



Office of British Columbia Ferries Commissioner

Report on the Preliminary Price Cap Decision for the Fifth Performance Term

*Prepared and submitted in accordance with
Sections 40 and 41 of the Coastal Ferry Act
of the Province of British Columbia*

March 31, 2019

British Columbia Ferries Commissioner
PO Box 9279 Stn Prov Govt
Victoria, BC, V8W 9J7

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

Table of Contents

1. Introduction	3
2. Review of BC Ferries' Performance Term Five ("PT5") Submission	4
3. Performance Reviews in PT4	9
4. Public Comments.....	11
5. Determinations for Price Caps for the Next Performance Term - PT5	11
a) Financial Targets	11
b) Operating and Non-controllable Costs	11
c) Efficiency Target	12
d) Capital Plan	12
e) Fuel Set Price	12
f) Fuel Deferral Mechanism for PT5	14
g) Provincial Transportation Service Fees	14
h) Ancillary Revenues	14
i) Price Cap Index	15
6. Commissioner's Preliminary Price Cap Decision for the Next Performance Term	15
7. Appendices	15
A. Statutory Framework for Setting Price Caps	
B. PwC's Assessment of BC Ferries' PT5 Submission	
C. PwC Report on Price Cap Compliance in PT4	
D. PwC Report on Drop Trailer Compliance in PT5	

1. Introduction

Under the *Coastal Ferry Act* (the “Act”) the British Columbia Ferries Commissioner (the “commissioner”) is responsible for the setting of price caps for each four-year performance term. A link to the statutory requirements, including the guiding principles for the commissioner and the process for setting the price caps that are set out in the Act can be found in Appendix A.

The primary requirement for setting the price caps is that they must allow the ferry operator to earn a return sufficient to recover operating and administrative expenses, amortization of capital costs and all financing charges. The price caps must also take into account any productivity or efficiency gain that, in the opinion of the commissioner, the ferry operator should achieve in the following performance term.

In setting the price caps the commissioner must determine that the operating and administrative expenses are reasonable and that capital costs incurred in the current performance term and to be incurred in the next performance term are also reasonable.

The statutory requirements and the commissioner’s framework for an affordable, efficient and sustainable ferry service that guided the commissioner in setting the price caps for the current performance term have guided the commissioner in making his preliminary decision for the price cap for PT5.

As required under the Act the ferry operator (“BC Ferries”) filed its submission (“PT5 Submission”) on September 28th 2018 for the next performance term (“PT5”) covering the period April 1, 2020 – March 31, 2024. The PT5 Submission is comprised of the following five reports:

Part 1: Performance Term Four Report, submitted in accordance with section 40 of the Act;

Part 2: Report on Fuel Management Plan Outcomes in Performance Term Four submitted in accordance with British Columbia Ferries Commissioner Order 15-03 Final Decision on Price Caps for the Fourth Performance Term Pursuant to the Act, dated September 16, 2015;

Part 3: Capital Plan (fiscal years 2019 through 2030), submitted in response to the requirements of section 64.1 of the Act;

Part 4: Strategies for Enhancing Efficiency in Performance Term Five and Beyond, addressing the requirements of section 40(1.1) of the Act; and

Part 5: Traffic Demand Forecast (fiscal years 2019 through 2024), provided as supplemental information to help inform the price cap determination.

Upon receipt of BC Ferries' PT5 Submission the commissioner posted the contents on the Commission's website, invited public comments by issuing a public notice in relevant print media in BC, and retained the firm of PricewaterhouseCoopers LLP ("PwC") to assist in his review.

The following is a review of the PT5 Submission reports and other supplemental information from BC Ferries, public comments and the commissioner's determinations. A link to PwC's Assessment of BC Ferries' PT5 Submission and their conclusions is included in Appendix B.

2. Review of BC Ferries' Performance Term Five ("PT5") Submission

a) Performance Term Four Report

This report responds to the information requirements of section 40(1) (a) to (f) of the Act. It provides an overview of the ferry services BC Ferries has provided and expects to provide in the current performance term four ("PT4") (April 1, 2016 - March 31, 2020).

