

Date May 24, 2006

To Martin L. Crilly, BC Ferry Commissioner
Alan Eastwood, Deputy Commissioner

From Rob Clarke, EVP Finance and CFO

Subject Fiscal Year 2004/05 Annual Report to the Commissioner

Route financial results for the fiscal year ended March 31, 2004 require restatement in order to adjust the allocation of certain costs to individual routes and provide consistency of cost allocation with the year ended March 31, 2005.

The March 31, 2004 route financial results require restatement for the following items:

1. Correction of vehicle throughput statistics used in cost allocations and
2. Allocation of vessel refit and maintenance costs on year to date rather than monthly costs and vessel sailing hours.

These items are described below:

1. In preparing route financial results, proportionate vehicle throughput by terminal and by route is the statistic used by BCF for allocating terminal costs, including amortization and debt costs of terminal assets and certain corporate and regional overheads. BCF has discovered that the vehicle throughput statistics used in the preparation of the route financial results for the fiscal year ended March 31, 2004 were not correct. Route financial results for the year ended March 31, 2004 have been restated to reflect allocation of costs using corrected proportionate vehicle throughput statistics.

The cause of the incorrect vehicle throughput statistics was found to be a data transfer from one system to another system incorrectly including additional information in the vehicle throughput category. This resulted in a misstatement of the proportion of the number of vehicles by route served by a particular terminal and caused the cost allocations to be similarly misstated.

2. During the year ended March 31, 2004, certain vessel refit and maintenance costs were allocated to routes monthly, based on that vessel's sailing hours. The refit and maintenance costs included in the published route statements for that year therefore included allocations of vessel refit and maintenance costs which were the sum of the monthly allocations. During the year ended March 31, 2005, BCF reviewed this approach and determined that it would improve the reasonableness of vessel refit and

maintenance allocations to amend this process to recalculate allocations on a year to date basis. In order to enhance comparability of year over year results by route, the route results for the year ended March 31, 2004 should be restated to reflect this change. Attached as Appendix A are the original and restated route financial results (net income or loss) for the year end March 31, 2004 reflecting the revised allocations. It should be noted that total expenditures and net income reported were correct and do not change.

On February 1, 2006, the Commissioner's Office issued a number of questions with respect to the route financial results for the year ended March 31, 2005 (with comparatives for the prior year). Answers to those questions incorporating the revised prior year route financial results are currently being prepared and will be forthcoming shortly. We apologize for the delay in responding.

APPENDIX A

**Route Statement Results 2003-04
Net Income by Route**

	<u>Original</u>	<u>Revised</u>	<u>Difference</u>
01-Tsawwassen - Swartz Bay	(27,014,785)	(25,876,304)	1,138,481
02-Horseshoe Bay - Nanaimo	(15,453,821)	(13,476,685)	1,977,136
30-Nanaimo - Tsawwassen	10,629,202	10,657,882	28,680
Major Routes	<u>(31,839,404)</u>	<u>(28,695,107)</u>	<u>3,144,297</u>
04-Swartz Bay - Fulford Harbour	(140,176)	(762,152)	(621,976)
05-Swartz Bay - Gulf Islands	495,732	21,978	(473,755)
06-Vesuvius Bay - Crofton	(261,480)	(255,845)	5,635
07-Salterty Bay - Earls Cove	(304,246)	(252,676)	51,570
08-Horseshoe Bay - Snug Cove	167,531	(288,209)	(455,739)
09-Tsawwassen - Gulf Islands	1,690,846	1,630,286	(60,560)
17-Comox - Powell River	(35,868)	(304,808)	(268,939)
18-Texada Island - Powell River	726,662	543,065	(183,597)
19-Gabriola Island - Nanaimo Harbour	(1,239,606)	(1,233,205)	6,401
20-Thetis Island - Kuper Island - Chemainus	243,678	244,945	1,267
21-Denman Island - Buckley Bay	(546,163)	(519,821)	26,343
22-Hornby Island - Denman Island	(1,300,484)	(1,223,978)	76,506
23-Quadra Island - Campbell River	(574,622)	(500,051)	74,571
24-Cortes Island - Quadra Island	(152,223)	(141,649)	10,574
25-Alert Bay - Sointula - Port McNeill	(543,249)	(382,970)	160,279
26-Skidegate - Alliford Bay	(850,914)	(905,780)	(54,865)
Minor Routes	<u>(2,624,581)</u>	<u>(4,330,868)</u>	<u>(1,706,286)</u>
10-Bear Cove - Bella Bella - Prince Rupert	3,369,023	3,388,665	19,641
11-Prince Rupert - Skidegate	(1,359,736)	(1,115,764)	243,972
Northern Routes	<u>2,009,287</u>	<u>2,272,901</u>	<u>263,613</u>
03-Horseshoe Bay - Langdale	2,965,944	2,187,618	(778,326)
12-Mill Bay - Brentwood	214,459	204,373	(10,087)
13-Langdale - Gambier Island - Keats Island	526,279	(396,332)	(922,612)
40-Bear Cove - Mid-Coast	660,104	669,505	9,401
Unregulated Routes	102,851	102,851	0
Corporate Total	<u>(27,985,060)</u>	<u>(27,985,060)</u>	<u>0</u>

