



# *Review of the Coastal Ferry Act*

*BC Ferry Commission*

*January 24, 2012*





January 24, 2012

Honourable Blair Lekstrom  
British Columbia Minister of Transportation and Infrastructure  
Province of British Columbia  
Parliament Buildings  
Victoria, BC  
V8V 1X4

Dear Minister,

We hereby submit the report on our review of the Coastal Ferry Act as mandated. Our report includes recommendations for changes to the Act which will better enable the Commissioner to balance the interests of ferry users with the financial sustainability of ferry operators.

**Commissioners,**

Gordon Macatee  
Commissioner

Sheldon Stoilen  
Deputy Commissioner



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# **1 Executive Summary**

## **1.1 Purpose and Scope of the Regulatory Review**

Under Bill 14, the BC Ferry Commission (the “Commission” or the “Commissioner”) has been mandated by the Province of BC to conduct a review (the “Review”) of the Coastal Ferry Act (the “Act”) as it relates to the regulation of ferry operators. The objective of the Review is to recommend to the Minister of Transportation and Infrastructure changes to the Act which will better enable the Commissioner to balance the interests of ferry users with the financial sustainability of ferry operators.

The Commissioner has adopted a holistic approach to conducting the Review. The approach taken has the following main elements:

- A comprehensive public consultation process which included public meetings in coastal communities and written submissions.
- A jurisdictional review of other price cap regulatory models and other ferry systems.
- Options analysis regarding the appropriate balance of the interests of ferry users, interests of taxpayers and the sustainability objectives of the ferry operator while also addressing technical areas of the Act. Potential changes to the Act are viewed according to this balance.

In this report, the Commissioner provides recommendations for changes to the Act and other measures to improve the current regulatory model. The proposed changes and measures are intended to achieve the key objectives of affordability, accountability and financial sustainability of the ferry system.

## **1.2 Organization of the British Columbia Coastal Ferry System**

The Coastal Ferry Act of 2003 created the following:

- The British Columbia Ferry Authority (the “Authority”) as a non-share capital corporation whose purpose is to hold and administer a voting share in BC Ferries, elect directors to the board of directors of BC Ferries and to approve compensation plans for the directors and executives of BC Ferries.
- The British Columbia Ferry Services Inc. (“BC Ferries” or the “operator”) as the operating subsidiary of the Authority providing coastal ferry services. With 35 vessels travelling between 47 terminals, on 25 routes, BC Ferries is one of the largest ferry operators in the world, both in terms of fleet size and passengers carried.
- The British Columbia Ferry Commission, as the provincial regulatory body with statutory responsibilities under the Act for making regulatory decisions affecting ferry operators in the Province.

The Commissioner’s role includes regulating core ferry services that are defined in a Coastal Ferry Services Contract between the ferry operator and the Province, establishing price caps for each performance term and monitoring compliance with the price caps.

## **1.3 BC Ferries’ Performance under the Price Cap System**

Under the existing price cap model, fares have risen in line with increases in operating and capital expenditures and according to a regulated rate of return on equity formula. Fares on the minor routes have risen faster than on the major routes as a result of a prohibition on cross subsidization between route groups, whereby costs are being spread across lower volumes of traffic compared to the major routes. Other performance outcomes over two performance terms include the following:

- farebox recovery and ancillary revenues now cover operating costs and the government subsidies cover the remaining capital and interest charges;
- while cash flows improved significantly over PT1 and PT2, overall earnings did not meet the regulated rate of return in PT2 due to traffic declines and higher fuel costs;
- with fleet renewal, the average age of vessels has improved; and
- affordability issues dampen otherwise high customer satisfaction ratings.

BC Ferries has been the subject of two independent government reviews since its inception as an independent entity. Both the Auditor General and the Office of the Comptroller General have reviewed BC Ferries' operations and governance. Both reports were generally very positive and encouraging of the success of BC Ferries in its transformation from a Crown Corporation to an independent regulated entity. Each report had some recommendations to strengthen the existing governance model and broaden the role of the Commission.

## **1.4 Public Consultation Summary**

The Commissioner has conducted a comprehensive public consultation process which included the following:

- 27 public meetings in coastal communities served by BC Ferries;
- additional meetings with various municipal councils, regional districts on the coast;
- meetings with the Chairs of the Ferry Advisory Committees, the Chairs of Coastal Regional Districts, the Islands Trust Council, First Nation representatives and other interested parties; and
- publishing a number of discussion papers on the Commission's website and inviting public comments thereon.

In total over 40 meetings took place with the Commissioner and Deputy Commissioner appearing before approximately 2,000 people. In addition, the Commissioner received over 200 written submissions from the public and various organizations.

The key themes that emerged from the consultation process are in the following areas:

- Affordability
- Accountability
- Financial sustainability

The oral and written responses received by the Commission are invaluable to the Review. They were wide ranging and divergent in their positions. The Commissioner is able to draw the following conclusions in relation to the Review:

- Current ferry fares and the proposed increases have reached the tipping point of affordability and are imposing significant hardship on ferry dependent communities and the ability of people to visit family members and friends as frequently as they would like.
- The six "guiding principles" in the Act are not perceived to be protecting the interests of users.
- There needs to be greater transparency and accountability for the operation of the ferry system. Governance and oversight of the ferry system is perceived to be weak. There may need to be some strengthening of the oversight role of the Commission as a result, particularly with regards to BC Ferries' operating and capital costs.

- There needs to be a more effective process for consultation and input from ferry users. BC Ferries' operating policies and procedures do not appear to ferry users to be serving their interests as a priority and there is a perceived lack of meaningful consultation on decisions affecting them.

## **1.5 Price Cap Jurisdictional Review**

A jurisdictional review was conducted by PricewaterhouseCoopers LLP ("PwC") under the direction of the Commission. The focus of the review was on the identification of relevant price cap regulation systems, in order to draw lessons applicable to the B.C. ferry system. The scope of the jurisdiction review examined public sector transport regulators and independent regulators in other sectors in the UK, with the following focus:

- How user interests are defined
- How other jurisdictions balance interests of users and financial sustainability
- Best practices regarding the role of the regulator in approving the service provider's capital expenditures
- Identification of how other jurisdictions with comparable regulatory models determine return on equity

The jurisdictional review sought to identify how different regulatory models have addressed the issues identified by the Commission. This is a factual analysis underpinned by: the supporting regulatory legislation, the regulatory determinations made, supporting regulatory analysis and papers and other evidence as identified.

The jurisdictional review has determined the following common themes in terms of regulatory roles:

- a primary duty of the regulator towards protecting or furthering the interests of users; and
- a secondary duty towards financial sustainability of the regulated monopoly. Financial sustainability generally translates to the ability to meet operational requirements and financing of capital.

In comparison to the regulatory model for BC coastal ferries, the role of the regulator in other jurisdictions is generally more active in addressing user interests and long-term capital planning. In addressing the interests of users, the regulatory role often includes considerations that go beyond regulating fares to include more independent monitoring of customer satisfaction and other interests such as environmental considerations. Regulators have an active role in reviewing capital investment plans and have powers (in relation to a primary interest to protect users) to approve or reject capital investment plans.

In addition there is more clarity around the role of government and the regulated entity, with affordability issues typically addressed by government.

## **1.6 Review of Other Ferry Systems**

The Commissioner requested PwC to conduct research on other ferry systems with the view of understanding the following:

- Trends with operating and governance models for ferry systems
- The relative efficiency of BC Ferries

As part of its assessment, PwC reviewed a number of industry reports, annual reports of ferry companies, case studies, government reviews and ferry benchmark studies, some of which have included BC Ferries.

The approach to assessing the efficiency of BC Ferries included assessing performance against other ferry operators, against its own stated performance metrics and based on its performance over time. The following comments on the relative efficiency of BC Ferries are made.

- Many ferry operating and governance models, both public and private, are in place around the world. An important trend with publicly-subsidized systems in the past 20 years has been contracting out in order to reduce subsidy levels. It is most commonly employed in European ferry systems.
- Subsidy formulas for 'life-line' type ferry services reflect a wide variety of public policies including subsidies for residents. It is common for various levels of government to contribute to subsidies. There appears to be some pressure from European Union competition rules to reduce subsidies, which is expected to have the effect of reducing sailings, particularly during off-peak periods, in order to increase capacity utilization.
- Measuring the relative efficiency of ferry operators across multiple jurisdictions poses many challenges. Factors which influence the relative efficiency of ferry operators include: mandated crew levels, capacity, sea route condition and age of vessels. The review identified, more often than not, publicly-owned systems that are in and out of crisis and which require periodic government interventions, instead of any obvious 'best-in-class' ferry operators.
- Amongst the publicly-owned systems, BC Ferries appears to be relatively efficient based on the analysis. Indeed, many ferry operators appear to want to emulate some of BC Ferries' practices. The company compares well with farebox recovery and ancillary revenue. Costs appear to be reasonable based on a number of independent reviews and on substantial improvement in several areas since 2003.
- However, there is large variability with route utilization within the BC Ferries' route groups, with the lowest utilization serving remote communities. Similar patterns are observed in jurisdictions like Scotland and Alaska.
- The weak earnings performance experienced by BC Ferries during the last three years is consistent with the global ferry industry.

## **1.7 Recommendations to Improve the Current Regulatory Model**

The Act was created to deal with a number of specific problems with the former operating and governance model. The embedded principles in the Act were intended to remove "political" involvement from ferry operations, apply a commercial approach to the business with a focus on efficiency, and leverage private sector financing for fleet renewal. It can be argued that many of these goals have been achieved through the light-handed approach to regulation and the application of the above principles.

However, the issue with this model has been its effect on affordability. Due to a combination of factors, including a downturn in the economy, a decline in ridership, reduced tourism and particularly the application of the greater reliance on the user pay principle, ferry fares have risen sharply across the system, especially so in the less populated parts of the BC coast. Projections for the next performance term currently indicate four more years of high fare increases, with every reason to expect even larger fare increases in the following performance term, when a large bulge in capital spending in relation to planned fleet replacement is scheduled to occur.

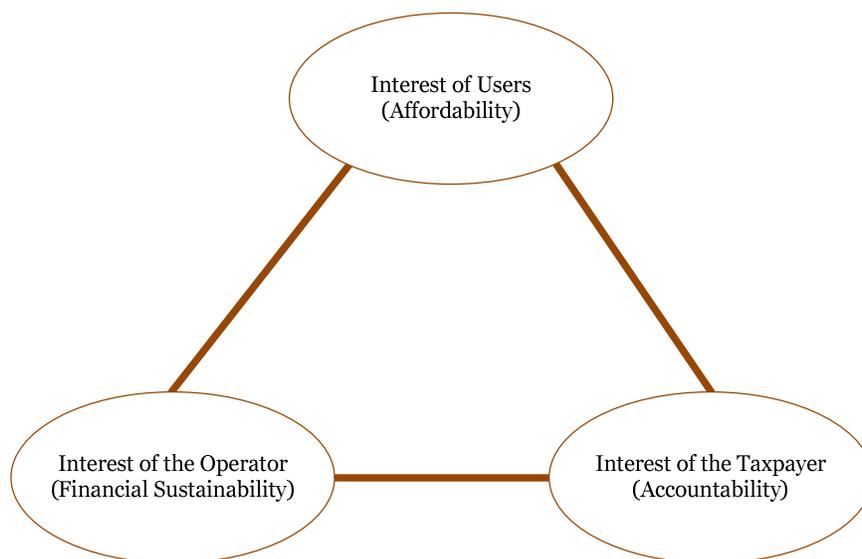
The objective for the review was to determine ways in which the benefits of the current model can be retained while also delivering affordable, predictable fare increases in future. All of the principle stakeholders need to be part of the solution. As the ferry system is costly to operate and requires significant capital investments on an on-going basis, ferry users need to be receptive to changes in the delivery of ferry services and have realistic expectations for levels of service, while the operator needs to have a focus on cost control and revenue generation. The Province is responsible for defining the public interest in this critical piece of transportation

infrastructure and will continue to have an ongoing role in providing financial support to ensure financial sustainability of the ferry operator.

