouver Island in their "Go Vancouver Island" campaign targeted in Alberta. Four BC Ferries Vacations ads will air on Global TV and online, featuring Black Rock Ucluelet Retreat, Poets Cove Pender Island Retreat, Westin Bear Mountain Golf Adventure and Tigh-Na-Mara Parksville Retreat packages. BC Ferries' investment is 5% of the total $0.5 million campaign, and will reach close to 4 million Alberta residents over the 10 week campaign. Plans are also underway to partner with Northern BC Tourism again on a British Columbia targeted campaign featuring Northern products.

> "*Tigh-Na-Mara Seaside Spa Resort & Conference Centre (TNM) and BC Ferries Vacations (BCFV) began working together nearly 2 years ago. During that time, BC Ferries Vacations and Tigh-Na-Mara worked together to develop packages and offers exclusive to the BCFV market. This partnership is successful through ongoing dialogue and a clear understanding of what each party could bring to the relationship, each enhancing what the other offers.*
>
> *More than 50% of our guests come to the Island from the lower Mainland, and BC Ferries is a vital link to our guest transportation and therefore our business. Unfortunately access to Vancouver Island via BC Ferries continues to be our top marketing challenge. The perception of increasing ferry travel*

costs, access to the Island and travel time have impacted our ability to attract new and repeat leisure, corporate and convention guests. Overcoming these objections and/or perceptions is critical to on-going business success on Vancouver Island.

BC Ferries Vacations packages have been successful for Tigh-Na-Mara from day one. We have been partners in cooperative marketing, promoting each other with seasonal specials and exclusive TNM offers for BCFV guests. Tigh-Na-Mara in turn extensively promotes BC Ferries throughout our marketing, encouraging our guests to use BC Ferries as their means of travel to the Island when not booking a BCFV package. Most recently this was a button on our home page linking to the CoastSaver as well as CoastSaver information on every page detailing our specials/ packages."
Jennifer Houtby- Ferguson, Director Sales & Marketing Tigh-Na-Mara Seaside Spa Resort and Conference Centre, BC Ferries Vacations partner

VII. CoastSaver Price Point Promotion

The B.C. Ferries management group has done an excellent job of maintaining and upgrading the ferry fleet since 2003. In addition, surveys show a high level of customer satisfaction and low employee turnover. There is a simple way to increase revenues, without raising prices. There is plenty of capacity on board the ships during off-peak times, such as weekdays and during late fall, winter and early spring seasons. The solution? Fill up these boats year round. The corporation should now reduce the emphasis on operations in favour of a new focus and investment on marketing activities. There are more than 2.5 million people residing on the Lower Mainland, and with appropriate marketing programs many would enjoy trips to the Island. The more passengers, the more revenues to cover expenses, the less need to raise prices.
Rodger Darbey, Times Colonist**,** April 23, 2011

Price promotions are an important strategic and tactical tool used by the service industry, manufactures and retailers to trigger immediate and aggressive responses from consumers. In many industries, promotions represent a large percentage of the marketing mix budget. Nondurable good manufacturers are now spending more money on promotions. Airlines often offer discounts to generate incremental traffic and revenue. Financial institutions use promotions to induce customers to use their services. Farm equipment manufacturers use price promotions to sell excess inventory. Across industries, then, price promotions are an integral part of the marketing mix.

Over the years different industry sectors have proven that customers make different purchase decisions than they would with regular unit pricing, making time-limited offerings an effective tactical tool to accelerate the purchase decision. In 2009, CoastSaver research conducted for BC Ferries by Mustel Group reported that some BC Ferries customers were travelling up to five times more during the summer CoastSaver promotional period.

Customers typically use reference prices when making purchase decisions. It is generally difficult for anyone to assess the true value of a product or service. Therefore, customers compare the price with alternatives. Such alternatives can be other methods of solving the same problem or they can be competitive solutions from other vendors or in harder economic times like those experienced the last few years, an alternative can mean not travelling all together. But customers also compare prices with previous prices, special prices or standard list prices. Therefore, once you set the right pricing based on the value of your product, the question becomes, will new customers be won and can revenue be increased by offering price promotions in addition to regular customers being able to use more of your service due to promotions?

The BC Ferries CoastSaver program began in 2006 for Routes 1, 2 and 30 as a price cap management tool. It is a branded fare program that is lower than BC Ferries' standard price, which indiscriminately rewards customers for choosing to travel on specific days and on specific routes by providing them significant percentage discount savings (for example the March 2011 promotion offered a 33% discount off fares).

