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# *Drop Trailer Compliance Review*

*British Columbia  
Ferry Commission*

*March 2019*



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# *Executive Summary*

PricewaterhouseCoopers LLP (“PwC”) was engaged by the B.C. Ferry Commission (the “Commission”) to review British Columbia Ferry Services Inc.’s (“BCFS”) recent drop trailer service operating results in accordance with the Coastal Ferry Act (the “Act”).

PwC was asked to review the information provided by BCFS, and, using determinations found in the Commissioner’s Orders and their professional expertise, provide an assessment of BCFS’ compliance with Act S45.1: Unfair Competitive Advantage Regulation for drop trailer during Performance Term 4 (“PT4”).

Drop trailer compliance during PT4 was determined based on an assessment of BCFS’ supporting analysis used to calculate operating margins. The analysis provided was for an interim PT4 period from July 1, 2018 to September 30, 2018. The analysis is consistent with the Commission’s Orders. In addition, key inputs for historical revenues, rebates, and operating expenses could be accurately traced back to the general ledger and accounting systems for the selected sample quarterly period ending September 30, 2018. BCFS appears to be in full compliance with the Commissioner’s orders for drop trailer services for the portion of the PT4 period from April 1, 2016 to September 30, 2018.

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# *Notice to Reader*

This Report is issued by PwC for the exclusive use of the BC Ferry Commission in connection with its review of British Columbia Ferry Services Inc.'s ("BCFS") drop trailer service under Section 45.1(1) of the Coastal Ferry Act (the "Act").

Our work did not constitute an audit conducted in accordance with generally accepted auditing standards, an examination of internal controls nor attestation nor review services in accordance with the standards established by the Chartered Professional Accountants of Canada. Accordingly, we do not express an opinion nor any other form of assurance on the financial or other information, or operating internal controls, of the BCFS drop trailer service.

PwC did not examine, compile or apply agreed upon procedures to satisfy the requirements of the Chartered Professional Accountants of Canada to the financial information used in this Report and we therefore are unable to express assurances on such information except where expressly stated in the Report to form part of the scope of our work.

Further this Report does not constitute an opinion as to legal matters, including the interpretation of the Act or any other similar matters.

Our work is based primarily on the information and assumptions listed in the body of this Report. We did not perform checking or verification procedures except where expressly stated in the Report to form part of the scope of our work. Our work and commentary is subject to assumptions, which may change with the benefit of further detailed information. We make no representation regarding the sufficiency of our work and had we been asked to perform additional work, additional matters may have come to our attention that would have been reported to the BC Ferry Commission.

The outputs of the Report are intended to provide the BC Ferry Commission with information to assist in informing their decision making process pertaining to the regulations of BCFS' drop trailer service. PwC accepts no liability in respect of any loss, damage or expense of whatsoever nature caused by any use the reader may choose to make of this Report, or which is otherwise consequent upon the gaining of access to the Report by the reader.

Our Report, including schedules, must be considered in its entirety by the reader. Selecting and relying on specific portions of the analyses, or factors considered by us in isolation may be misleading.

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# *Background*

In April 2003, the Province of British Columbia (the “Province”) established the B.C. Ferry Authority, an independent corporation that holds the single issued voting share of British Columbia Ferry Services Inc. (“BC Ferries”, “BCFS” or the “Company”).

The Office of the BC Ferries Commissioner (the “Commission or the Commissioner”) is a regulatory agency operating under the Coastal Ferry Act (British Columbia) (the “Act”). The Commission’s mandate includes regulation of price caps for ferry fares, monitoring the compliance of BCFS to the Coastal Ferry Services Contract (“CFSC”), and approvals of major capital expenditures.

BCFS commenced drop trailer services in October 2009 enabling commercial customers to drop off their semitrailers full of goods at one of the BCFS terminals and to pick up their trailers on the other side of the route. In the drop trailer service, hostling units haul the trailers onto vessels. This service is in contrast to the live trailer service where truckers drive directly onto vessels.

The Act was amended in June 2010 whereby the Commission became responsible for regulating unfair competitive advantage, initiating searches for Alternative Service Providers, monitoring of the customer complaints process and for considering the interests of ferry users in the regulation of ferry operators.

More specifically, Section 45.1 of the Act required the Commission to determine whether BC Ferries was operating a competitive service and, if so, determine whether the competitive service was:

1. pricing below direct costs and an appropriate proportion of indirect costs associated with providing the service; and
2. at an unfair competitive advantage, including but not limited to:
  - a. the use of, access to, or ownership of vessels or terminals that are or had been owned by the government or a government body within the meaning of the Financial Administration Act;
  - b. any tax exemption; and
  - c. any subsidy.

