



Background to Commission Memorandum 24A dated July 22, 2008

Fuel Surcharges: Questions and Answers

July 22, 2008

CONTENTS

1. Why fuel surcharges?	2
2. Is BC Ferries absorbing any of the extra cost?	2
3. What is the impact of the carbon tax?	2
4. Why so soon after the last fare increase?	3
5. Is BC Ferries conserving fuel?	3
6. Why no surcharge for the north?	4
7. Has the Commission given up control over fuel surcharges?	4
8. What about public input?	5
9. Why higher surcharges on smaller routes?	5
10. What about hedging?	5
11. Isn't the surcharge just increasing BC Ferries' revenue?	5
12. Percentage or Dollar Surcharge?	6
13. Was support information given to the Commission?	6

1. Why fuel surcharges?

What is the basic reason for fuel surcharges?

As car drivers have seen for gasoline prices, prices for diesel fuel burned by BC Ferries have risen at an extraordinary rate. In fact, until 2006, BC Ferries had a relatively favourable fuel price as a result of a contract signed when fuel prices were low. Under their present contract for diesel fuel the price has escalated even faster than the price of gasoline.

Marine diesel prices for BC Ferries are now much higher than we thought they would be when we set the caps on ferry fares through 2012, and it seems they will stay higher. Fuel is an important cost element for BC Ferries: it accounted for 15% of BC Ferries total costs¹ in fiscal 2007/8.

One of the principles in the Coastal Ferry Act requires us to attend to the financial sustainability of BC Ferries. We judge that BC Ferries cannot be expected to shoulder all of the extraordinary cost without harming its financial sustainability. In particular, BC Ferries has borrowed money in capital markets at preferential rates and, in order to keep a good credit rating they need to make a reasonable profit to satisfy their bond holders and the credit rating agencies.

So these costs, at least in part, simply have to be passed through to customers.

2. Is BC Ferries absorbing any of the extra cost?

You say passed to customers “at least in part”. BC Ferries earned \$38 million last year. So is BC Ferries actually having to cover any of the extra cost?

Yes. They are absorbing 2.5 cents per litre, which is costing the company about \$3 million per year. Its earnings can be expected to fall by this amount this year, below what they would have been if fuel prices had not increased so quickly.

3. What is the impact of the carbon tax?

The Province introduced the carbon tax July 1: does that play a part in the fuel surcharge?

Yes, a relatively small one.

¹Commission estimate based on BC Ferries data. Includes full fuel costs, i.e. includes deferred fuel costs; total costs are total of operating costs (including full fuel costs), amortization and interest expense plus a return on equity.

If we had authorized a fuel surcharge to cover the carbon tax alone (and not the increase in fuel price for all other reasons), we estimate for the three major routes and route 3 (Horseshoe Bay-Langdale) the surcharge would have been about 0.5% for 2008/9, compared to the increases of 10.3% and 9.2% we authorized today. For the minor routes, it would have been 0.8%, compared to the 17.6% we authorized.

4. Why is a fuel surcharge being introduced so soon after the last fare increase?

Fares just went up April 1. Why is this surcharge happening so quickly afterwards? Why wasn't this foreseen in April?

The rise in fuel prices caught us (and many others) by surprise. Last fall we finalized our decision on new fare caps to start April 1 2008. We made that decision before the exceptional rise in marine diesel fuel prices occurred in 2008. For the current fiscal year, our ruling assumed an average price of \$0.78/litre. Now, in July 2008, the revised figure is over 70% higher, at \$1.34/litre.

When making our price cap decision we knew that future fuel prices were highly uncertain. We included an automatic fuel surcharge/rebate mechanism as part of our ruling. It operates to pass through to fare payers the fuel costs/savings (less the 2.5 cents per litre mentioned under question 2 above) due to variations in fuel price from the forecast \$0.78/litre baseline. You will find a technical description of the mechanism at http://www.bcferrycommission.com/BCFCMemo024_copy.pdf

5. Is BC Ferries conserving fuel?

The total cost of fuel can be reduced by burning fewer litres: what is BC Ferries record in fuel conservation?

In December 2005, as part of an earlier fuel surcharge ruling, we set a fuel conservation target for BC Ferries through March 2008—a reduction of 1% in fiscal 2006/07 and a further 1% percent in 2007/08—and required a fuel conservation plan.

In July 2007 BC Ferries proposed an upward-revised target for 2007/08. This recognized the extra fuel necessarily burned due to the urgent replacement of the Queen of the North by a higher-consumption vessel, the Northern Adventure. BC Ferries has reported that it has successfully met the 2% cumulative efficiency target, which was at 2.3 million litres for 2007/8, but from an adjusted baseline.²

You may view BC Ferries fuel conservation plans at http://www.bcferrycommission.com/BCFerriesFuelSavingsPlan_copy.pdf and http://www.bcferrycommission.com/Addendum_to_FuelSavingsPlan_FINAL.pdf

² The revised 2007/8 target for total fuel consumption was 121.7 million litres (up from 113.3 million litres originally).