The report also summarizes the contractual arrangements under the Coastal Ferry Services Contract ("CFSC") between BC Ferries and the Province of British Columbia (the "Province"). Under the terms of the CFSC BC Ferries must deliver core service levels on 25 regulated routes, with the Province contributing transportation fees on most of these routes to cover operating expenses which exceed revenues.

While BC Ferries cannot reduce service below the core service levels specified in the CFSC, it may exceed them. In fiscal 2018, BC Ferries delivered 79,082 round trips, of which 2,962 were above the number of round trips required under the CFSC. BC Ferries is forecasting that it will meet or exceed core service level requirements for the remainder of PT4. The commissioner has monitored BC Ferries' performance with the requirements of the CFSC regarding service levels and expects BC Ferries to be in compliance with the CFSC for the duration of PT4.

By Order 15-03 dated September 16, 2015, the commissioner set the price caps for PT4 covering the period April 1, 2016 - March 31, 2020. While the decision allowed for price cap increases of 1.9% each year in PT4, BC Ferries implemented average tariff or fare increases below those allowed. BC Ferries has summarized their fare initiatives as follows:

“In fiscal 2018, BC Ferries did not increase fares for vehicles or passengers on the inter-island routes, the northern routes or the route connecting Horseshoe Bay to Langdale. On major routes connecting Metro Vancouver and Vancouver Island, passenger fares were held flat. At the same time, vehicle fares on these routes were increased by 1.9 percent, reservation fees were reduced, and several vehicle fare promotions were implemented. Together, this resulted in reduced average vehicle fares for the fiscal year.

In fiscal 2019, the Company applied a fare reduction of 15 percent on the northern routes, the interisland routes and on the major route connecting Horseshoe Bay and Langdale. Fares will remain at these levels through March 2020. BC Ferries and the Province are each contributing \$39 million to cover the cost of these fare reductions. Fares remained unchanged (frozen) on the major routes connecting Metro Vancouver with Vancouver Island.

Also in fiscal 2019, the British Columbia seniors’ passenger discount increased from 50 percent to 100 percent for travel Monday to Thursday on the major and inter-island routes. The Province will contribute an additional \$20 million towards offsetting the value of the enhanced British Columbia seniors’ discount through March 2020.

The total value of the fare and seniors discount initiatives over the two years is \$98 million.”

Of the \$98 million, BC Ferries’ contribution was \$39.0 million in foregone revenues over fiscal 2019 and 2020. In addition, BC Ferries decided to forego \$15.7 million it was entitled to collect through fuel surcharges in fiscal 2018.

Over PT4, traffic has increased steadily. In fiscal 2017 vehicle traffic increased by 2.9% and passenger traffic by 1.7% compared to the prior year to the highest levels since fiscal 2008. In fiscal 2018 traffic levels continued to increase with vehicle traffic up by 5% and passenger traffic by 4.7%. Further increases in traffic are forecasted in the range of 1.7% to 2.6% for fiscal 2019 and 2020.

Despite the increase in traffic during PT4, BC Ferries forecasts tariff revenues will decline by 3% to \$637.9 million in fiscal 2019. This is due to the fare freeze on the major routes connecting Metro Vancouver and Vancouver Island, the 15% rollback on all other routes, and the restoration of the 100% BC seniors' discount on the major and inter-island routes, partially offset by traffic growth and reservation fees.

Operating expenses have increased above inflationary rates in PT4 primarily with labour costs due to the increase in traffic and which on an overall basis create a higher base on which PT5 forecasts are predicated. Despite a strong correlation of increased labour costs with increased traffic, the significant increase in scheduled and unscheduled overtime is driving up expenses. Also of concern is the significant increase in costs related to business transformation initiatives enabled by major IT projects.

The efficiency target outcomes set by the commissioner for PT4 for operating efficiency gains of \$4.9 million/year and productivity gains of \$2 million/year are not well documented but it is true that revenue growth, primarily due to traffic growth, has outpaced expense growth in PT4.

Finally when the commissioner set the price caps for PT4 he established a target for BC Ferries of a \$100 million reduction in the Long Term Capital Plan. To date, this does not appear to have been addressed in a formal way.