RESPONSE TO BC FERRY COMMISSION QUESTIONS

Question 1

What are the reasons for re-classifying some revenues and expenses in the 2004/05 Route Report versus the Annual Audited financial statements? There is an apparent difference in the treatment of Ancillary Revenue, Total Operating Expenses, Amortization and Interest Expense.

ANSWER

The Route Report presents the results of BC Ferries subsidiary companies differently than the annual report. On the Route Report, the amounts shown for Ancillary Revenue, Amortization, Interest Expense and Loss on Disposal of Capital Assets are the unconsolidated amounts. Items related to BC Ferries subsidiary companies are reported as Operating Expenses on the Route Report. The (Loss) Gain on Foreign Exchange is also reported as Operating Expense on the Route Report.

Question 2

Why were the amounts for Operations, Maintenance and Administration expenses re-stated for the 2003/04 fiscal year in the 2004/05 Annual Audited financial statements? What was the basis for the re-statement? After the re-classification of 2003/04 expenses there was no re-statement of individual route operating expenses in the 2004/05 Report to the Commissioner. Why were the individual route finances not affected by the re-classification of expenses? Is a consistent method of classifying expenses going to be used for financial reporting for the balance of the first term of the Coastal Ferry Services Contract?

ANSWER

In fiscal year 2003/04, we began to classify our expenses into Operations, Maintenance and Administration (OM&A). However, it was noted that a complete review of the expenses classification was necessary. A detailed review of how operating expenses should be classified between the categories OM&A was done in fiscal year 2004/05. The amounts for Operations, Maintenance and Administration expenses for the 2003/04 fiscal year were restated in the 2004/05 Annual Audited financial statements to provide prior year comparative figures, conforming to the results of this review.

In conducting the expense classification, we found guidance in another regulated industry, the natural gas industry. The British Columbia Utilities Commission (BCUC) regulates this industry in the Province of BC and has issued by Order a document entitled "Uniform System of Accounts Prescribed for Gas Utilities". The primary purpose of this document is to ensure consistency of application and to provide comparability of results between gas utilities. The BCUC issued document provides definitions of each of "operations expense", "maintenance expense" and "administrative expense". We borrowed heavily from this guidance provided by the BCUC in classifying expenses.

Total actual expenses, and therefore the individual route expenses, were not affected by this re-classification. Nor did it change any allocation factors. The only change was the category “classification” among operations, maintenance and administration expenses.

It is expected that this method of classifying expenses will be consistent for the balance of the first term and beyond.