As a branded "value sailing" product or price point (similar to Air Canada's Tango fare) CoastSaver aims to maximize revenue under the price-cap on the major routes and meet revenue targets while managing and driving incremental traffic which sometimes acts as a positive means for shifting travel (load-shaping) from peak to off-peak travel days during the promotion period.

Past history and analysis of the price discounts offered by CoastSaver sailings suggest that lower prices in non-peak periods and/or on lesser traveled routes will modify traffic patterns, providing that timely marketing occurs to allow consumers to change their travel patterns. As a result, during peak travel periods, CoastSaver sailings can be used strategically to divert traffic away from high traffic periods.

As a price promotion, the program can be activated on a tactical basis as business needs dictate, while at the same time building longer-term continuity and awareness by offering consumers a 'choice' when selecting travel to/from Vancouver Island. In addition, during holidays (e.g. New Years, Spring Break, etc.), CoastSaver sailings can be used to encourage additional discretionary travel. Survey results from 2009 indicate that 77% of those who used CoastSaver were traveling for personal/pleasure reasons. Furthermore, 56% of customers who were aware of CoastSaver subsequently used it as a result of marketing. Of those who took advantage of the program, 59% used CoastSaver 2-5 additional times, suggesting that the much of this travel was incremental and discretionary.

Finally, the program provides an avenue to increase ancillary revenue by increasing the number of ferry reservations, increasing sales of BC Ferries Vacations packages as well as non-tariff on-board spending.

Execution of CoastSaver is achieved in 2 primary ways:

- customers are informed early and consistently through direct to consumer marketing (for the duration of the program) about the discount savings to be received, dates, routes and times of the program availability to ensure they know about it and benefit from the discount; and
- media is purchased and creative campaigns (posters, radio, newspapers, and website positioning and social media) are used to reach BC Ferries' customers informing them of the promotion.

Without mass marketing for the CoastSaver program many customers who benefit from it would not be aware of the program and hence may miss the opportunity for savings. More importantly, BC Ferries would give away discounts without benefiting from increasing volume and load-shaping that is achieved when the program is marketed.

Key findings from CoastSaver 2009 research conducted for BC Ferries by Mustel Group include:

- Almost nine-in-ten who travel between Vancouver and Vancouver Island are aware of the special fare, with the BC Ferries website and advertising (particularly print advertising) being the primary sources of awareness.

- Just over half (56%) of Vancouver/Vancouver Island travellers have used the CoastSaver fare. Among those who have not yet used the program, high proportions (67%) anticipate using it at some point in the future.

- Among those who have used CoastSaver, an average of just over four trips (4.3) has been taken.

- Approximately four in-ten CoastSaver users report to have taken additional trips on BC Ferries that they may not have taken if not for the special fare. These additional trips account for approximately one-third of all trips taken using the CoastSaver fare.

- Almost three-in-ten (29%) who travelled by vehicle report that the special fare influenced them to travel by vehicle rather than as a foot passenger.

- Moreover, over one-third of CoastSaver travellers report that the special fare encouraged them to change their weekend travel plans to mid-week to take advantage of the savings offered.

- Personal reasons (visiting friends and family being the most common) is the main purpose for the CoastSaver trip. They also tend to be the reason for additional trips that may not have normally been taken.

- The summer is the most popular season for expected use of the CoastSaver fare but sizeable groups expect usage at other times of the year as well. Approximately half have applied the savings to future fares, spent more on BC Ferries food or merchandise, and to a lesser extent applied the savings to reservations.

The CoastSaver fare program has been very well received by BC Ferries' customers and has become an anticipated and important promotion. The program has increased the number of trips taken by BC Ferries travellers, and to some degree has shifted travel and converted foot passengers to vehicle travellers. Furthermore, the research suggests that some of the savings in fares were recaptured by other BC Ferries services.

VIII. Consumer Market Research

BC Ferries Customer Satisfaction Tracking (CST) survey is not only a requirement of the Coastal Ferry Services Contract but a great source of consumer information. This consumer research provides an avenue for BC Ferries to obtain a complete understanding of customer sentiment toward products and services on a selection of routes so that responses are actionable and progress can be measured over time.

The CST survey was designed to track performance on satisfaction levels overall and with specific service attributes. The survey is undertaken three times a year, in June, August and November. Once a year, the annual satisfaction scores are published on BC Ferries' website as required by the Coastal Ferry Services Contract. The survey is designed to provide input to BC Ferries' Corporate Strategic Plan. In addition, it aims to measure satisfaction with attributes that span the entire range of points of customer contact with BC Ferries. It tracks changes in satisfaction over time, and across customer segments, and it identifies the critical improvements to the current service offerings that will have the greatest impact on customer satisfaction.