The commissioner has determined that the financial information and explanations provided by BC Ferries regarding the forecast for PT4 results are reasonable and that the operating and administrative expenses, and capital charges, are appropriate and can be relied upon for PT5 for price cap setting purposes.

b) Fuel Management Report for PT4

This report is submitted in accordance with Order 15-03 - Final Decision on Price Caps for the Fourth Performance Term dated September 16, 2015. This report describes the progress BC Ferries has made in PT4 in its strategies for fuel procurement, minimizing fuel consumption and transitioning to alternate fuels. Fuel is the second highest operating cost after labour in the ferry system and managing this cost is a critical component in delivering an efficient ferry operation.

In PT4, higher than anticipated traffic volumes resulted in more sailings and higher fuel consumption. However overall fuel cost is forecasted to decline in PT4 due to a reduction in diesel fuel prices and the transition to lower-cost LNG fuel used on some vessels. Diesel fuel consumption per automobile equivalent (AEQ) or vehicle carried has declined in PT4. The designs of new Island Class vessels coming on

stream in PT5 allow for hybrid propulsion systems utilizing diesel and electric power with provision for conversion to all-electric propulsion, but no timelines are specified for the conversion on these vessels.

In summary the commissioner has determined that fuel consumption and costs have been effectively managed by BC Ferries. The company is encouraged to develop a plan for the conversion to all-electric ferries as soon as the necessary infrastructure and technology is available.

c) Long Term Capital Plan

The Long Term Capital Plan (fiscal 2019 through 2030) (“LTCP”) responds to the specific information requirements of section 64.1(1) of the Act and provides information on the capital expenditures the Company anticipates incurring over the next 12 years. The LTCP has been developed based on the existing service requirements set out in the current CFSC.

The commissioner is not required by the legislation to make any determination regarding the LTCP other than his acceptance or non-acceptance of the capital plan for PT5. The commissioner does however review the plan for the impact it may have on the performance terms beyond PT5.

The Capital Plan covers the fiscal 2019-2030 period: the last 2 years of PT4, PT5, PT6, and the first 2 years of PT7.

The fiscal 2019-2030 Capital Plan includes: the introduction of 17 new vessels and retirement of 13 vessels; the replacement or upgrade of the Horseshoe Bay Terminal, the Swartz Bay Terminal, and the Langdale Terminal; 2 berth replacements/rebuilds; and IT projects.

The estimated total costs of the Capital Plan are in excess of \$3.9 billion over the next 12 years. 61% of expenditures are comprised of major capital projects. Capital expenditures are forecast to peak in 2020, 2023 and 2024.

The LTCP beyond PT5 has a moderate impact on PT5 price caps and a much larger impact on price caps for the following performance terms. It should be recognized that the time involved in building vessels means that capital decisions need to be made well in advance of the performance term in which the expenditures are made.

Given the magnitude of capital expenditures included in the LTCP and the upward pressure they could have on price caps beyond PT5, the commissioner recommends that BC Ferries and the Province jointly review the LTCP with a view to

identifying opportunities to reduce the LTCP by considering alternate delivery models for future ferry services at lower costs. Significant public consultation may be advisable.

d) Strategies for Enhancing Efficiencies

BC Ferries' strategies for realizing further efficiencies in the next performance term are described in Strategies for Enhancing Efficiencies in Performance Term Five and Beyond (the "Efficiency Plan"). This plan addresses the information requirements of section 40(1.1) of the Act.

The Efficiency Plan focuses on five strategies to be pursued in PT5. These include the transition to Low Carbon Technology by using alternate fuels such as LNG or electricity on new vessels; maintenance and labour opportunities; new customer-focused information technology; new revenue management technology enabling variable pricing; and exploration of opportunities to grow and diversify revenues to mitigate the impact of economic cycles.

Most of the initiatives identified in the Efficiency Plan are consistent with the commissioner's recommendations as a result of the Coastal Ferry Act Regulatory Review conducted in 2012.