If the Commission found that BCFS’ drop trailer service was a competitive service and is priced below cost, or had an unfair competitive advantage over other companies’ drop trailer services, it must order BC Ferries either to (a) handle drop trailers through an alternative ferry service provider, or (b) charge a Commission-specified minimum tariff for them.

On July 19, 2010 the Commission found (in Memorandum 37) that the drop trailer service was a competitive service as defined in the Section 45.1 of the Act. The drop trailer service offered by BC Ferries on its major route group was substantially similar to services being provided by Seaspan Coastal Intermodal Company (“Seaspan”) and Van Isle Barge Services Limited (“Van Isle”). These companies provided drop trailer services across Georgia Strait between terminals near to those of BC Ferries. They were sufficiently near BC Ferries’ terminals that the Commission considered that BC Ferries’ drop trailer service to be in competition with Seaspan and Van Isle. Accordingly the Commission found that BC Ferries’ drop trailer service on its major routes across Georgia Strait was a competitive service as defined in Section 45.1 of the Act. The findings in Memorandum 37 triggered a requirement for the Commission to make certain determinations under Section 45.1 of the Act. The Commission subsequently began a review of BCFS’ drop trailer service as it related to Section 45.1 of the Act.

During 2015, BCFS’ drop trailer service reached the volume specified in Order 11-01. The Commission on December 2, 2015, invited interested parties to submit comments on BCFS’ drop trailer services. Submissions were received from eight interested parties, including BCFS and Seaspan. The Commission took all comments into consideration in making certain determinations under Section 45.1 of the Act.

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On September 6, 2016, the Commissioner issued order 16-01. This Order supersedes Order 11-01, Confidential Order 11-01A and Memorandum 42. The Order determined, given that BC Ferries is not pricing its drop trailer service below costs, and given that BC Ferries does not have any unfair competitive advantages in providing its drop trailer service, the Commissioner is not authorized by the Act to set a minimum tariff for the drop trailer service. It was unnecessary for the Commissioner to make a determination regarding whether he could consider the interests of ferry users, taxpayers and the financial sustainability of ferry operators in making this determination under section 45.1. 6. To ensure BC Ferries does not price its drop trailer service below cost in future, BC Ferries is required to submit quarterly reports to the Commissioner, on a four quarter rolling basis, of revenues, direct costs and the appropriate proportion of indirect costs associated with its drop trailer service, as determined by the Commissioner (the “Drop Trailer Quarterly Reports”). The Commissioner will undertake independent audits of the Drop Trailer Quarterly Reports from time to time, at the Commissioner’s discretion.

# Scope and Approach

PwC was asked to review the information provided by BCFS, and using determinations found in the Commissioner’s Orders and their professional expertise, provide an assessment of BCFS’ drop trailer compliance. Our assessment was conducted in accordance with Order 16-01.

The focus of PwC’s assessment was on BCFS’ drop trailer operating margin calculations and accuracy of their data sources. The scope and approach of our work included:

Scope	Approach
1. Compliance review of BCFS’ quarterly filing spreadsheets and supporting data.	<ul style="list-style-type: none"> <li>● Examined the structure of Excel spreadsheets and key formulas to verify that inputs and calculations were consistent with the September 2016 Drop Trailer Decision</li> <li>● For 1 sample quarter ( Q2 F2019 ending Sept 30 2018), reconciled contract details, pricing and volumes to BCFS’ general ledger for all customers</li> <li>● For 2 sample quarters ( Q2 F2019 and Q2 F2018), randomly selected two customers and traced invoice details to BCFS’ general ledger</li> <li>● Reviewed the spreadsheets for errors and formula consistency using a spreadsheet analytics tool</li> <li>● Compared the average tariff per vessel-foot for each quarter from Q1 F2017 to Q2 F2019 against the average costs.</li> <li>● Met with BCFS representatives in person to discuss the drop trailer service operating results</li> <li>● Walked through the data flow between BCFS’ general ledger, customer contracts and drop trailer working papers</li> </ul>
2. Provide analysis and decision support in relation to the drop trailer service	<ul style="list-style-type: none"> <li>● Reviewed the financial information of the drop trailer service</li> <li>● Met with BCFS representatives in person to discuss the drop trailer service</li> </ul>
3. Clarification of any issues observed	<ul style="list-style-type: none"> <li>● Developed questions and information requests for BCFS</li> <li>● Reviewed responses to questions from BCFS</li> <li>● Reviewed information received from BCFS</li> </ul>
4. Draft and finalization of the report	<ul style="list-style-type: none"> <li>● Discussed the drop trailer compliance results with the Commissioner</li> <li>● Discussed our analysis of the drop trailer service with the Commissioner</li> <li>● Debriefed a draft version of this report with the Commissioner</li> </ul>

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# *Overview of the Drop Trailer Service*

BCFS' drop trailer business is a service offered by the Company which complements existing services provided to its commercial trailer business. The drop trailer business enables commercial customers to drop off their trailers full of goods at one of the designated BCFS terminals and to pick up their trailers on the other side of the route. BCFS has storage areas at its three terminals servicing Route 1 and 30. It moves trailers back and forth from vessels with the use of hostling units. In contrast, in its traditional "live" trailer business, truckers drive on and off vessels in their trailer vehicles.