There are three principle “stakeholders” in the BC ferry system whose interests need to be considered, and kept in a reasonable balance with the interests of the other two. The first is the user of the ferry system, broadly defined as riders, commercial operators who use the ferries to transport their products, tourism operators who depend on the ferries to transport their customers, and the extended families of the residents of ferry dependent communities. The interests of these collective users are for affordable and reliable transportation, safe vessel operations, and reasonable levels of service.

The second “stakeholder” is the ferry operator, which needs to be financially sustainable in order to meet service level obligations, cover operating costs, borrow money for capital investments in vessels and terminals, meet debt obligations and retain the staff necessary to operate the system.

The third “stakeholder” is the taxpayer. All of the comparable ferry systems we’ve looked at depend on public funding to survive. The BC ferry system is presently less dependent than many others, but the re-investment that is needed over the next decade is only going to be possible with more contributions from the taxpayer. The interests of the taxpayer are to keep public funding at an acceptable level and to ensure that there is effective governance, full transparency and accountability in the operation of the ferry system.



The following major recommendations are made to improve the regulatory model. They address the need for the Commission to have more explicit authority to allow it to focus on the sustainability of the coastal ferry system while still maintaining the light-handed nature of the current model.

### Principles

1. The primary responsibility of the Commissioner should be to protect the interests of ferry users and the taxpayer. The term “ferry user” should be interpreted broadly, to include ferry customers, their families, ferry-dependent communities and businesses which depend on ferry services to be affordable and reliable.
2. The secondary responsibility of the Commissioner is to protect the ongoing financial sustainability of the ferry operator by encouraging the ferry operator to:
  - a) operate efficiently;

- b) take a commercial approach;
  - c) be innovative; and
  - d) minimize its operating expenses.
3. The Commissioner should also have the authority to determine the respective interests of the ferry users, the taxpayers and the ferry operator and how best to balance those interests.
  4. The principle of elimination of cross subsidization from the major routes to other routes should be removed from the Act. Future price caps should be set at one level for all routes or all route groups as may be established by the Commissioner.
  5. The principle of a greater reliance on a user pay system should be removed from the Act.

### **Affordability**

6. The Province should work collaboratively with BC Ferries to develop a long-term vision of coastal ferry services in BC. A draft discussion paper should go out for public consultation. The resulting vision should be formally adopted by the Province and provide the basis for the long-term capital plan of the ferry operator. Ideally the vision would be in place before major capital decisions are made regarding PT4.
7. The Act should explicitly require that the Commissioner must approve the long-term capital plan and any modifications thereto and that the Commissioner's approval be based on a determination that the capital plans are compliant with the long-term vision and its guiding principles.
8. The Act should require that all major capital investments (i.e. new vessels and mid-life upgrades, and terminal upgrades above a threshold determined by the Commission) should be approved by the Commissioner based on a determination that such investments are reasonable, prudent and consistent with the long-term capital plan.
9. The Province should make provision for some improvements to capacity utilization within defined parameters. Subject to those parameters, the Commissioner should be given authority to approve specific changes to service levels, based on a consideration of the interests of ferry users, the taxpayer and the financial sustainability of the ferry operator.
10. The Province should empower the Commissioner to approve additional services which have been approved by the BC Ferries Board, if the Commissioner is satisfied that adding a new route is in the interests of ferry users, the taxpayers and the ferry operator and can be accomplished without creating an expectation for additional subsidies.
11. The Province should consider an increase in subsidies together with other initiatives to hold price cap increases to the rate of inflation for the balance of PT3.
12. The Act should explicitly authorize the Commissioner to establish fuel deferral accounts and to have discretion to set terms and conditions for their use.
13. The Province should consider extending its policy of absorbing at least a portion of both fuel surcharges and rebates on northern routes to all routes for the balance of PT3.
14. The Act should empower the Commissioner to authorize a municipal or regional government to "buy down" ferry fares on routes to and/or from their communities, to set whatever conditions are considered appropriate, to provide oversight on the arrangement, and to make orders as necessary to ensure that all funds contributed by a local government are used for the exclusive benefit of the intended routes.
15. A high priority should be placed on upgrading BC Ferries' traffic forecasting capabilities, including upgrades to the reservation and point of sale systems.
16. In determining the final price cap decision, the Commissioner should have the option to consider:

- a) adjusting the price cap;
  - b) ordering a change to service levels on specified routes with whatever terms and conditions the Commissioner considers appropriate;
  - c) ordering a reconsideration of upcoming capital projects; or
  - d) any combination of a) through c).
17. The Commissioner should be provided with additional options for dealing with an extraordinary situation, including the ability to order a temporary reduction to service levels, or a temporary delay to capital projects, without compromising safety or operational reliability. As well, extraordinary decisions by the Commissioner should be able to be reversed or modified if the extraordinary circumstances change, or no longer exist.

### **Financial Sustainability**

18. The section of the Act which prescribes a pre-tax return on equity as the basis for determining price caps should be amended to direct the Commissioner to set targets for equity levels and cash flows sufficient to meet debt requirements to allow the company to maintain its current rating for long-term bonds.
19. Municipal and regional governments should be empowered to pass resolutions requesting the Commissioner to establish a marketing surcharge on ferry routes which lie within their boundaries, for purposes of promoting destination marketing which is reasonably likely to increase ferry ridership. The surcharge would be collected by BC Ferries and remitted to a designated regional tourism entity. Surcharges would only apply to specified routes, and the proceeds would need to be used entirely for the benefit of the community which pays for them. The Commissioner should be authorized to set conditions on use of the surcharge, and to limit the time periods that a surcharge will remain in effect.
20. The Act should be explicit that the Commissioner be expected to encourage the ferry operator to generate new ancillary revenue, if doing so is considered to be in the interests of ferry users and taxpayers.

### **Accountability**

21. The Act should be more explicit that the Commissioner may issue an order which requires the ferry operator to:
- a) prepare a plan,
  - b) review a policy,
  - c) undertake a public consultation, or
  - d) cause information to be made public.
22. The Commissioner should be authorized to approve or reject a plan or a policy which has been submitted, but should not be authorized to impose an alternative plan or policy created by the Commissioner.
23. The Act should explicitly authorize the Commissioner to conduct routine performance audits on an on-going basis as deemed necessary and in the interests of ferry users and taxpayers.
24. Ferry Advisory Committees should be appointed by the Commissioner and remain advisory. The terms of reference, structure of and appointments to the Committees should be at the discretion of the Commissioner, with the intention of ensuring that each committee includes people with a range of perspectives on the various users of the system, including a resident, a commuter, a tourism operator, a commercial operator and a local government official.

## **2 Purpose and Scope of the Regulatory Review**

### **2.1 Background**

The Act requires the Commission to establish a price cap once every four years. Performance Term 2 (PT2) expires at the end of March 2012. Performance Term 3 (PT3), runs from April 1, 2012, until March 31, 2016.

The Act is prescriptive about how the price caps are to be calculated. The Commissioner is first required to calculate the regulated return on equity (“ROE”) the operator is entitled to earn, based on a specific formula. For PT3, the regulated ROE is 12.7% per year. The Commissioner then reviews projections provided by the operator for operating costs, financing costs, capital plans, and ridership. A price cap must be calculated for each of three route groups, without allowing for any cross subsidization between them. The Commissioner is required to publish a preliminary price cap decision, which is followed by a period for public comments. This is also the period in which the Province and the ferry operator negotiate amendments to the Coastal Ferry Services Contract. Any changes in service levels or subsidies are reported to the Commissioner and then a final price cap decision is determined.

In 2010 there was a significant amendment to the Act, which added a requirement that the Commissioner “consider the interests of ferry users”. In setting the preliminary price caps levels for PT3, the Commissioner did undertake to consider those interests, with four specific initiatives:

- a smoothing of the price cap increases so that there were two levels of increase instead of four;
- balancing the increases across the four years instead of setting different rates for each year, and specifically, he did not front end load the increases for the next term;
- not applying replacement cost valuation to assets as required, due to the very high impact it would have on fares; and
- applying a performance target of \$18.5 million on the ferry operator.

The resulting price caps for PT 3 were then set at 8.23% on the northern on minor routes, and at 4.15% on the major and Langdale routes. At these levels, public feedback was very negative, and conveyed a high level of concern with increases perceived to be excessive.

Subsequent to the announcement of the preliminary price cap decision, the ferry operator provided the Commissioner with a legal opinion on the four “considerations” explained above, and expressed a view that the Commissioner may not have had the authority to make these adjustments. A recalculation of the price cap decision without those “considerations” indicated that much larger numbers would be required if all four were successfully challenged. The increases which would be necessary, for just the first year of PT3 alone, would have been 16.4% for the major routes (Vancouver to Vancouver Island), 81.1% for the north and central coast routes and 43.1% for the 18 minor routes. The Commissioner was very concerned about increases of this magnitude, and based on a reading of Hansard records from 2003, didn’t believe the Act intended to produce such results. The new requirement for the Commissioner to “consider the interests of users” did not come with any definitions or additional regulatory tools.

The Commissioner felt certain prescriptive provisions in the Act were producing price cap increases which are unsustainable. Faced with making a final price cap decision in September 2011, which would remain in place for four years, the Commissioner felt the Act needed to be reviewed and with some urgency. The Commissioner took his concerns to the Minister of Transportation and Infrastructure, who is the Minister responsible for the Act. The Minister agreed that a review was needed, and brought forward Bill 14 which enabled this review.

The Province imposed a price cap of 4.15% on all routes for the first year of PT3 and deferred a final price cap decision for the remaining three years of PT3 to September 30, 2012 pending the outcome of the review and to allow sufficient time for the Province to consider the recommendations in this report.

## 2.2 Approach and Scope of the Review

Under Bill 14, the Commissioner has been mandated by the Province to conduct a review of the Act as it relates to the regulation of ferry operators. The objective of the Review is to recommend to the Minister of Transportation and Infrastructure changes to the Act which will better enable the Commissioner to balance the interests of ferry users with the financial sustainability of ferry operators. The Commissioner is required to submit his report to the Minister containing recommendations on amendments to the Act by January 24, 2012.