IX. Customer Satisfaction Tracking Results

The following table provides a year-to-year comparison of overall customer satisfaction levels of customers with recent experience traveling with BC Ferries.

	2003	2004	2005	2006	2007	2008	2009	2010
Overall Satisfaction - Annual	4.00	4.10	4.10	4.23	4.13	4.14	4.26	4.22

NOTE:
- Scores are based on customers who rated satisfaction on a 5-point scale. 1 = very dissatisfied to 5 = very satisfied.
- Annual scores include the mean for all waves for a complete year, equalling the combined mean of customers who rated satisfaction on a 5-point scale. 1 = very dissatisfied to 5 = very satisfied.

X. Partnerships

> *"BC Ferries has been an important partner of the Royal BC Museum for many years, helping to increase our profile across the province. In addition, the support of BC Ferries has been vital to the success of the museum in securing and promoting international exhibitions of a high calibre, such as Titanic or Treasures: the World's Cultures from the British Museum. Without the support of BC Ferries, we would find it exceedingly challenging to continue to bring these world-class exhibitions to Victoria – exhibitions that have an enormous cultural, educational and financial impact on the community we share. In this way, BC Ferries has helped to bring the world to British Columbia, and British Columbians to the Royal BC Museum."*
> Royal BC Museum, corporate partner

BC Ferries is continually looking ahead to understand the trends and drivers that will shape business in the future. From this, BC Ferries understands the importance of partnerships and community investment.

Partnering with organizations that share a similar philosophy, set of principles, priorities and actions enables BC Ferries to create long-term sustainable growth for the business and increase customer value. Partnerships give BC Ferries the financial flexibility, market reach, community connection, and market intelligence needed to accelerate business. The better BC Ferries understands its consumers, the more value can be gained and delivered. Similar to BC Ferries' core demographics, the target markets for key partnerships are identified as primarily residents of British Columbia with the following characteristics:

- 47% male
- 40% female
- 13% gender unknown
- Ages 40 – 65

The following key partnerships assist BC Ferries in reaching these target markets:

BC Bike Race[3]
BC Ferries has been an integral sponsor of the annual BC Bike Race event since its inaugural staging in 2007. This partnership delivers both national and international recognition in over 60 countries, drives discretionary travel and builds ancillary revenue. The partnership provides consumers with the opportunity to experience BC Ferries, Vancouver Island and the Sunshine Coast. Without BC Ferries sponsorship, this event would likely move in-land. BC Ferries receives a 63% return in value through this partnership.

Victoria Dragon Boat Festival[4]
Taking place in Victoria's scenic Inner Harbour, this festival attracts more than 90,000 festival goers and 2,500 paddlers from across North America. BC Ferries has supported this festival for the last several years by optimizing full integration into the event promotion and activities through distribution of marketing materials. This partnership offers BC Ferries the opportunity to drive event business, build brand visibility, and create social contributions within a core marketplace.

Royal BC Museum[5]
Through this partnership, BC Ferries is able to share the community's passion for culture, enriching the lives of consumers and build discretionary travel to meet corporate objectives. With the museum being a premier tourist attraction in Victoria, BC Ferries is able to maximize its marketing reach to bring visitors to and from Victoria and encourage return trips. This partnership exposes BC Ferries to potentially over 500,000 consumers annually.

Canada Day Festivities[6]
Working together with Canada Place, BC Ferries supports one of British Columbia's biggest festivals, Canada Day. This family centric event is one of the most attended events in Vancouver. Through this partnership, BC Ferries is able to create a presence in its single biggest market, with exposure to 190,000 day-time event attendees. This is further supported through the Vacation Center, which used event activation to attract in excess of 750 people to the centre over three days last year.

Vancouver Canucks
BC Ferries develops and maintains high profile and strategic partnerships with organizations in key communities that support our business objectives and provide value to our customers. The Vancouver Canucks partnership is one that aligns with our brand, consumer demographic and marketing mandate.

BC Ferries largest market is Vancouver, therefore, the Vancouver Canucks partnership provides BC Ferries with a platform to speak to new and existing customers through multiple communication channels to influence their travel purchasing decisions. BC Ferries also leverages the Vancouver Canucks partnership by communicating targeted and relevant messages directly to their customer database. These types of high profile, targeted partnerships are important to our business, because they focus on attracting new consumers while maintaining positive connections with current consumers.

