



**BC Ferry Commission
Memorandum 43**

To: Mr. Rob Clarke
Executive Vice President and CFO
BC Ferry Services Inc.

From: Martin Crilly
BC Ferries Commissioner

Date: March 4, 2011

Re: Order 11-01: Identification and Correction of Errors

The commissioner issued Order 11-01 on February 7, 2011 under section 45.1 of the Coastal Ferry Act. The Order set a minimum allowed average tariff (MAAT) for BCFS' drop trailer service on its major routes, and a horizon traffic volume (HTV) for drop trailers that could trigger a review of the MAAT in future. The regulation of drop trailer service is to begin April 1, 2011.

On February 11, 2011 during a meeting on unrelated matters, BCFS made an oral statement to the commissioner to the effect that there appear to be errors in the commissioner's calculations for Order 11-01. The commissioner responded that he was prepared to consider BCFS' detailed observations for the purpose of identifying any material errors, including arithmetic, and mistakes in transcription or interpretation of the source materials provided by BCFS in its submissions. The commissioner was not prepared, however, to consider submissions on the methodology used in arriving at the figures in Order 11-01.

In making determinations on this matter, the commissioner has communicated with BCFS only in the form of written correspondence. He has also reviewed unsolicited letters from Seaspan Ferries Corporation dated February 21 and 22 and March 2 and 4, offering observations on procedural fairness in this matter, suggesting modifications to it, and commenting on the errors alleged by BCFS.

As requested by the commissioner, BCFS provided by February 23, 2011 detailed written observations on the calculations for MAAT and HTV, listing seven issues. This Memorandum 43 provides the commissioner's response to these issues, using the same headings used by BCFS.

1. Data Input Error in Calculating Route Capacity Charge (Overhead)

BCFS observes that the MAAT appears to have been inadvertently calculated using the wrong number from BCFS' revenue-related expenses¹ data table as an input. BCFS asserts that some of these expenses should have been allocated to passengers, rather than, as effectively in the commission calculation, 100% to vehicles.

The commissioner concurs that the portion of revenue-related expenses that are attributable to passengers should be excluded. He notes that Exhibit C-1 in BCFS' original August 31, 2010 Submission did not allocate revenue-related expenses between vehicles and passengers. However, a subsequent table provided on February 23, 2011 by BCFS did provide an allocation, which he accepts as valid.

Accordingly the commissioner accepts the need for a correction, which is neither large nor immaterial. The correction is made in a revised spreadsheet calculating the MAAT.

2. Current Direct Costs of Operation

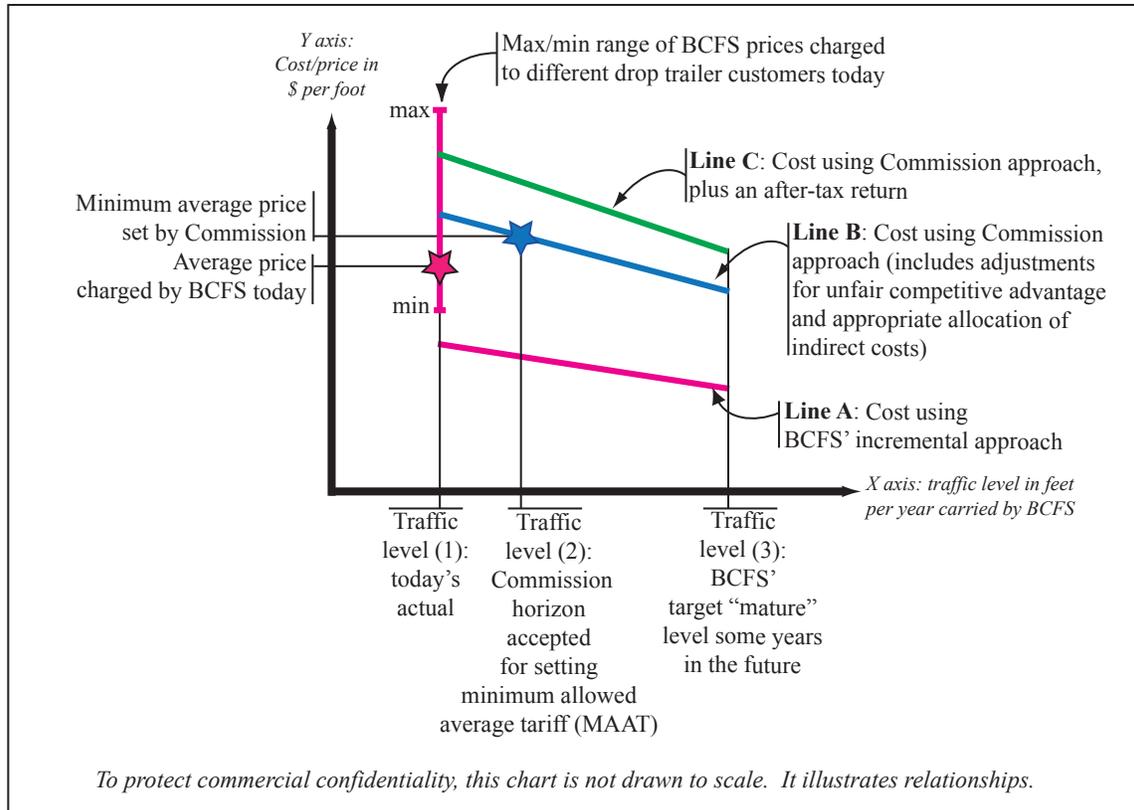
Among the inputs for calculating MAAT are "today's" data for cost and traffic volume. These were shown as traffic level (1) in the diagram on page 5 of Commission Memorandum 42 which is reproduced overleaf.