The Commissioner has adopted a holistic approach to conducting the Review. The approach taken by the Commissioner had the following main elements:

- A comprehensive public consultation process which included 27 public meetings in coastal communities as well as several meetings with public bodies or organizations such as the Chairs of the Ferry Advisory Committees, Chairs of the Coastal Regional Districts, the Islands Trust Council and various First Nations representatives and municipal councils. Over 200 submissions were received from the public in response to a public notice inviting comments on various aspects being considered by the commissioner as part of his review.
- A jurisdictional review of other price cap regulatory models and other ferry systems.
- Analysis regarding the appropriate balance of the interests of ferry users, interests of taxpayers and the sustainability objectives of the ferry operator while also addressing technical areas of the Act. Potential changes to the Act are viewed according to this balance.

Some of the submissions to the Review called for repeal of the Act and a return of the ferry service to government. It came up in several of the written submissions, and when it came up in public meetings the idea was often met with enthusiasm by other members of the audience. While the Commissioner's mandate did not include an analysis of this and other options, the Commissioner acknowledges that within the range of options converting BC Ferries back to a crown corporation is an option for the Province.

In this report, the Commissioner provides recommendations for changes to the Act and other measures to improve the current regulatory model. The proposed changes and measures are intended to achieve the key objectives of affordability and financial sustainability of the ferry system.

The Commissioner has engaged PricewaterhouseCoopers LLP in the review process. PwC has assisted in assessing the price cap regulation system since 2003 as measured against the Province's stated public policy and the guiding principles contained in the Act. The scope of the consultant's work has been to provide policy, economic and financial advisory services to the Commissioner to complete the Review covering the following:

- operational and financial performance of BC Ferries over time;
- a jurisdictional reviewed that primarily focused on price cap systems in the UK;
- a review of other ferry systems that included efficiency and financial comparisons; and
- financial analysis of various funding options based on various assumptions and long term capital requirements.

## 2.3 Organization of the Report

In the following section, an overview of the BC coastal ferry system and its regulation is presented. Section 4.0 profiles BC Ferries' performance under the price cap system. Section 5.0 summarizes the results of the Commissioner's public consultations. Sections 6.0 and 7.0 include reviews of other jurisdictions and other ferry systems, respectively, and provide comments on the relative efficiency of BC Ferries. Sections 8.0 through 12.0 present and summarize the Commissioner's analysis and recommendations.

## **3 Overview of the British Columbia Coastal Ferry System**

### **3.1 The Coastal Ferry Act**

It is generally accepted that the genesis of the Act was the 1999/2000 report by the Auditor General of British Columbia. In the opinion of the Auditor General, the governance role of the BC Ferries board was at that time compromised by its loss of control to the provincial Cabinet over its capital plan. In other words BC Ferries did not have control over the most important decisions that affected its financial and operating performance.

A review was subsequently conducted by Mr. Fred R. Wright. The terms of reference for the review included identifying the changes necessary to enable BC Ferries to provide an efficient, customer-focussed ferry service at an acceptable cost to taxpayers. The review's report released in December 2001 recommended a new model for BC Ferries where the powers of the Province would be vested in an "independent board of directors with responsibility for governing, exempt from political and bureaucratic interference". Under this model BC Ferries would receive a clear mandate and understanding of the Province's expectations, annually present its business plan and report quarterly on the results of its operations.

These reports eventually gave rise in the spring of 2003 to the creation of the Coastal Ferry Act through Bill 18. The Act establishes the governance structure for the newly created British Columbia Ferry Authority and the conversion of the British Columbia Ferry Corporation into a new company called British Columbia Ferry Services Inc. The Act also establishes an independent commissioner as the regulator of ferry operators.

Since 2003 the Act has been amended twice. Under Bill 20 enacted in 2010, the Commissioner was given new responsibilities including the requirement that in regulating the ferry operator he is to consider the interests of ferry users. Under Bill 14 enacted in June 2011, the Commissioner was given a mandate to conduct a review of the Act and to submit recommendations to the Minister to better enable the Commissioner to balance the interests of ferry users with the financial sustainability of the ferry operator.

### **3.2 The BC Ferry Authority**

The BC Ferry Authority is a non-share capital corporation and its purpose is to hold, administer and sell a voting share in BC Ferries, elect directors to the board of directors of BC Ferries and to approve compensation plans for the directors and executives of BC Ferries.

The board of directors of the Authority (the "Board") consists of nine individuals appointed as follows:

- Four directors are appointed to represent the coastal regional districts. Each of four regional districts nominates qualified individuals and one of those individuals per regional district is appointed.
- One director is appointed to represent the trade union representing the BC Ferries employees. That director is appointed from the nominations of qualified individuals received from the union.
- Four directors are appointed from qualified candidates, two of whom are specifically appointed by the Lieutenant Governor in Council.

The Authority, when electing directors to the board of BC Ferries, must select individuals that, as a group, hold all the skills and experience needed to oversee the operation of BC Ferries in an efficient and cost-effective manner.

### 3.3 British Columbia Ferry Services Inc.

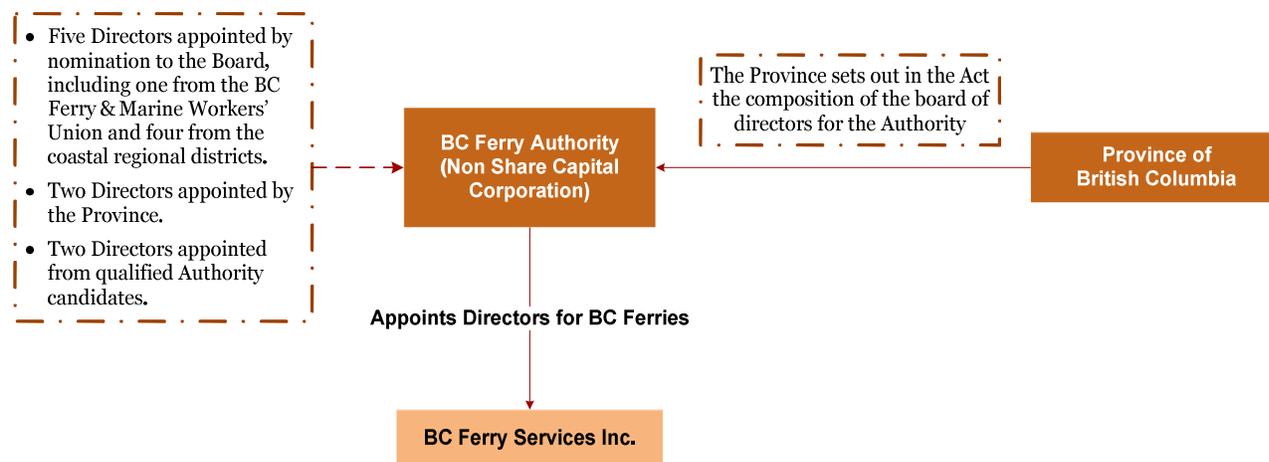
BC Ferries is the operating subsidiary of the Authority providing coastal ferry service. With 35 vessels travelling between 47 terminals, on 25 routes, BC Ferries is one of the largest ferry operators in the world, both in terms of passengers and vehicles carried.

In addition to the creation of BC Ferries as a wholly-owned subsidiary of the Authority, the Province established the initial capital structure of BC Ferries through the issuance of preferred shares. The Province also owns the terminal lands and leases them on a long-term, exclusive basis to BC Ferries. A 60-year Coastal Ferry Services Contract exists between the Province and BC Ferries. The contract specifies service levels and transportation fees or subsidies on 22 routes on the coast. The contract is subject to amendments for each new performance term coinciding with price cap reviews conducted by the Commissioner prior to the start the next performance term. Within this operating and governance framework, BC Ferries has direct access to capital markets.

Ferry Advisory Committees have been established as part of BC Ferries’ public consultation program since 1993 to ensure customer needs are met by BC Ferries’ services. Ferry Advisory Committees represent 12 local communities on all routes except the major routes served by BC Ferries. The committees are appointed in cooperation with local governments, the Islands Trust and First Nations and they usually meet twice a year to discuss route specific operational issues, planned improvements and policy issues of BC Ferries.

B.C. Ferries also has Terminal Liaison Committees for three of its major terminals and consults with various interest groups on a project or issue-specific basis. The specific interest groups include, but are not limited to, the Accessibility Advisory Committee, the BC Trucking Association and the BC Coalition of People with Disabilities.

#### Governance Structure of BC Ferry Services Inc.



### 3.4 The BC Ferry Commission

The BC Ferry Commission, referred to under the Act as the “commissioner” is a provincial regulatory body with statutory responsibilities for making regulatory decisions affecting BC Ferries. The role includes:

- regulating in relation to the core ferry services provided by BC Ferries and the tariffs charged for the core ferry services;
- establishing price caps for each performance term and monitoring compliance with the price caps on a quarterly basis;
- regulating unfair competitive advantage;

- approving BC Ferries' complaints process;
- monitoring results of BC Ferries' annual ferry user satisfaction surveys;
- monitoring compliance of BC Ferries with the Act and to the terms of the Coastal Ferry Services Contract with the provincial government; and
- overseeing the Authority's compliance with the Act.

The Commissioner is independent of both the provincial government and of BC Ferries. In the course of his regulatory activities, the Commissioner is obliged to follow six principles in protecting the public interest, which are set out in Section 38 of the Act. These principles are as follows:

- priority is to be placed on the financial sustainability of the ferry operators;
- ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;
- ferry operators are to be encouraged to seek additional or alternative service providers on designated ferry routes through fair and open competitive processes;
- ferry operators are to be encouraged to minimize expenses without adversely affecting their safe compliance with core ferry services;
- cross subsidization from major routes to other designated ferry routes is (i) to be eliminated within the first performance term of the first Coastal Ferry Services Contract to be entered into under this Act, and (ii) before its elimination, to be minimized; and
- the designated ferry routes are to move towards a greater reliance on a user pay system so as to reduce, over time, the service fee contributions by the government.

The Commissioner is also required to consider the interests of ferry users in his regulation of ferry operators although interests of ferry users are not defined in the Act.

## **4 BC Ferries Performance under the Price Cap System**

### **4.1 Overview of the Current Price Cap Regulatory Model**

In the past few decades, new approaches toward price regulation have arisen. These approaches attempt to provide an effective discipline on companies with monopoly power, but at a lower regulatory cost, and in a form which preserves incentives for companies to be cost efficient. The most widely known, and now widely adopted regulatory type is price cap regulation.

This format has two dimensions. The first is the cap itself. The format allows a company to increase prices whenever there is inflation or an increase in costs. Prices can be increased up to the cap. Usually the cap is set at inflation, less a provision for efficiency gains expected to be achieved by the company.

The second dimension of price cap regulation is the price basket. The price cap does not have to apply to all prices or fares of services the company sells. Some prices or fares are allowed to have greater increases than the cap – provided other prices or fares have increases under the price cap. It is only the average increase in prices or fares of all services in the “price basket” which must not exceed the price cap. This allows the company considerable flexibility to change prices within its product or service line without the need for regulatory approval.

The approach enables desirable long term shifts in relative prices of different services which cost-based regulation might prevent. Price caps have typically been set for periods of time such as five years. Once every performance term, the regulatory body does an audit or review. It then sets a new price cap for the next performance term. Thus the company is free of regulatory proceedings and costs for a considerable period.

This regulatory method is low cost for the company being regulated, the regulator and ultimately the users and general public. It is the essence of the ‘regulatory light’ approach. It is intended to provide a higher degree of flexibility for a price-regulated company. It also provides incentives for innovation and efficiency. If the company figures out a way to lower costs, it is not forced to lower its prices until the next review term. The review process also recognizes the need for above inflation price increases to cover the costs on new capital investment.