The advantages for shippers using the drop trailer service include the cost savings associated with eliminating the need to have truck drivers travel on vessels and the efficiencies that are gained from scheduling deliveries and other related aspects of supply chain management.

## **Competitors**

Seaspan Ferries Corporation is BCFS' only competitor in the drop trailer market after it acquired the only other major competitor in the market, Van Isle Barge Services Ltd. ("VIBS") in 2011. Seaspan Ferries provides a daily, scheduled truck and trailer ferry service between terminals on the mainland at Tilbury in Delta and Surrey, and on Vancouver Island at downtown Nanaimo, Duke Point Nanaimo, and Victoria (Swartz Bay). Seaspan Ferries is part of the Washington Companies, a private company that also owns Seaspan Marine, Vancouver Drydock, Vancouver Shipyards, Victoria Shipyards, and Marine Petrobulk.

## **Types of Services**

BC Ferries' drop trailer service is offered year round. The drop trailer service uses the same space allocated to the broader Commercial Reservation Pool. However, a "live" customer can book and hold a reservation for a specific sailing, and it can do so at no additional charge. By contrast, BCFS decides which sailings will carry drop trailers and, if so, how many it will carry. BCFS also decides which specific drop trailers are to be put on a certain sailings in order to maximize efficiencies while still maintaining the commitment to a customer of getting a trailer to its destination at or by a specific time.

There are two primary product offerings:

- The "At" service requires the customer to specify the desired delivery time for their goods. It provides certainty of delivery within two sailings.
- The "By" service in contrast is less time sensitive – it provides certainty of delivery within four sailings.

Customers may also be granted the privilege of dropping their trailers off for an appointment time of one hour prior to a mutually agreed upon sailing in order to maximize operational efficiencies. However, this does not guarantee that the trailers will be shipped on the next sailing. Only "live" customers can book and hold a reservation for a specific sailing.



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# *Regulatory Framework*

## *Pricing Drop Trailer Service Above Cost Compliance (Order 16-01)*

The 2016 Drop Trailer Decision set the compliance standards in fiscal 2017. This was determined through determinations that include the following:

1. BC Ferries' drop trailer service on its major routes remains a "competitive service", as defined in the Act.
2. BC Ferries has not, and is not currently, pricing its competitive drop trailer service below its direct costs and the appropriate proportion of indirect costs associated with providing that service.
  - a. An appropriate proportion of indirect costs associated with providing BC Ferries' drop trailer service must be included in calculating BC Ferries costs associated with providing that service, including an allocation of reasonable corporate and route overhead.
  - b. The overhead allocation BC Ferries currently applies to its route statements linked to its general ledger system in support of its audited financial statements allocates an appropriate portion of indirect costs to BC Ferries' drop trailer services.
  - c. Return on equity is not to be included in a calculation of BC Ferries' direct and indirect costs associated with its drop trailer service.
  - d. In calculating direct and indirect costs, actual costs and volumes are to be used; a calculation based on horizon volumes is no longer appropriate.
3. BC Ferries does not have an unfair competitive advantage in providing its drop trailer service. The Commissioner examined five potential sources of competitive advantage, and found that none currently provides BC Ferries with an unfair competitive advantage in providing its drop trailer service.
4. Given that BC Ferries is not pricing its drop trailer service below costs, and given that BC Ferries does not have an unfair competitive advantage in providing its drop trailer service, the Commissioner is not authorized by the Act to set a minimum average allowable tariff for the drop trailer service.
5. BC Ferries will be required to submit quarterly reports to the Commissioner, on a four quarter rolling basis, of revenues, direct costs and the appropriate proportion of indirect costs associated with its drop trailer service. The Commissioner will undertake independent audits of the quarterly reports from time to time, at the Commissioner's discretion.
6. BC Ferries' commercially sensitive financial information, including that provided to the Commissioner in the Drop Trailer Quarterly Reports, should be held in confidence to protect its commercial interests. In the Commissioner's view, disclosure of such information could reasonably be expected to harm BC Ferries' financial interests.

# Pricing Above Service Cost Compliance

PwC has reviewed the information provided by BCFS, and using the determinations found in the Commissioner’s Orders and their professional expertise, provided an assessment of BCFS’ compliance with pricing drop trailer service above service costs. Our assessment was conducted in accordance with the 2016 Drop Trailer Decision.