Question 3

*The table on page 17 of the Report to the Commissioner classifies cancellations as to whether or not the cancellations are allowed by Schedule A,2(a) of the Coastal Ferry Services Contract. The shaded section titled “Cancels Not Allowed for in Schedule A,2(a) of the Coastal Ferry Services Contract” totals 60 sailings which have a service fee value of about \$53,000 (see attached **Attachment 2**). The reported service fees in the Report to the Commissioner are about \$17,000 less than the maximum allowable service fees. How were the reduction in service fees calculated on a route by route basis, and how do the reduced service fees relate to “Cancels Not Allowed for in Schedule A,2(a) of the Coastal Ferry Services Contract”?*

ANSWER

Attached as Appendix B is a reconciliation of the total service fees reported in fiscal year 2005. They consist of the calculated maximum ferry service fee less service fee reductions for the last quarter of the previous year and the first three quarters of fiscal 2005. The information for the final quarter of each year is not available in time to be recorded in the fiscal year when it occurred so is recorded at the beginning of the following fiscal year.

The second part of this question is “How were the reduction in service fees calculated on a route by route basis and how do the reduced service fees relate to “Cancels Not Allowed for in Schedule A,2(a) of the Coastal Ferry Services Contract”. Not all "Cancels Not Allowed for" carry a service fee reduction. The determination of whether a service fee reduction is required is actually the “the smaller of” 2 individual calculations as per Schedule “B” of the Coastal Ferry Services Contract. Attachment 2 only considers the first calculation. The second calculation basically is an elimination of the service fee reduction if the total traffic carried in the current year was higher than the previous year and could also be a reduction of the amount in the first calculation if the traffic was somewhat lower. Detailed calculations are available upon request.

Question 4

When individual route finances are compared to the vessel refit schedule, a large swing in expenses year-over-year can usually be explained by the timing or extent of the refits for vessels on a route. Please provide explanations for the large change in costs in 2004/05 for the following routes, which do not appear to be explained by the timing of vessel refits:

- *Route 4 (Fulford – Swartz Bay) had a significant improvement in Net Route Earnings in 2005 (\$836,000), partially due to a 5% increase in revenue. There was also a decrease in operating costs of \$476,000 in 2005 despite the fact the Skeena Queen did not go into refit in 2004 or 2005.*

- *Route 20 (Chemainus-Thetis-Kuper) showed an increase in operating costs of \$418,000 in 2005, while the Klitsa had a refit in 2004, not 2005.*
- *Route 24 (Quadra – Cortes) showed a decrease in operating costs of \$426,000 in 2005 while there was a similar amount of refit activity on the Tenaka or Tachek in each year.*

ANSWER

Answer Route 4: The revised increase in net earnings is \$215,000. This is due to an increase of \$238,000 in revenue, offset by an increase of \$45,000 in the cost of capital.

Answer Route 20: The revised increase in operating costs of \$417,000 is due to the allocation of refit costs for the Kahloke which did have a refit in 2005. The Kahloke is routinely used to provide winter service on route 20 as it can not be used on route 22 in the winter.

Answer Route 24: The revised decrease in operating costs of \$437,000. This is driven by the Tenaka refit which occurred in fiscal 2004, the Tachek was not used on route 24 in either year so there is no allocation of costs from the refit.

Question 5

The table on page 19 of the Report to the Commissioner indicates that Route 10 (Port Hardy – Prince Rupert) sailed 2 extra round trips. The Service Notices were examined for the 2004/05 fiscal year and no mention was found about extra unscheduled trips on Route 10. When were the 2 extra round trips performed, and how was the public informed of the trips so that they could reserve passage?

ANSWER

BC Ferries provided an additional Route 11 trip in September 2005 on a lay over Wednesday to facilitate back log of commercial traffic during the shoulder season. Any time there are over 6 drop trailers in the parking lot for the QCI, BC Ferries generally looks to providing additional sailings to clear up back log.

Also, an additional trip was added on route 10 during the All Native Basketball Tournament due to the vessel's inability to cross Hecate straight because of heavy weather. During these times, BC Ferries notifies customers by direct phoning of reserved and known travelers/shippers.