There are several regulatory “building blocks” from which the price cap is derived. The revenue requirement is a function of covering all operating costs, capital charges and a regulated rate of return on equity as suggested in the following simplified formula:

$$\text{Operating expenditures} + \text{Capital charges} + \text{Return on equity} = \text{Fares} + \text{Ancillary revenue} + \text{Subsidies}$$

In the transport sector, the revenue requirement from fares is divided by the quantity of traffic to arrive at a price cap.

Once a “price per unit” has been established there are a further range of issues the regulator is required to assess to develop:

- the profile of the price cap over the control period;
- the application of price baskets;
- compliance with the price cap including corrections for any over or under recovery of the price cap; and
- application of sub-caps to different elements of the price cap (e.g. application on a per route or passenger group basis).

The United Kingdom has been the earliest and strongest user of price cap regulation for a range of industries. For example, when the British Airports Authority and Manchester Airports were privatized in 1987, price cap regulation was applied to their activities. Price cap systems are now used in various jurisdictions including Australia, South Africa, Chile and Canada. They are most commonly applied in the transport sector with airports and rail.

Most of the principles described above currently apply or are relevant to the price cap system as it applies to the BC coastal ferry system. Features of the system include:

- defining core service levels through the Coastal Ferry Services Contract which establishes the operating cost structure of BC Ferries;
- setting price caps on a route group basis which enables BC Ferries to recover its operating and capital costs and provides a prescribed return on equity;
- establishing a methodology for calculating the weighted average fares for comparison with the price caps; and
- monitoring compliance with the price caps on a quarterly basis.

## **4.2 BC Ferries Financial Performance under the Price Cap System**

This section profiles BC Ferries’ performance over the first eight years under the price cap system that includes one full performance term and up to the third year of the second performance term.

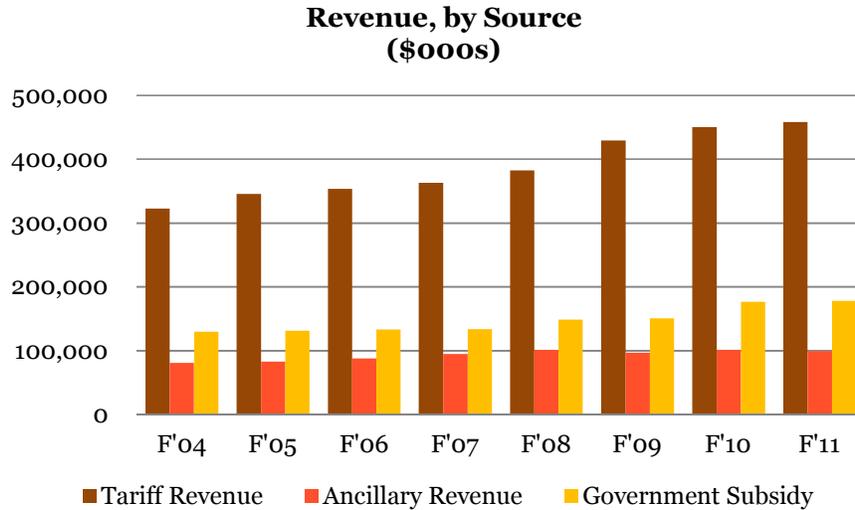
The current price cap system began on April 1, 2003 and provides specified fees (Ferry Transportation Fees) in exchange for contractual ferry service levels. The first performance term (PT1) covered the five-year period April 1, 2003 to March 31, 2008. The second performance term (PT2) covers the four-year period April 1, 2008 to March 31, 2012.

In the analysis, all references to years are to fiscal years ended March 31; for example, “2004” or “F’04” refers to the fiscal year ended March 31, 2004. Data is drawn from annual reports of BC Ferries and the Commission and additional information supplied by the ferry operator.

### 4.2.1 Revenues

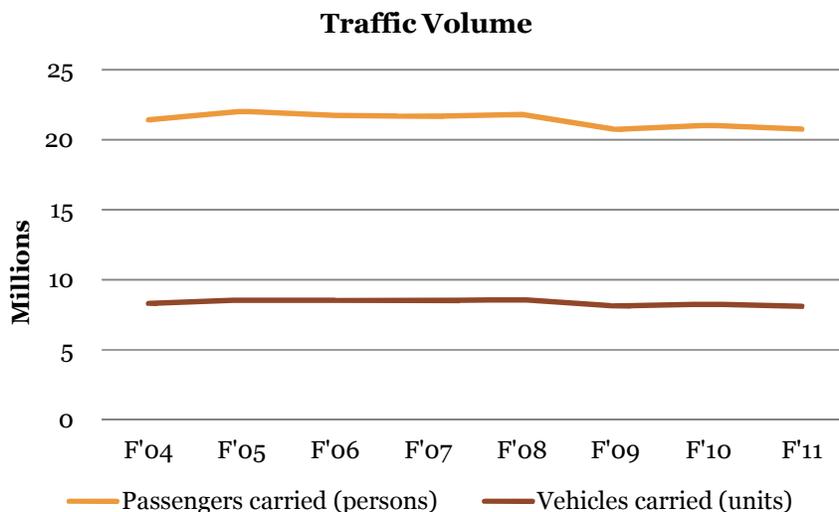
BC Ferries has three main sources of revenue:

- Tariffs – fares collected from vehicles and passengers
- Ancillary – revenue collected from on board services such as retail sales (on board and at terminals) catering, stateroom rental, parking and reservation fees
- Government subsidies – Ferry Transportation Fees, Social Program Fees and subsidies from the provincial and federal governments.



The above chart shows revenue by major source over the past 8 years. Total revenues have increased from \$534 million in 2004 to \$739 million in 2011. During the same eight-year period, passenger volume has fluctuated between 20.7 and 22.0 million passengers while vehicle volume has fluctuated between 8.1 and 8.6 million units.

Traffic volumes have not been increasing over time. The chart below shows traffic volume since 2004. Traffic volumes have declined since then. Traffic rose slightly during PT1 but began to fall in 2008 with a downturn in the global economy.



### 4.2.2 Fares

Fares are regulated by the price cap formula determined by the Commission. The following table provides a summary of various fares on a variety of routes for specific periods over the past eight years. While overall traffic volumes have remained relatively stable over the past eight years, passenger and vehicle volumes have declined on many of the minor routes. Fares have increased the most on these routes at rates much higher than inflation.

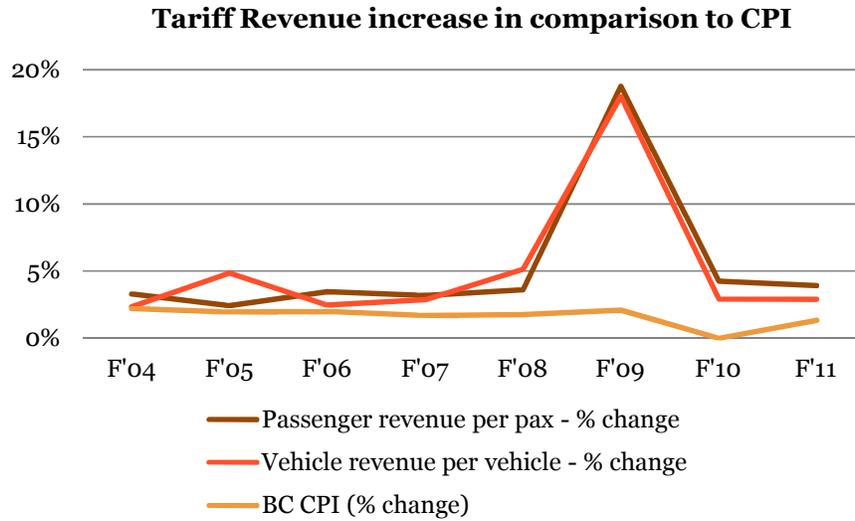
**Sample Vehicle plus Driver Fares by Route Group: 2003 through 2010**

Route and Group	Apr-03	Apr-04	Apr-05	Apr-06	Apr-07	Apr-08	Apr-09	Apr-10
Tsawwassen-Swartz Bay (Major Route)	\$44.75	\$46.00	\$48.95	\$52.25	\$53.80	\$61.40	\$58.50	\$59.50
Port Hardy/Mid Coast/Prince Rupert (Northern Route)	\$332.00	\$344.00	\$375.25	\$424.30	\$441.30	\$475.30	\$500.00	\$560.00
Powell River – Texada Island (Minor Route)	\$19.50	\$20.25	\$22.35	\$25.55	\$26.60	\$32.40	\$27.60	\$29.65

### 4.2.3 Tariff Revenue

Tariff revenue has increased significantly over eight years, from \$316 million in 2003 to \$458 million in 2011. During the five-year period of PT1, tariff revenue increased \$66 million, or 21%. During the first three years of PT2, tariff revenue has increased \$76 million, or 20%.

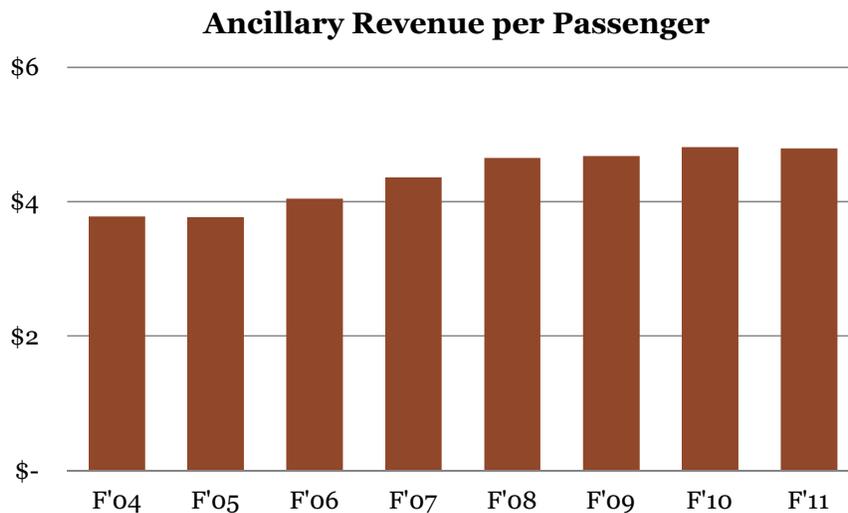
The increase in tariff revenue is attributable mainly to increases in fares, as the passenger and vehicle utilization has remained relatively constant, as shown above. The following table shows the increase in tariff revenue over the last eight years, in comparison to the change in provincial CPI.



The increase in tariff revenue per passenger is consistent with the principle underlying the Coastal Ferry Act that ferry routes move towards a greater reliance on a user pay system.

#### 4.2.4 Ancillary Revenue

Ancillary Revenue includes retail sales on board and at the terminals, catering, stateroom rentals, reservation fees and parking revenue. Ancillary revenue has increased from \$77 million when the structure of the organization changed in 2003 to \$99.5 million in 2011. The \$20 million increase has been almost all based on increased spending per passenger, given the relative stability in the number of passengers. The following chart shows Ancillary Revenue per passenger increasing to almost \$5 per passenger. This \$1.25 per passenger or 35% increase over the last eight years indicates strong performance relative to the original public policy objectives that included adopting a more commercial approach. Ancillary revenues contribute to reduced pressure on fares and service fees.