Accordingly the Efficiency Plan for PT5 is considered reasonable. As noted by PwC, specified timelines for full conversion to electric-powered vessels would enhance the plan.

e) Traffic Demand Forecast

BC Ferries' Traffic Demand Forecast (fiscal 2019 through 2024) is provided as supplemental information to help inform the price cap determination. Traffic in fiscal 2019 and 2020 continued to grow but at a lower rate compared to the growth rates in fiscal 2017 and 2018. In the PT5 years (fiscal 2021 to 2024), the passenger vehicle forecasts flattened.

Stantec was retained by PwC, on behalf of the commissioner, to assess the traffic forecasting undertaken by BC Ferries that forms part of the PT5 Submission.

BC Ferries adjusted its forecasting methodology for the majority of its traffic volumes for the remaining two years of PT4 and the entirety of PT5. The changes in the methodology were due to limitations of the use of input data such as tourism and employment projections in previous modelling.

Elasticities for major routes were reviewed for major and minor routes. Though different methodologies were applied in estimating the elasticities, they all appear reasonable and fall within an acceptable range.

It is the Stantec team's view that the baseline results can reflect the trend of traffic with the slowdown of economic growth and the limitation of capacity on major routes.

To summarize:

- The new traffic forecasting method is a suitable approach to utilize the forecasting of BC Ferries traffic.
- BC Ferries project minor growth in traffic in PT5 that is influenced by a projected slowdown in the growth of the economy.
- Price elasticity of demand relationships appear to be reasonable.
- There are no major concerns with BC Ferries' demand forecasting approach. On an overall basis, BC Ferries' demand forecasting methodology and its associated methodologies are considered appropriate for purposes of price cap rate setting.

3. Performance Reviews in PT4

The commissioner is authorized under section 46.1 of the Act to conduct performance reviews of BC Ferries' operations. The purpose of the performance reviews is to hold BC Ferries accountable for good management practices and to identify opportunities for improvement and cost savings. The commissioner has conducted the following performance reviews during PT4:

1) Review of BC Ferries' Annual Customer Satisfaction Survey (CST)

This survey, which is a requirement under the CFSC, has been conducted annually by BC Ferries since 2003. The methodology for the survey and the routes surveyed had not materially changed. As a result of the performance review all routes are now to be surveyed. The review was conducted by MNP LLP, who concluded that:

“In the years since its 2003 inception, the survey that is at the core of the CST has collected consistent and valid data through an intercept methodology. This has provided BC Ferries and the BC Ferries Commissioner with 13 years of high-level benchmark data on the customer experience across the full range of

activities in respect of which a customer is engaged with BC Ferries. While the current CST survey is somewhat representative in its findings and has been useful in the past, the time is appropriate for BC Ferries to address aspects of customer satisfaction in an integrated, outcome-driven and comprehensive manner that is conducive to results-oriented management along with governance. The CST Survey approach should be revised or augmented with other measurement tools (information sources) to reasonably cover all routes and all customer segments.”

2) Review of BC Ferries’ Procurement Policies and Practices

This review was conducted by Ernst and Young LLP, who concluded that:

“BC Ferries has solid procurement policies and practices in place, with good practices identified in numerous areas and in their ongoing continuous improvement activities. BC Ferries has a strong capital planning process that supports proactive planning for related procurement activities to enable alignment of strategic objectives. Additionally, a well-defined policy and governance framework supports strong consistency, risk management and control within procurement processes, and procurement and supply chain performance is regularly measured and reported. Contract mechanisms and vendor management enable BC Ferries to monitor and enforce supplier accountability, further supporting the achievement of value-for-money.”

The above conclusion gives the commissioner confidence that, given BC Ferries’ significant capital and operating expense profile, their procurement policies and procedures are sufficiently robust to deliver value for money for ferry users and taxpayers.

3) Price Cap Compliance

PwC conducted a performance review of BC Ferries’ price cap compliance with PT4 price caps. A link to their report is included in Appendix C. The report concludes that the company has been in compliance with price caps to date over PT4.

4) Drop Trailer Compliance

PwC conducted a performance review of BC Ferries’ drop trailer compliance with commissioner’s Order 16-01. A link to their report is included in Appendix D. The report concludes that the company has been in compliance

with the commissioner's Order regarding its drop trailer business.