The commissioner used data for fiscal 2010 which was the first (start-up) year. BCFS asks the commissioner to use instead the data for the first six months of the second year of operations (i.e. fiscal 2011, the current year).

The commissioner responds that the estimation of the MAAT will likely always be based on historical data and for practical reasons cover a full year. In particular, the commissioner was unable to tie in the 2011 YTD totals to Route Statement information provided in the Submission. This is of particular importance, as the Route Overhead Charge is calculated on the basis of full year costs for Routes 1 and 30.

The commissioner has determined that no error was made in this respect and that no change in the calculation will be made.

¹ "Revenue-related costs" means costs such as regional management and corporate services costs that are allocated to routes based on the route's revenue share, as stated on page 6 of Appendix C of BCFS' submission dated August 31, 2010.



3. Current Market Size

BCFS states that data submitted by Seaspan Ferries Corporation (SFC) indicates that the total drop trailer market is actually larger than BCFS stated in its August 31, 2010 Submission.

BCFS asks the commissioner to correspondingly increase the horizon traffic volume (HTV), which is shown as traffic level 2 in the above diagram (and, presumably, BCFS' own target "mature" traffic volume shown as level 3) on which the MAAT calculation rests.

The commissioner's review relies primarily on information provided by BCFS. He is not able to verify the market data provided by SFC.

Behind the commissioner's analysis is a concern that BCFS' target market state may not be achievable within the time frame specified, if at all. Indeed, to achieve even the smaller, commission-specified HTV could be a challenge. In light of the uncertainties, the commissioner is not prepared to make a change in the traffic volumes used for the calculation of MAAT, or in the HTV.

**4. Selection of Consumer Price Index (CPI) and
5. Application of CPI to Cost Items Not Affected by Inflation**

BCFS asserts that in establishing the MAAT (in terms of dollars of the year fiscal 2012), the commissioner applied a 2% CPI growth factor to fiscal 2010 expenses for fiscal 2011 and fiscal 2012. However, the CPI growth factor used in determining the MAAT differs from the CPI indexes that the commissioner had already used in establishing the published price caps for fiscal 2011, and will use in establishing price caps for fiscal 2012. BCFS submits that the same CPI growth factor should be used and that adopting a different CPI factor is inconsistent and represents an error.

The commissioner responds that there were several considerations in the use of two years of a 2% per year growth in all cost elements applied to set the MAAT for fiscal 2012. This was in fact not specified² as a CPI-based adjustment, but as a reasonable assumption of BCFS' cost inflation in this period.

Some adjustment of the MAAT is clearly required to acknowledge cost inflation up to fiscal 2012, and several options are available. The commissioner chose a straightforward adjustment. Much detailed analysis using separate cost inflation factors applied to the individual inputs for drop trailer service, and associated overheads, could be undertaken and this would almost certainly produce a figure other than 2% per year, but such refinement would have spurious accuracy.

It is worth remembering that even small changes in some of the crucial assumptions behind the MAAT would swamp refinements such as this. Among the most crucial are (1) the value of the HTV and (2) the allocation on a deck area basis of marine transportation costs between passengers and vehicles.

The commissioner believes that the 2% factor is not unreasonable, and indeed may be low. He notes for comparison that BCFS is forecasting a 4.5% increase in system operating costs (which comprise three quarters of its total costs) from fiscal 2010 to 2011, and 1.9% from fiscal 2011 to 2012.³

6. Recognition of Duty Remission received for Coastal Class Vessels

BCFS notes that two expenses included in the MAAT are linked to the asset values of the Coastal Class Vessels: amortization and income tax advantage. The asset value used in calculating these expenses, however, did not reflect the fact that BCFS received \$82.3 million in duty remission and related GST on the three coastal class vessels in October 2010.

² Line 45 of MAAT tab in confidential workbook supplied to BCFS.

³ From the commissioner's initial analysis of BCFS' price cap submission for the third performance term, for all traffic for all route groups combined. The percentages quoted do not reflect other-than-CPI changes in fuel costs, which are reflected in separate cost deferral accounts.

The commissioner observes that the duty remission occurred in fiscal 2011 and is not recognized in the costs used for MAAT (and in particular the Route Overhead Charge), which is based on fiscal 2010 data.

Furthermore, the required adjustment as estimated by BCFS is, in the commissioner's view, so small as to be immaterial. Nonetheless the effect of the change in asset values will be captured when the MAAT is next reviewed by the commissioner, which could be triggered at the achievement of the HTV as provided in Order 11-01.

7. Terminal Cost Allocation

BCFS asserts that the Route Overhead Charge was based on an incorrect assumption that BCFS's classification of terminal related costs excluded costs appropriately assigned to passengers.

On examination of the source data and calculations, BCFS' position is valid.

A correction requires determining an appropriate allocation of terminal costs between passengers and vehicles. To date, this has not been determined: as BCFS points out, its original Submission did not provide this cost breakdown, and in its letter of February 23, 2011, has not indicated what it feels is the appropriate allocation, presenting an illustrative analysis only.

This issue of allocation of *terminal* costs parallels that of the allocation of *vessel* costs between passengers and vehicles, where, as earlier noted, the commission concurred with the use of deck space as the basis of allocation.

The commissioner is of the view that the great majority of terminal costs are attributable to vehicles, but has difficulty in identifying an engineering or economic basis to quantify the proportions. In the absence of this, he will recognize 10% of terminal costs as being attributable to passengers and 90% to vehicles. This results in a barely material adjustment to the value of the MAAT.

Conclusion

The above determinations result in a downward adjustment of the MAAT, which the commissioner considers to be modest but not immaterial, and no change in the HTV. These are reflected in an amended (confidential) version of Order 11-01 issued today. The non-confidential version, published on February 7, 2011, is unchanged.



BC Ferries Commissioner