We have asked BC Ferries to give details of their fuel conservation initiatives over the next two years.

6. Why no surcharge for the north?

Commission Memorandum 24 states that there are no fuel surcharges being imposed on the northern routes. Why not?

BC Ferries has not asked for any surcharge in the north, only for the major, minor and the Horseshoe Bay to Langdale routes.

7. Has the Commission given up control over fuel surcharges?

It seems that, starting in April 2008, the Commission has allowed BC Ferries to introduce or increase a fuel surcharge at any time and for any percentage amount they determine. Is that right and, if so, why?

No, the Commission retains control of the charges that may be made by defining the fuel surcharge adjustment/rebate mechanism.

Between 2005 and 2007 there were three fuel surcharges following BC Ferries applications in response to increases in the price of fuel. The process for dealing with the applications was cumbersome and resulted in fuel surcharges being imposed long after fuel prices had climbed. As part of the Price Cap review process in 2007 and the setting of Price Caps from 2008 to 2012, the commission had issued an instruction to BC Ferries that governs the amount and the timing of fuel surcharges. The instruction (Memorandum #24 dated March 30 2007 and subsequently amended by Memorandum 24A dated July 22 2008) requires BC Ferries to act as follows:

- *the portion of fuel costs resulting from prices higher than the level used by the commission in establishing the allowable fare increases for 2008 and the three following years are collected in a deferral account, (excluding the portion of excess fuel cost borne by BC Ferries);*
- *when these excess fuel costs reach an amount that is equal to 2% of the annual tariff revenue for a route group, fuel surcharges may be introduced (or changed) at a percentage rate that will allow BC Ferries to recover the excess fuel costs over the balance of Performance Term 2;*
- *in response to changes in fuel prices the surcharge may be changed once in each three month period and BC Ferries must give 15 days public notice.*

The Commission will monitor BC Ferries' actions with respect to fuel surcharges to ensure that the amounts placed in the deferral accounts are ONLY the costs resulting from higher than expected fuel prices and that the revenue from the surcharges is used to reduce the outstanding balances of excess costs in the deferral accounts. In the event of significant declines in fuel prices the commission will ensure that, within three months, the surcharges are reduced.

8. What about public input?

Why are fare payers not being asked to contact the Commission with comments within a 30-day period as was the case for previous fuel surcharges?

We set out the proposed mechanism for adjusting fuel surcharge/rebates in performance term two (which began April 1 2008), and published it in our Memorandum 24 dated March 30 2007. This was issued as a companion to our preliminary ruling on fare caps for performance term two, under section 40 of the Coastal Ferry Act. There was then a 90-day period for public comment. The public has had an opportunity to comment on the new mechanism.

We think the new mechanism has advantages. The process used from 2005 to 2008, under section 42 of the Act, was lengthy and caused delays in changing the surcharge, which was inequitable as later fare payers had to make up for the delays in imposing or changing surcharges.

The public can still give views to the commission on fuel surcharges at any time.

9. Why higher surcharges on smaller routes?

Both ferry fares and surcharges have seen much bigger percentage increases on the smaller (“non-major”) routes than for the major routes. Why?

Fare revenue on the smaller routes covers only about 50% of the costs on those routes with the remaining 50% covered by service fees from the province and a small contribution from the federal government. When costs rise by, say, 10% as a result of higher fuel prices, without an increase in the provincial service fee, fares need to rise by 20% to raise the amount of revenue equal to the cost increase.

10. What about hedging?

Does BC Ferries enter into forward contracts for fuel as a method of keeping their fuel costs down?

Yes. They use forward contracts to reduce major fluctuations in their fuel costs. When prices are rising, as in recent experience, they record gains on forward contracts, which reduce their overall fuel costs to the benefit of fare payers.

11. Isn't the surcharge just increasing BC Ferries' revenue?

Are you sure that BC Ferries are not asking for a fuel surcharge as a means of increasing their own revenue. Is it not the case that the earlier they can impose a surcharge the more revenue they will collect?

No. Under the formula set out in the Commission's instruction and following the practice established from 2005 to 2008, BC Ferries can only use the revenue from fuel surcharges to offset the excess fuel costs. None of this surcharge revenue provides an increase to BC Ferries' profits so they have no incentive to introduce a surcharge earlier than required.

12. Percentage or Dollar Surcharge?

How will the fuel surcharge percentages be applied?

The fuel surcharges will be applied as were previous fuel surcharges. There will be a vehicle surcharge and a passenger surcharge in specific dollar amounts on each type of fare, judged so that the total revenue generated equals the percentages given in our Memorandum 24A of July 22 2008.

13. Was support information given to the Commission?

Has BC Ferries provided any data to support the fuel surcharge percentages?

Yes BC Ferries has provided the Commission with data and documentation involving forecasts of deferral account balances, deferral account transfers, and surcharges received by each of the three route groups.

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