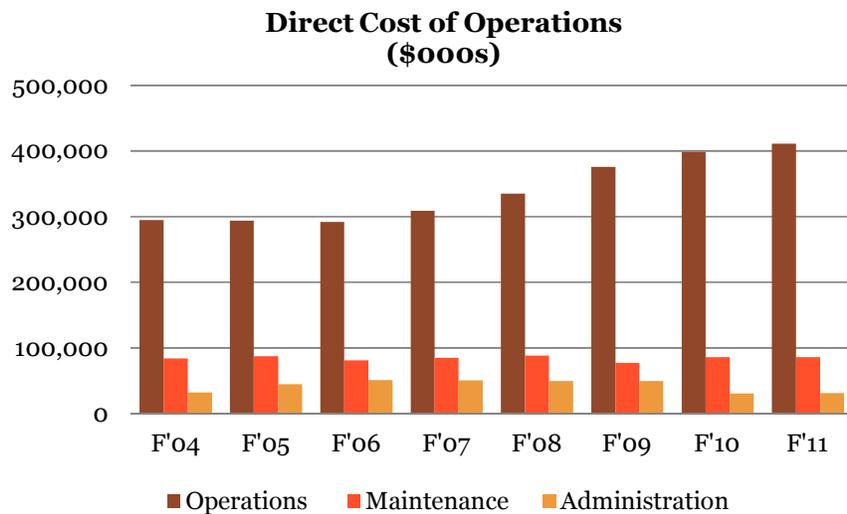
### 4.2.5 Expenses

BC Ferries reports three categories of expenses in calculating Earnings from Operations: Direct Cost of Operations, (Operations, Maintenance, Administration), Cost of Retail Goods Sold and Amortization. Interest expense is deducted from Earnings from Operations to arrive at Net Earnings.

### 4.2.6 Direct Cost of Operations

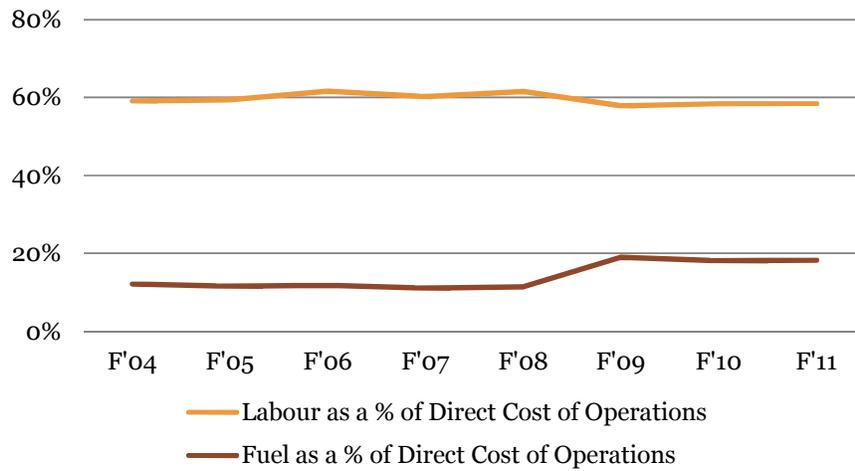
Direct Cost of Operations includes labour and fuel. The Direct Cost of Operations has increased significantly over the past eight years, as shown in the following graph. The Direct Cost of Operations has increased over 25% in eight years, faster than the provincial CPI which has increased 14% for the same period.

The breakdown of Direct Cost of Operations between Operations, Maintenance and Administration over the past eight years is as follows:



As shown above, the category of expenses with the most notable increase is Operations costs, the main components of which are fuel and labour. The following chart isolates the impact of the cost of fuel and labour on the overall cost of BC Ferries.

### Labour and Fuel as a % of Direct Costs

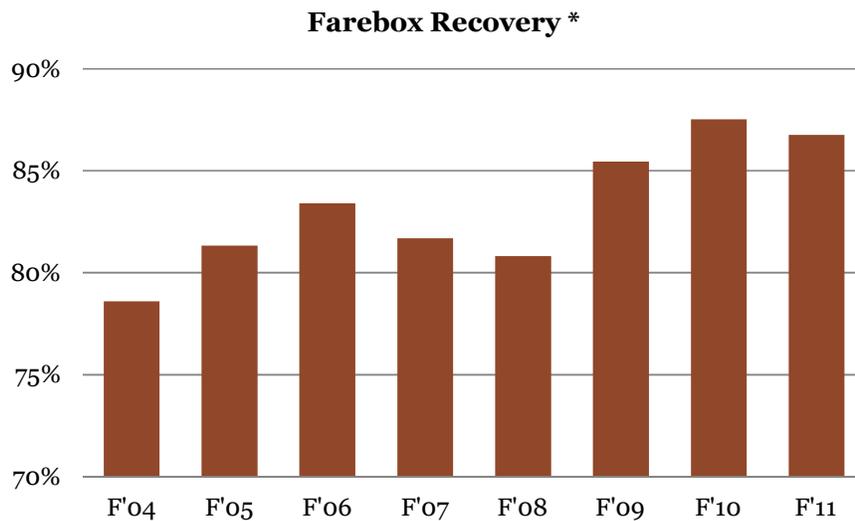


In contrast, Administration costs dropped significantly in 2010, when 77 administration positions were eliminated. This was to better align costs in relation to revenues as per BC Ferries’ long-term operating plan. Administration costs have levelled off since then.

Maintenance costs have remained relatively static over the past eight years as the size of the fleet has not changed significantly.

#### 4.2.7 Farebox Recovery

A generally accepted measure of profitability in the ferry industry is Farebox Recovery, defined as Tariff Revenue as a percentage of Direct Cost of Operations. The intent of the measure is to understand how much of the entity’s operating costs are covered by revenue from users. The following chart shows the ratio for each of the past eight years.

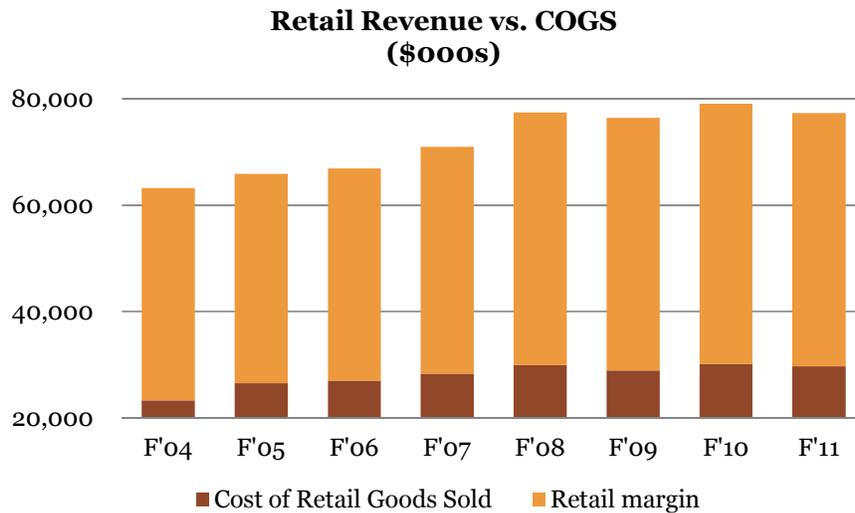


\*Tariff revenue as a % of Direct Cost of Operations

The increase in Farebox Recovery over the past eight years indicates that while operating costs have certainly increased over the period, tariff revenue has increased at a greater pace, such that more expenses are covered by tariffs.

#### 4.2.8 Cost of Retail Goods Sold

Cost of Retail Goods Sold covers the cost of catering operations (e.g. food and labour for the cafeteria) and the cost of retail operations (e.g. gift shop staff and inventory sold on board vessels and in the BC Ferries shops at the various terminals). The cost of retail operations has increased by \$6 million since 2004, however the associated revenue has increased \$15 million, such that the profit margin from retail operations has been steadily increasing over the years. Profit from retail and other ancillary operations compares well against BC Ferries’ peers.



#### 4.2.9 Amortization

Amortization is the expenditure of capital assets over time and it is a significant expense for BC Ferries’. Although amortization is a non-cash expense, it is an important factor in BC Ferries’ financial performance and in setting price caps.

BC Ferries vessels have differing life expectancy, depending on the asset class and the components of the assets. For example, the hull is amortized over 40 years, food service and life saving appliances are amortized over 13 years and propulsion components are amortized over 20 years.

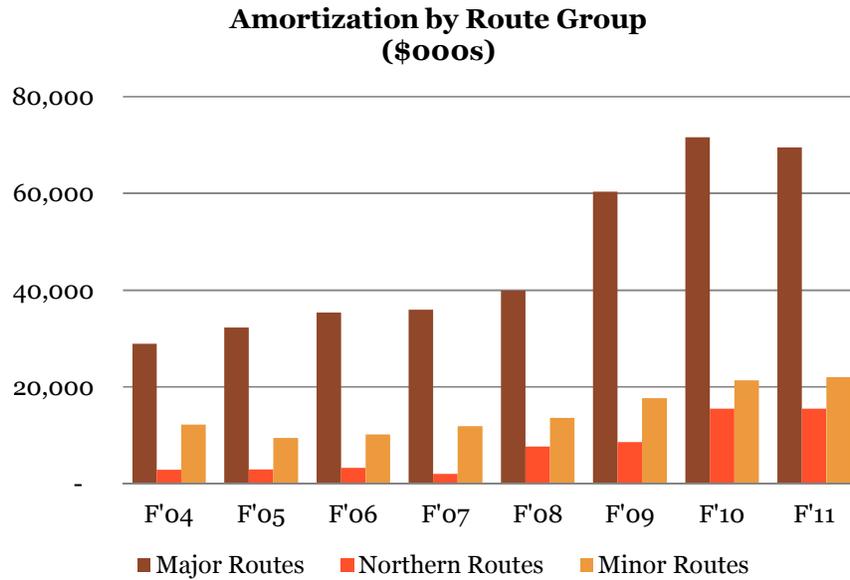
One of BC Ferries biggest challenges since becoming an independent company in 2003 has been its aged infrastructure. A focus has been on replacing or renewing the fleet, as well as upgrading terminals.

Amortization has been increasing continually since 2003. The large increase between 2008 and 2010 reflects five new vessels coming in to service:

- The three Coastal Class vessels were placed into service between March and November of 2008, resulting in the retirement of the three V class vessels that were more than 40 years old. The final cost of the Coastal Class vessels was \$432 million. Amortization is approximately \$4 million per vessel per year.

- Acquisition of the Northern Expedition, which commenced service on the Prince Rupert route in May 2009. The purchase of the vessel and associated terminal upgrades cost \$188 million resulting in initial amortization in fiscal 2010 of \$7.2 million.
- 14 month project to extend the useful life of the Queen of New Westminster, at a total project cost of \$52 million, resulting in initial amortization in fiscal 2010 of \$3.7 million.
- Construction of the Island Sky, for a budgeted cost of \$54 million, to allow for the retirement of the Queen of Tsawwassen. The Island Sky went into service in February 2009 and fiscal 2010 amortization was \$2.3 million.