4. Public Comments

A total of 8 written comments were received by the commissioner, in the period between September 28, 2018 and February 8, 2019. The commissioner reviewed the comments.

The comments pertain mostly to existing service levels:

- Overloaded sailings on Route 22 during peak season.
- Kwuna Route 26 scheduling and reduction in service.
- Service delays and long wait times.
- Expensive prices during holiday season.
- Lack of accommodation and support from staff for elderly and disabled.
- Suggestion to eliminate alcohol served onboard Route 10 (Port Hardy – Prince Rupert).

5. Determinations for Price Caps for the Next Performance Term - PT5

The Act requires the commissioner to set price caps that allows the ferry operator to earn a “return sufficient to enable the ferry operator to (i) meet its debt obligations, and (ii) maintain access to borrowing rates that, in the opinion of the commissioner, are reasonable in all of the circumstances;”

Accordingly, the preliminary price caps have been determined as follows:

a) Financial Targets

For PT4 the commissioner set the price caps to maintain financial targets for BC Ferries to sustain its access to external financing with favourable credit ratings. The two targets were a debt service coverage ratio (DSCR) of 2.5 or higher, and a debt equity ratio of 82.5% or lower. For PT4, BC Ferries is expected to achieve these targets and the preliminary price caps for PT5 have been set to achieve these targets within a reasonable variance range to the end of the performance term.

b) Operating and Non-controllable Costs

Despite the significant increase in operating and other expenses in PT4, BC Ferries expects to manage increases in its operating and administrative costs during PT5 approximately at the rate of inflation, which for purposes of price cap setting is assumed to be 2% per year. The commissioner has accepted BC Ferries' expectation and projections for PT5 expenses but believes that BC

Ferries must be vigilant and committed to containing operating and administrative expenses, particularly costs for labour overtime and IT costs, at forecasted levels. Other than non-controllable costs, higher operating costs in PT4 should not necessarily be sustained in PT5 given what is essentially a flat traffic forecast for PT5.

The increase in non-controllable costs in PT5 includes the increase in the provincial carbon tax (\$19.8 million over PT4) and the new provincial employer health tax (\$6.1 million over PT4). There is also an increase in Canada Pension Plan rates for employers (\$19.4 million over PT4).

c) Efficiency Target

To provide an incentive for BC Ferries in their efforts to contain or control costs in PT5 an efficiency target of a 1% reduction in annual operating, maintenance and administrative expenses has been incorporated in the setting of the price caps for PT5. By implementing efficiency plans set out by the company in its submission, together with tighter controls on costs such as overtime, and fuel, together with new yield management tools coming to bear, this target is considered reasonable and achievable. The commissioner will require BC Ferries to establish a tracking process and a reporting requirement for this target.

d) Capital Plan

The capital plan for PT5 is accepted for price cap setting purposes. Acceptance does not imply approval. Each project which exceeds the threshold for major capital expenditures, must be brought forward as a section 55 application for approval by the commissioner. The threshold is presently \$50 million for vessels, and \$25 million for terminals and IT projects. The thresholds are set out in commissioner's Order 19-03. It should be noted that the company's Board of Directors has additional, lower thresholds for capital project approvals, which provide an additional level of accountability and scrutiny on such expenditures.

e) Fuel Set Price

Diesel:

BC Ferries forecast diesel prices based on US pricing of crude oil, converted to diesel pricing by applying a refiner margin and translating to Canadian dollars. At the time of this report, the West Texas Intermediate ("WTI") index price for oil (the main index for crude oil) was around the range of \$US55-\$60 per barrel. The WTI prices for PT4 thus far have been in the \$US45-\$73 range. Long-term

forecasts of fuel prices are not always reliable but BC Ferries’ approach of taking the average of the futures curve and several forecasters’ views is reasonable. With the transition to LNG-powered vessels, BC Ferries’ fuel risk profile will be more diversified in PT5.

The commissioner has elected to establish the set price for diesel based on an assumed WTI price of \$US61.88 per barrel starting in the first year of PT5. The WTI price assumption is an average of the futures curve forecast, consensus economics forecast, and reserve evaluators forecasts. The WTI price is forecasted for the duration of PT5 based on these forecasts.