Question 6

Route 1 (Swartz Bay – Tsawwassen) experienced traffic growth (3.7% for vehicles and 4.9% for passengers) and 7.3% revenue growth in 2004/05 compared to 2003/04, but a 10.5% increase in expenses resulted in reduced net earnings for the route. Please explain why expenses grew more than revenues in 2004/05 compared to 2003/04.

ANSWER

The revised increase in operating expenses of 9.5% (\$9.7 million) is primarily due to the following:

- \$4.7 million increase in refit and maintenance
- \$2.2 million increase in property taxes
- \$1.7 million increase in information technology system support costs
- \$0.7 million write off of obsolete inventory
- \$0.4 million one time insurance credit received in 2003/04
- \$0.2 million re: Corporate Capital Tax (re)assessment

The \$4.7 million increase in refit and maintenance costs (from \$9.4 million to \$14.1 million) is mainly due to a \$6.1 million increase in expenditures on the Spirit of British Columbia which underwent two refits (including one dry docking) in 2004/05, partially offset by reduced costs of refits on other vessels (including \$1.5 million reduction on the Spirit of Vancouver Island).

The \$2.2 million increase in property taxes is due to 2005 being the first complete calendar year of the change from paying grants in lieu of taxes to property taxes.

The \$1.7 million increase in information technology system support costs is a result of major information system implementations including Crew Scheduling, Employee Self Service and Corporate Incident Management systems.

British Columbia Ferry Services Inc.
 Ferry Transportation Fee Revenue
 Account #44005
 Coastal Ferry Services Contract
 For the year ended March 31, 2005

Appendix B

Per Appendix 1 of Schedule "B" Ferry Transportation Fee - Table 1 Coastal Ferry Services Contract

Service Fee Reductions (see attached)

Per BCFSI, total of monthly calculations	Reported 2005
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Route #	A Core Round Trips	B FTF per Core Round Trip (\$)	A * B				
3	2,985	1,676.65	5,004,800.25	-	5,150.54	4,999,649.71	5,000
4	2,880	1,753.01	5,048,668.80	-	2,775.61	5,045,893.19	5,046
5	3,456	3,163.09	10,931,639.04	-	1,634.67	10,930,004.37	10,930
6	5,066	284.98	1,443,708.68	-	532.62	1,443,176.06	1,443
7	2,880	3,257.24	9,380,851.20		-	9,380,851.20	9,381
8	5,569	929.35	5,175,550.15	-	2,444.33	5,173,105.82	5,173
9	832	8,268.98	6,879,791.36		-	6,879,791.36	6,880
10	122	43,496.47	5,306,569.34		-	5,306,569.34	5,307
11	191	42,669.37	8,149,849.67		-	8,149,849.67	8,150
12	3,215	443.32	1,425,273.80		-	1,425,273.80	1,425
13	4,142	127.75	529,140.50		-	529,140.50	529
17	1,462	4,301.63	6,288,983.06	-	555.05	6,288,428.01	6,289
18	3,648	889.66	3,245,479.68	-	889.66	3,244,590.02	3,245
19	5,732	444.67	2,548,848.44		-	2,548,848.44	2,549
20	4,013	618.87	2,483,525.31		-	2,483,525.31	2,484
21	6,149	438.05	2,693,569.45		-	2,693,569.45	2,694
22	4,506	458.16	2,064,468.96		-	2,064,468.96	2,064
23	6,253	462.88	2,894,388.64		-	2,894,388.64	2,894
24	2,134	1,240.36	2,646,928.24	-	3,343.58	2,643,584.66	2,643
25	3,961	799.78	3,167,928.58		-	3,167,928.58	3,167
26	4,378	604.90	2,648,252.20	-	604.90	2,647,647.30	2,648
40	39	48,546.64	1,893,318.96		-	1,893,318.96	1,893
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Total	73,613	164,876	91,851,534.31	-	17,930.96	91,833,603.35	91,834.00