The following chart shows Amortization expense broken down by Route group. The various vessels put into service as discussed above are reflected in each Route group’s amortization. The Coastal Class is part of the Major Routes and the Northern Expedition is part of the Northern Route.



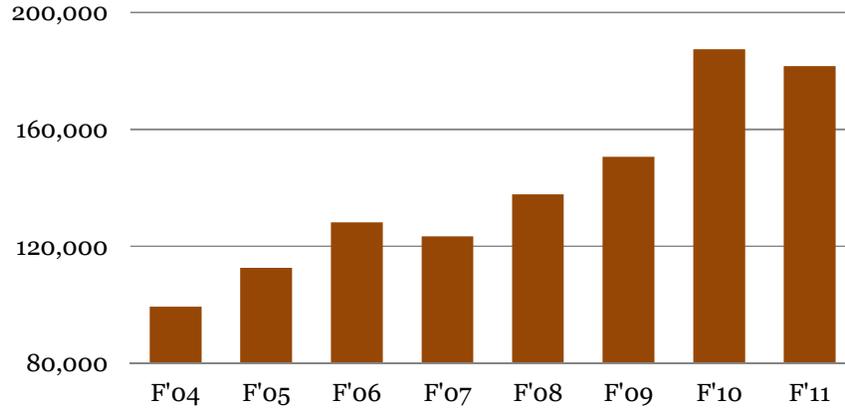
Amortization expense is forecast to increase further to \$123.9 million by the end of fiscal 2012. This reflects the continued investment BC Ferries is making in its infrastructure.

#### 4.2.10 Profitability and Return on Equity

##### Profitability

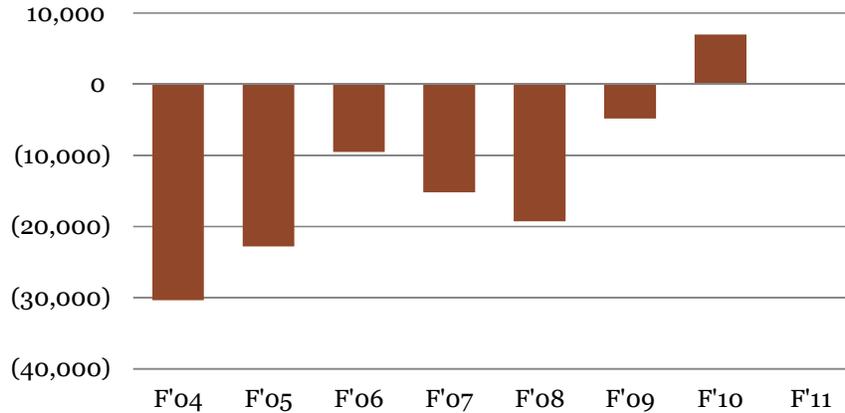
BC Ferries has realized improved cash flows since its inception as a regulated entity. The following chart shows Cash Flow from Operations which is Total Revenue (including subsidies from government) less the Direct Cost of Operations and the Cost of Retail Goods Sold. This measure is important in assessing debt carrying capacity and is comparable to EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) in the private sector.

**Cash Flow from Operations  
(\$000s)**



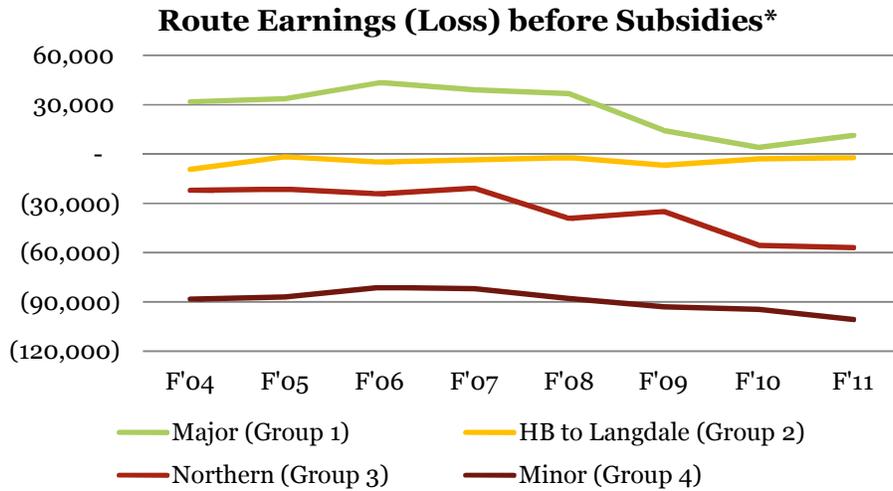
The increased cash flows have resulted in improved operating margins. The increase since 2004 is shown below, and is just as strong a trend as Cash Flow from Operations above. This metric shows significant success for BC Ferries in its effort to move towards great reliance on a user pay system. Essentially, the chart below shows that tariffs and ancillary revenue have increased to the point that they cover operating costs.

**Net Operating Margin before Subsidies\*  
(\$000s)**



\* Operating Margin= tariff revenue + ancillary revenue - direct cost of operations - COGS

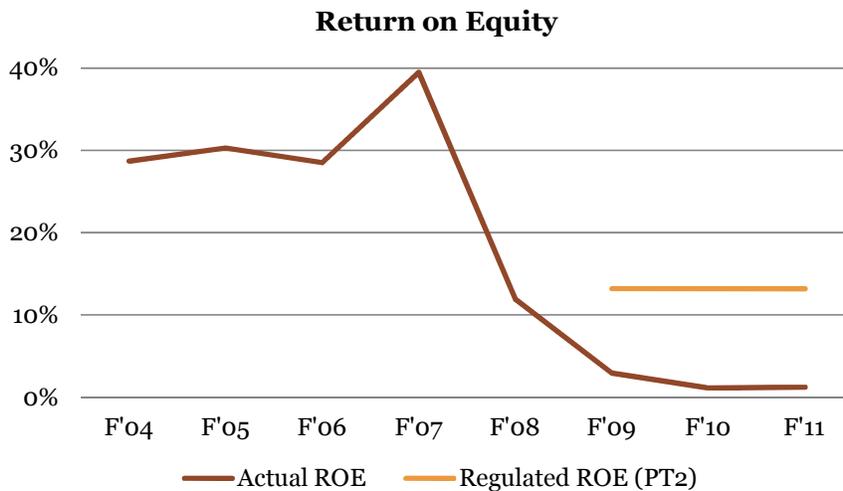
Another key measure is the performance of the route groups without government subsidies. Government subsidies are required on routes that are not commercially viable. Government subsidies are generally required only to cover capital charges (interest and amortization) associated with vessels and other assets on the minor and northern route groups.



\* Route revenues include Social Program Fees

### Return on Equity

The increased operating profit margin has come during a time of significantly increased debt load to the point that Return on Equity (ROE) has been seriously eroded, especially in PT2. The ROE in the first three years of PT2 has fallen to close to no return and is well below the regulated ROE or 13.16% for PT2. However this pattern is consistent with the global ferry industry and is discussed further in Section 7.0.



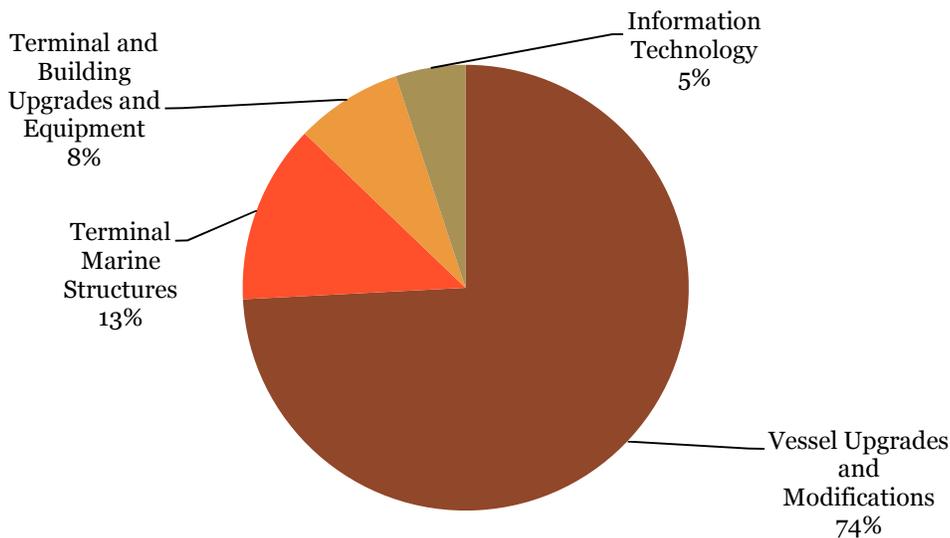
#### 4.2.11 Capital Investments

BC Ferries operates a fleet of 35 vessels from 47 terminals. Those numbers have remained unchanged since April, 2003, the inception of BC Ferries in its current form. Although the quantity of vessels and terminals has remained static, a significant amount of investment has occurred, as BC Ferries strives to renew its fleet and improve ferry users' travel experience and reliability.

In 2003, BC Ferries initiated a 15 year \$2.4 billion capital expenditure program. In the first decade, a total of over \$1.8 billion was planned to be spent – 75%, or \$1.3 billion, on new vessels, vessel upgrades and component replacement; and the remainder, close to \$500 million, on improving terminals to enhance the ferry user experience.

Eight years after setting out on the investment plan, \$1.7 billion has been spent, in the following four areas:

**Capital Expenditures by Category, 2004 to 2011**



#### **4.2.12 Vessel Acquisitions, Upgrades and Modifications**

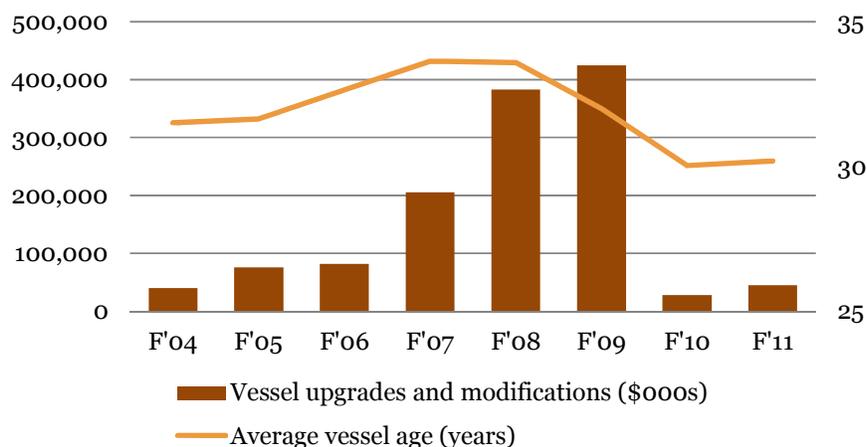
BC Ferries has one of the largest fleets in the world, but when it became an independent company in April, 2003, it also had one of the oldest fleets in the world, at 31 years. As a result, spending of \$1.3 billion, or 74% of the total capital investment, was on vessels. The average age of BC Ferries' fleet, has dropped to 30 years in 2011.

The vessel acquisition program has included the following seven new vessels in the past eight years:

- 2007 Northern Adventure and Kuper
- 2008 3 Super C-class vessels: Coastal Renaissance, Coastal Inspiration and Coastal Celebration
- 2009 Island Sky and Northern Expedition

The following chart shows how investment has impacted the average age over the years.