Fiscal Year	FY2021	FY2022	FY2023	FY2024
Average of WTI Commodity Forecasts	61.88	62.68	63.45	63.76

Assuming a refiner margin of \$CAN0.327 /litre, that barrel price translates to a fuel set price of \$CAN1.03 /litre in the first year of PT5, after taxes are included.

LNG:

At the time of this report, the main US-based Henry Hub (“HH”) natural gas index prices have ranged from \$US1.15 to \$US4.65 /MMBtu¹. Similar to diesel, BC Ferries takes an average of futures curve and forecaster views, which is a reasonable approach. The fuel deferral mechanism is also applicable to LNG and can be depended on to make adjustments over time.

For purposes of determining the preliminary price caps for PT5, the commissioner has elected to establish the set price for LNG based on an assumed Henry Hub price of \$US3.01 per MMBtu starting in the first year of PT5. The HH price is forecasted for the duration of PT5 based on futures curve and reserve evaluators’ forecasts.

Fiscal Year	FY2021	FY2022	FY2023	FY2024
Average of HH Commodity Forecasts	3.02	3.09	3.16	3.24

Assuming a spread of \$CAN 0.044 /DLE², the MMBtu price translates to a fuel set price of \$CAN 0.469 /DLE after taxes are included.

The diesel refiner margins and natural gas spreads are also impacted by the

¹ 1,000,000 British thermal unit

² Diesel litre equivalent

US/CA dollar exchange rate. The foreign exchange volatility of the US/CA dollar is impacted by global trade tensions, oil prices, and interest rates. For purposes of the preliminary price cap determination, the commissioner has accepted the exchange rate assumptions used by BC Ferries in developing fuel price projections.

f) Fuel Deferral Mechanism for PT5

The fuel deferral mechanism currently in place for PT4 will continue through PT5 in accordance with Order 15-03A. Under this Order the deferral account was required to be brought to a zero balance at least once during PT4, which has been accomplished. This condition will be carried on in PT5 as well. The trigger for a fuel surcharge will remain at 2% of total revenue for each year through PT5. The trigger for a fuel rebate will be set at 4% for the first 2 years of PT5, and revert to 3rd for the 3rd year and 2% for the final year.

g) Provincial Transportation Service Fees

For PT5 preliminary price cap setting purposes, the commissioner has been advised that the service fees provided by Province will include:

- the service fees committed by the Province for the last year of PT4;
- the Province's contribution towards the fare reductions;
- the restoration of the full seniors' discount in fiscal 2019 and 2020 and will remain constant at that these levels for the duration of PT5.

Any adjustment up or down from those assumed levels will be addressed in the final price cap decision in September of 2019. The commissioner is assuming that BC Ferries and the Province will agree to continue with the amalgamation of all route groups into one route group for purposes of price cap regulation.

h) Ancillary Revenues

Ancillary revenues from non-regulated business activities are a key contributor to keeping fares lower than would otherwise be the case. Revenue from food service, parking, gift shops, terminal services, drop trailer hostling and parking, BC Ferries Vacations and others contribute to the company's bottom line. The commissioner does not regulate these activities, but considers them essential to keeping fares low. The price caps are based on the assumption that BC Ferries will continue its efforts to maximize ancillary revenues from existing and new sources over time. The projections provided in the submission have been accepted for price cap setting purposes.

i) Price Cap Index

The price cap index is used by the commissioner to oversee compliance with the price caps during the performance term. For each performance term the price cap index is reset to 100. The index will again be reset to 100 at the beginning of PT5 by way of a separate Order at that time.

6. Commissioner's Preliminary Price Cap Decision for the Next Performance Term

Based on his determinations under subparagraphs 5(a) to (i) above, the commissioner's preliminary decision regarding price caps for the next performance term provides for increases of 2.3% annually from April 1, 2020 to the end of the next performance term at March 31, 2024.

7. Appendices

- A. [Statutory Framework for Setting Price Caps](#)
- B. [PwC's Assessment of BC Ferries' PT5 Submission](#)
- C. [PwC Report on Price Cap Compliance in PT4](#)
- D. [PwC Report on Drop Trailer Compliance in PT4](#)