## Compliance Review Findings

The specific components included as direct costs and an appropriate proportion of indirect costs are:

Procedure	Observations
<p>Examined the structure of Excel spreadsheets and key formulas to verify that inputs and calculations were consistent with the 2016 Drop Trailer Decision</p>	<ul style="list-style-type: none"> <li>BCFS’ supporting analysis has included terminal fees (hostling) and other charges (i.e. parking) in the total revenue from drop trailer in accordance with Memorandum 42</li> <li>BCFS’ supporting analysis has (correctly) included hostler footage in the total number of drop trailer service feet in accordance with Memorandum 42</li> <li>BCFS’ supporting analysis has correctly calculated the average tariff per foot figure used to verify compliance with requirements for pricing above cost</li> <li>BCFS’ supporting analysis starts in fiscal 2017. This rate is indexed annually by the British Columbia consumer price index (“CPI”)</li> <li>BCFS’ methodology for calculating CPI and indexation appear to be implemented correctly in the supporting analysis</li> </ul>
<p>For a sample quarters (ending September 30, 2017, ending September 30, 2018), randomly selected 2 customers and traced contract details, pricing and volumes to BCFS’ general ledger</p>	<ul style="list-style-type: none"> <li>PwC did not note any discrepancies between customers’ contract terms, pricing/volume inputs on supporting analysis and BCFS’ general ledger</li> </ul>
<p>Reviewed the spreadsheets for errors and formula consistency using a spreadsheet analytics tool</p>	<ul style="list-style-type: none"> <li>PwC found no errors in the spreadsheet and any minor errors/inconsistencies had no impact on compliance</li> </ul>
<p>Compared the average tariff per vessel-foot for each quarter from Q1 F2017 to Q4 F2018 against the average cost</p>	<ul style="list-style-type: none"> <li>The average tariff per vessel-foot was above the average cost in all quarterly instances</li> <li>Tariff rates per vessel-foot for individual customers are also above the attributable average cost.</li> </ul>

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# *Analysis of Drop Trailer Costs*

## *Comparison to PT4 Submission*

### **Direct Operating Costs**

- Direct operating expenses are relatively stable year over year, and show a seasonal pattern with costs starting low in the beginning of the fiscal year and rising each quarter.
- Management salaries are allocated based on estimated time spent on drop trailer management and are in proportion to drop trailer service revenue in relation to overall commercial traffic revenue.

### **Direct Asset costs - Amortization and Net Financing Costs**

- Direct asset expenses have increased slightly over the prior fiscal year. The increase is due to higher depreciation and amortization expenses. Net financing costs remain flat.

### **Route Overhead Allocation**

- The total capacity provided on Route 1 and 30 has decreased slightly while total route overhead charge has increased slightly. The overall result is an increase in the route overhead allocation per foot.
- In F2017, BC Ferries revised the calculation of an AEQ (automobile equivalent) from 5.34 metres to 6.1 metres to more accurately reflect actual vehicle sizes. Dividing the capacity of the Company's vessels in lane metres by the new 6.1M standard resulted in a reduced AEQ capacity for the vessels (including those vessels operating on the major routes). This impacted capacity-related calculations, including the Route 1 and 30 annual capacity in feet which is required to determine the "Route Overhead per Foot Allocation".

### **Total Cost per foot**

- This value is calculated as the sum of the above cost categories. Total cost per foot is comparable to the previous fiscal year.

## *Summary of PT5 Analysis*

No major issues were identified in the assessment. Minor benefit costs related to management salaries were missed in the first two quarters of F2019 and not included in direct operating costs. With respect to the allocation of net financing costs, the allocation assumes capital assets are 100% financed by bond debt. A calculation allocation based on the weighted-average cost of capital (WACC) is considered a more appropriate allocation method. The impact of these two adjustments is very minor on a cost per foot basis and does not change any conclusion.

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# *Conclusion*

PwC has reviewed BCFS' compliance with the drop trailer pricing above service cost requirements in accordance with the 2016 Drop Trailer Decision. BCFS is required to ensure that the average revenue per vessel-foot occupied (land feet occupied by drop trailers and their hostler units) for the quarter, shall not be less than the average cost. PwC did not observe any instances where the average revenue per vessel-foot for the quarter was below the average cost. The calculations and supporting data used by BCFS to report the quarterly total revenue from its drop trailer tariff on the major routes and the number of vessel-feet occupied (land feet occupied by drop trailers and their hostler units) were appropriate. Based on our observations, BCFS appears to be fully compliant with the drop trailer average cost requirements of Order 11-01 and Confidential Order 11-01A and does not price its drop trailer service below its direct cost and an appropriate proportion of indirect costs.