This partnership provides BC Ferries with the following benefits:[7]

- Averages over 900,000 game attendees per season, connecting with new and existing customers

[3] BC Bike Race Review of BC Ferries 2010 Event Sponsorship
[4] Victoria Dragon Boat Festival Sponsorship Package 2010
[5] Royal BC Museum 2010 Annual Report
[6] Canada Day at Canada Place 2010 Post Event Summary
[7] Source: Vancouver Canucks Annual Report 2009.10 Activation Review

- 2.5 million viewers for entire regular season, highest regional broadcast audience per capita of any Canadian NHL team
- Static rink boards deliver 2.5 million impressions alone
- Exposure on canucks.com, averages 3.6 million impressions
- Access to 30,000 Canucks e-news subscribers
- Strong community involvement and grass root programs

Lastly, each of these partnerships is further leveraged to expose the BC Ferries Vacations brand to the individual markets. Marketing and sales initiatives are designed to dovetail into the programs, providing mutual benefit to both BC Ferries and its partners.

XI. Community Investment

> *"BC Ferries has been a long-time supporter of the Powell River Kings' Hockey Association. The managers at BC Ferries are always a pleasure to work with as communication is always wide-open and new ideas are always welcomed. Of course, BC Ferries also benefits from the partnerships as each of the opposing teams travel to Powell River via BC Ferries. Throughout the entire season BC Ferries is proudly announced, pictured, advertised, promoted and celebrated as a key contributor to the Powell River Kings. My personal favourite are the six BC Ferries game-nights scattered throughout the season which include the BC Ferries Frisbee toss during the first intermission. The Powell River Kings would not be where it is today without the support of BC Ferries. Thank you BC Ferries!"*
> Elise Statham, Powell River Kings, community investment recipient

> *"On behalf of the Sunshine Coast Swim Team I would like to thank Sport BC & BC Ferries for their support in providing travel vouchers to our team members. I enclose for your records a team photograph and local newspaper clipping."*
> Sunshine Coast Swim Team, community investment recipient

BC Ferries is committed to giving back in a strategic way to the communities it serves and operates in. The community investment program was created following an internal review of BC Ferries corporate and regional giving practices. From that review, community investment practices were better aligned with BC Ferries' business objectives.

Current support spans a wide range of activities, from coastal festivals and sports to children's charities. Contributions that support BC Ferries' long-term commitment to community investment fall within the following identified priorities.

Community Festivals and Events

- Assists communities with demand generation by supporting events/festivals that have the ability to create incremental demand for the destination and therefore the ferry service.
- Demand generating activities also work to build non-resident ferry traffic on the route ultimately contributing to fare management through increased route usage.

Community Sports

- Allows ferry travel by sports teams that might otherwise not travel.
- Incremental tariff achieved through non-athlete travel and through ancillary revenue.
- Tournament and league play brings competitor teams that otherwise would not travel to the destination, nor use the ferry system.

Children's Charities

- Improves BC Ferries brand perception and visibility in target communities.
- Provides positive interactions with customers outside of BC Ferries operational venues.
- Demonstrates positive corporate citizenship.

Annually, the Community Investment program receives over 600 direct requests for support. Approximately 50% of requests meet the established criteria for eligibility, and are provided with travel assistance or small cash donations.

Sport BC is BC Ferries' sport partner and the primary instrument for supporting organized sport in coastal communities. In fiscal year 2011, over 350 requests were received by Sport BC, who in turn was able to support over 4,000 athletes and coaches to compete in over 40 unique sports, from archery to volleyball.

XII. Marketing Communications

Marketing Communications is the steward for BC Ferries corporate brand management, focused on the integrity and promotion of BC Ferries brand, and generating demand for our products and services. Marketing Communications includes the coordination and integration of all marketing communication tools, avenues, and sources within BC Ferries into a seamless program in order to effectively communicate to target audiences at a minimal cost. This integration affects all BC Ferries business-to-business, marketing channels, and internally and externally directed communications.

The goal for BC Ferries is to create and maintain communication with its customers and its own employees, ensuring consistency of message and the complementary use of media including e-marketing campaigns or programs, traditional print (newspaper, magazine), brochures, posters, banners, terminal signage, and customer information hand outs.

Marketing Communications services all BC Ferries departments providing them with resources and tools to execute programs and meet objectives. Emphasis is always focused on aligning our people, resources and operations.