### Vessel Investment vs. Average Fleet Age



#### 4.2.13 Investment in Terminals and Information Technology

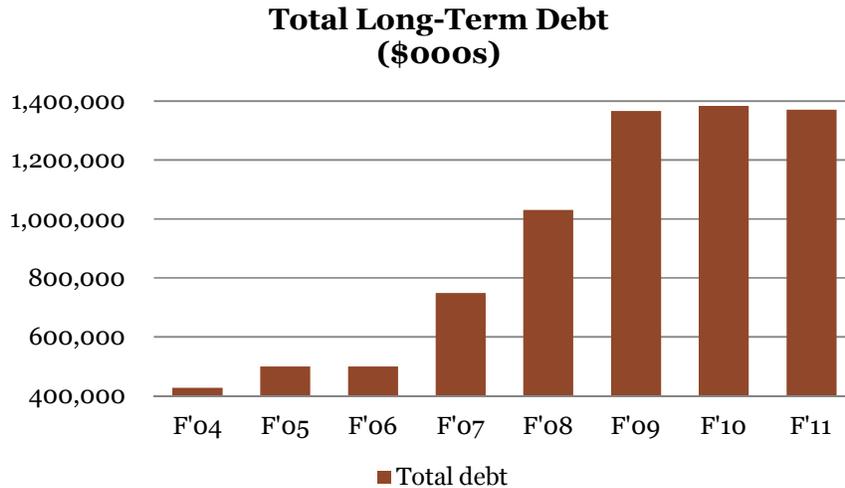
Other projects completed by BC Ferries as part of their overall investment in ferry user service, safety and cost reduction include:

- Replacement and refurbishment of berth 4 at Tsawwassen terminal (\$32 million).
- Departure Bay terminal – new retail and ticket buildings, new waiting room, consolidation of waste management facilities, and reconfiguration and expansion of the holding compound and employee and ferry user parking lots (\$15 million).
- Tsawwassen Quay – new retail building (\$10 million).
- Major upgrades at Skidegate, Prince Rupert, Bear Cove and McLoughlin Bay to correspond with the in-service data for the Northern Expedition (\$31 million).
- Nine major and northern terminals – multi-year project to upgrade security, including fences, gates, lights, access control and closed-circuit television.
- Capital lease investment and secured loan for new corporate office building in downtown Victoria.
- Smaller terminals – pontoons, ramps, dolphins, etc.
- Terminal waste water program - Multi-year sewage and waste water treatment projects, including connection to Tsawwassen municipal infrastructure, pump-ashore projects and holding tanks.
- Information technology – software development for retail and food service management, software development for crew scheduling catering, reservations software, automated ticketing kiosks, wireless handheld point of sale systems at smaller terminals, free wireless internet at Tsawwassen terminal, Swartz Bay terminal and on the vessels servicing that route.

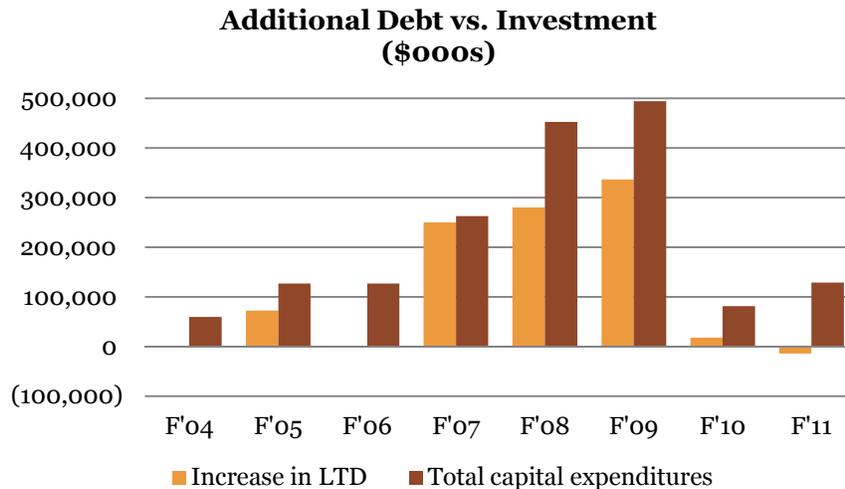
#### 4.2.14 Financing of Investments

The major fleet and asset renewal program in PT1 and PT2 was funded through cash flow generated from operations, as well as bank financing, debt issues and accepting obligations under capital leases.

As shown below, the total long-term debt (including capital lease obligations) at the end of each fiscal year increased each year for the past eight years, with a slight drop in fiscal 2011.



The increase in debt is directly attributable to capital expenditures, as shown in the chart below:



Interest expense has increased significantly over the past eight years, due to the rising level of debt. When BC Ferries first became an independent company, interest expense was a mere \$23 million. In order to invest \$1.7 billion in capital improvements, additional debt and lease obligations have been assumed, to the point that interest expense in 2011 was triple that of the 2004 level, at \$72 million.

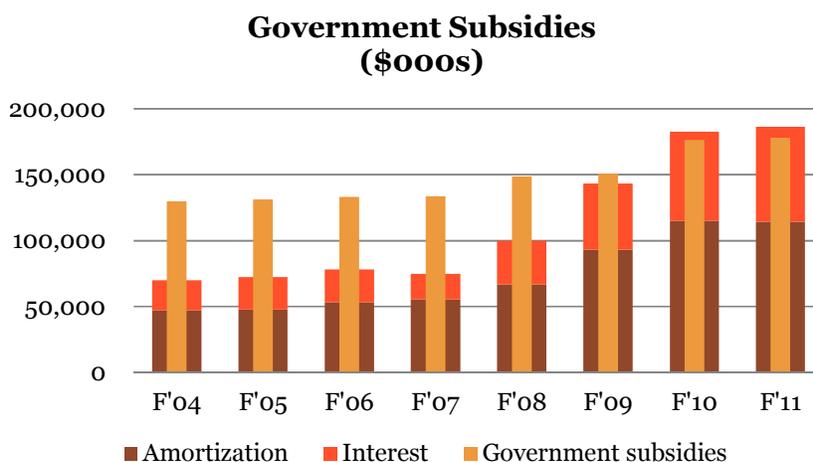
### 4.2.15 Government Funding

BC Ferries receives the following sources of funding from government

- Social Program Fees for transporting passengers under various provincial government social programs (seniors, school passengers and Ministry of Health);
- Ferry Transportation Fees for routes that are not commercially viable, in exchange for providing regulated ferry service, especially on the Northern and minor routes that include smaller Gulf Island and northern Sunshine Coast routes; and
- An annual amount under the Federal-Provincial Subsidy Agreement regarding the provision of ferry services to coastal British Columbia.

The Federal-Provincial Subsidy Agreement and the Social Program fees increase annually by the rate of inflation. The Ferry Transportation Fees have remained relatively constant over the past nine years except in the north where the fees have increased from under \$100 million in 2004 to \$127 million in 2011, which equates to \$6 per passenger. The increase in the Ferry Transportation Fees in the north is attributable to covering the cost of the new vessel after the sinking of the Queen of the North and to cover the rising costs of fuel.

As referenced earlier, tariff and ancillary revenues have reached the point where they now cover the cost of operations. However, funding is still relied upon to cover the cost of interest attributable to the debt load assumed for the recent upgrade of the fleet and to cover amortization. The chart below shows total government revenue in relation to interest expense and amortization combined.



### 4.2.16 Monitoring of BC Ferries’ Performance

As required by the Coastal Ferry Act, the British Columbia Ferry Commission monitors the performance of BC Ferries on a quarterly and annual basis. .

The Commission monitors compliance with the price caps and the delivery of core services required under the Coastal Ferry Services Contract. In addition to monitoring compliance with price caps and meeting all of its contractual obligations, the Commission also reviews on time performance, customer complaints and ferry user satisfaction. Since 2003, BC Ferries has met its contractual obligations under the Coastal Ferry Services Contract.

The following table outlines BC Ferries' performance for on-time performance and customer satisfaction for each of the past eight years:

	<b>2004 PT1</b>	<b>2005 PT1</b>	<b>2006 PT1</b>	<b>2007 PT1</b>	<b>2008 PT1</b>	<b>2009 PT2</b>	<b>2010 PT2</b>	<b>2011 PT2</b>
On time performance	84%	84.3%	85.3%	86.3%	o/s	87.9%	88.6%	89.6%
Ferry user satisfaction		88%	86%	89%	86%	91%	89%	

On time performance is self-reported by BC Ferries and is defined as the system-wide average of number of sailings departing within 10 minutes of the scheduled time.

Customer satisfaction has been consistently measured through an annual sampling survey conducted by an outside firm. While ferry user satisfaction levels as measured through the current process are high, a 2010 survey suggested that a significant minority of passengers are not satisfied with the overall value for money they receive.

#### **4.2.17 Summary of Performance**

Under the price cap system, fares have risen in line with increases in operating and capital expenditures and according to the regulated rate of return formula. Fares on the minor routes have risen faster than on the major routes as a result of higher costs being spread across a lower volume of traffic compared to the major routes. Other performance impacts over two performance terms include the following:

- farebox recovery and ancillary revenues now cover operating costs and the government subsidies cover the remaining capital and interest charges;
- while cash flows improved significantly over PT1 and PT2, overall earnings did not meet the regulated rate of return in PT2 due to traffic declines and higher fuel costs;
- with fleet renewal, the average age of vessels has improved; and
- value for money considerations dampen otherwise high customer satisfaction ratings.

A more thorough discussion of the relative efficiency of BC Ferries is described in Section 7.0.

### **4.3 Other Reviews**

BC Ferries has been the subject of two independent government reviews since its inception as an independent entity. Both the Auditor General and the Office of the Comptroller General have reviewed BC Ferries operation and governance. Both reports were generally positive and encouraging of the success of BC Ferries in its transformation from a Crown Corporation to an independent regulated entity. However, each report had some recommendations to strengthen the existing governance model and broaden the role of the Ferry Commission.

#### **4.3.1 Auditor General Review – December 2006**

The Office of the Auditor General of British Columbia (AG) completed a report in December 2006 entitled “Changing Course – A New Direction for BC’s Coastal Ferry System. A Review of the Transformation of BC

Ferries”. The AG completed the report to assess whether BC Ferries’ structural transformation was meeting government’s objectives for the province’s ferry system. The AG conducted a review of the new structure, and of how progress in meeting the objectives is monitored and reported to government and the public.

The AG stated that the transformation of BC Ferries has created a structure that achieved its immediate objective and has the potential to achieve more. No significant weaknesses were identified regarding efforts to make the ferry system sustainable, however, it is still early in the 60-80 year contract. The AG recommended establishing criteria to measure and evaluate the coastal ferry system’s success in relation to the objectives of the transformation and also to develop performance measures relating to the quality of service provided. The report confirmed four significant accomplishments which are summarized below.

*The new structure has achieved its immediate purpose.*

The immediate objective of separating government policy decisions from BC Ferries’ business decisions has been achieved, such that BC Ferries can make its own business decisions, including those related to the timing and cost of ferry replacement. The Province retains the major risks and benefits of ownership, and through negotiating service levels in the Coast Ferry Services Contract, government has the ability to set out what ferry services will be provided and what BC Ferries will be paid in return.

*BC Ferries governance has changed significantly.*

Along with BC Ferries’ increased independence is decreased control by government. The directors who control BC Ferry Authority are not answerable to owners or shareholders, and therefore may be less affected by market and regulatory pressures. However, constraints are imposed on the company by the Coastal Ferry Act, the selection process for the directors, securities regulators and to some extent public opinion.

As the Coastal Ferry Services Contract is 60-80 years in duration, the only terms to be periodically renegotiated are core service levels and the service fees paid for those services. Therefore any steps necessary to correct the transformation process would need to be via repealing or revising the legislation.

*Government is seeking to make the ferry system sustainable through reduced dependence on public funding.*

The cost of BC Ferries is successfully being shifted from the taxpayer to those who use the ferry system. BC Ferries is being expected to reduce costs, improve service and increase revenue, along the lines of a private-sector company.

The Auditor General expressed the caution that while BC Ferries Commissioner regulates and monitors fares and service, there is a concern regarding the effectiveness of control against monopolistic behaviour.

*Some monitoring is carried out, but more could be done.*

Both the Ferries Commissioner and the Ministry of Transportation monitor BC Ferries to ensure compliance with the Coastal Ferries Services Contract.

The Auditor General cautioned that reporting is fragmented between the BC Ferries and Ferry Authority annual reports and AGMs which are all available to the public, as well as the Commissioner’s annual report which is tabled in the Legislature.

#### **4.3.2 OCG Review – October 2009**

The Ministry of Finance, Office of the Comptroller General (OCG), issued a report in October, 2009 entitled “Report on Review of Transportation Governance Models”. The purpose of the engagement was to review the independent delivery model of BC Ferry Services Inc. to ensure taxpayers are receiving value for provincially funded grants and investments while meeting the objectives for which the independent models were created.

With the exception of compensation, the OCG found BC Ferries to be well managed and reasonably effective. The current governance framework has the components to be effective, however the implementation and decisions made by parties suggest improvements are required to ensure strong oversight and accountability. The OCG recommended independence between the BC Ferry Authority, the sole shareholder of BC Ferries, and the BC Ferries' Board. All nine members of the Authority sat on the BC Ferries' Board, which creates inherent conflict. In accordance with the provisions of Bill 20, the Authority replaced the directors of the Company on September 30, 2010. BCFA elected eight directors to the board of BCFS effective that date.

BC Ferries has appropriate financial and management controls and processes. Cost containment strategies, revenue generating efforts and ferry user service quality systems were in place.

The OCG raised concerns around the current intentions of the BC Ferries governance structure and the lack of clarity regarding issues such as minimizing fare increases, long term sustainability of coastal ferry transportation system as a whole (vs. Short term decisions focused on maximizing profit). A set of four core objectives of the Province that are assumed to be key to BC Ferries are not specifically identified within BC Ferries' governance material. They include protecting ratepayers' interest around administration and compensation, mandated ferry user service levels, minimizing costs and maximizing benefits regarding provincially funded grants and improving transparency and accountability for decisions and performance levels.

While the review concluded that the operations of BC Ferries are well managed and reasonably effective, the prioritization of the financial sustainability of the ferry operator has resulted in a narrow interpretation of the guiding principles and the regulatory role by the Commissioner.

As a result, the OCG recommended changes in the mandate and responsibilities of the Commission. In these changes, which were enacted by Bill 20, the OCG recommended the role of the Commission be expanded to include consideration of ferry users and to publish and comment on various aspects of BC Ferries plans for capital expenditures and efficiency improvements.

## 5 Public Consultation Summary

### 5.1 Introduction

Upon passage of Bill 14, giving the Commissioner the mandate to conduct a review of the Coastal Ferry Act, the commissioner immediately embarked on a comprehensive public consultation process which included the following:

Public Meetings	
June 6	Alert Bay
June 7	Malcolm Island
Aug 2	Bella Bella
Aug 2	Deny Island
Aug 3	Klemtu
Aug 3	Ocean Falls
Aug 3	Bella Coola
Aug 28	Sandspit
Aug 29	Masset
Aug 29	Port Clements
Aug 29	Queen Charlotte City
Sept 7	Gibsons
Sept 8	Powell River
Sept 9	Texada Island
Sept 15	Salt Spring Island
Sept 16	Galiano Island
Sept 16	Pender Island
Sept 17	Mayne Island
Sept 26	Quadra Island
Sept 27	Hornby Island
Sept 27	Denman Island
Sept 28	Penelakut Island
Sept 28	Thetis Island
Sept 28	Galiano Island
Oct 1	Saturna Island
Oct 15	Bowen Island

- 27 public meetings in coastal communities served by BC Ferries.
- Meetings with various municipal councils, regional districts on the coast.
- Meetings with the Chairs of the Ferry Advisory Committees, the Chairs of Coastal Regional Districts, the Islands Trust Council, various First Nation councils and other interested parties.
- Publishing a number of discussion papers on the commission’s website and inviting public comments thereon.

Notices were placed in all relevant local media for the public meetings and a public notice was published in all relevant major media outlets to invite comments on the discussion papers.

In total over 40 meetings took place with the commissioner and deputy commissioner appearing before approximately 2,000 people. In addition, the commissioner received over 200 written submissions from the public and various organizations.

### 5.2 Key Themes from the Public Consultation

The commissioners reviewed hundreds of submissions and listened to comments made at all the public meetings. The comments heard most frequently at the meetings or read in the written submissions were grouped into themes. The following key themes emerged:

- Affordability
- Accountability
- Financial sustainability
- Economic Development

Each of these themes is described in more detail below.

#### **Affordability**

**Affordability of fares was the predominant theme raised in the public meetings** The significant increase in fares over the past eight years has had a variety of impacts. These impacts range from unaffordability and reduced travel to quality of life issues and negative impact on local

economies. Quotes shown in italics are representative of comments heard by the Commissioner.

*Affordability is the key interest of ferry users. Ferry fares affect every aspect of life in communities that depend on ferry service. It affects the cost of all goods and services coming into the community or being exported from the community, the level of tourism which is a key economic driver and the ability to access work and services outside the community.*

*Ferry fares are no longer affordable and are impacting people's ability to travel frequently to visit family or friends or take vacations.*

*The rise in ferry fares is a significant factor in the decline of passenger and vehicle traffic on BC Ferries.*

*The vision of hiking fares in order to reduce the pressure on the government might have seemed reasonable at one time. Unfortunately there was no mechanism put in place to measure the impact of that vision.*

*The coastal ferry system should be treated as an extension of the highways system and supported by the taxpayer.*

*Inland ferries are free and to treat coastal ferries differently is unfair.*

### **Accountability**

**There appears to be a need for greater transparency and accountability for the operation of the ferry system based on the public input.** The roles of government, the BC Ferry Authority and the commissioner in the oversight of the ferry system are also poorly understood.

*BC Ferries does not appear to be accountable to anyone including its board of directors who are not accountable to any shareholders.*

*The independent company model for BC Ferries has not served the interests of ferry users and should be abandoned in favour of a crown corporation or at least accountability revert back to government.*

*The Commissioner should have a free hand to review all operations.*

*BC Ferries does not listen to the concerns of ferry users. Ferry users are not involved in their decision making.*

*There does not seem to be enough oversight of BC Ferries' costs.*

*Recent capital investment in new vessels and upgrades to existing vessels and terminals has been wasteful and not in keeping with basic needs of ferry users.*

### **Financial Sustainability**

**A financially sustainable ferry operator is generally understood to be in the interests of ferry users.** However, ferry users are generally not aware of the level of subsidy, the rising costs of operating the ferry system or the efficiency or inefficiency of the ferry system.

*The ability of the ferry operator to safely and reliably sustain operations is an interest of those who depend on ferry service.*

*It is important that the service be provided affordably, safely and reliably on an on-going basis – which requires the capacity for adequate investment. However, the ferry operation should be sustained at a lean and efficient level.*

### **Economic Development**

**The ferry system is important to coastal communities from an economic perspective.** The rapidly rising fares are having a negative impact on local economies that depend on the ferry system. Many members of the public stated that the higher fares are resulting in higher cost of living and are having a negative impact on tourism and on commercial and residential investment.

*The rise in ferry fares since 2003 has been unreasonable and harmful to the sustainability of coastal communities.*

*Higher ferry fares are “hollowing out” communities.*

*BC Ferries does not support local communities enough and a new guiding principle should be consideration of the impact of higher fares on the economies of ferry dependent communities.*

*BC Ferries should put more emphasis in promoting tourism in the mid and north coast regions by working in partnership with tourism operators and Tourism BC.*

## **5.3 Responses to Discussion Papers**

The Commissioner published a total of nine discussion papers on the Commission’s website and by public notice invited comments from the public. Selected submissions received will be posted on its website. The following extracts are representative of the key themes of the submissions:

### **Discussion Paper #1- Guiding Principles of Regulation**

- The six guiding principles in the Act do not serve the interests of ferry users especially the principles of a greater reliance on user pay and no cross subsidization.

### **Discussion Paper #2- Definition or Meaning of “Consider the Interests of Ferry Users”**

- “Consider“ in the context of “consider the interests of ferry users” when applied to the regulatory role has to mean “consider the interests of ferry users in setting the fare cap”. That has to mean the amount of the fare cap has to be able to be influenced by the concerns of the ferry users. Nothing less. And we know that the Commission presently has no tools to respond to the interests of the ferry users.

### **Discussion Paper #3- Definition or Meaning of Financial Sustainability**

- Under some regulatory regimes, the regulator has placed a limit on the level of debt the company can raise by limiting the debt to equity ratio in order to improve the financial resilience of the company and ensure it can deliver essential services. This demonstrates that the assessment of user interests can be beyond the prices charged to encompass wider considerations such as maintaining service levels and ensuring that a service can be provided to users.
- The regulated rate of return on equity should be limited to the requirements of lenders so that BCFS can borrow funds. Local governments should contribute financial support to the ferry services. Also, there should be a set percentage that each of the local governments, the Province and the ferry riders

contribute to the revenue requirements of the ferry service. However, service levels may also have to be examined, where it is possible to reduce costs by reducing service.

#### **Discussion Paper #4- Balancing the Interests of Ferry Users and Financial Sustainability of Ferry Operator**

- If the Commissioner determines that the legitimate returns needed by the operator to sustain a cost-efficient service cannot be achieved without increasing fares to a level that would have harmful economic and social consequences, then legislation should provide for the Commissioner making appropriate recommendations to the Province.
- In the absence of any material control of BCF expense projections and any control at all of the provincial government contribution, the commission is powerless to influence the affordability of fares for the ferry user.

#### **Discussion Paper #5- Price Cap Regulation**

- The regulation of ferry services is very different from, say, the regulation of electrical power providers where demand is predictable and stable. The traditional regulator role is too rigid when it comes to regulating ferry services. A more nimble and responsive regulatory touch is needed to respond to conditions that can change rapidly.

#### **Discussion Paper #6- Cross-subsidization of Route Groups**

- A one price cap model is more straightforward and equitable. A one price cap on average fares still allows flexibility in setting individual tariffs, which could be restricted from getting too extreme through a maximum price cap on individual tariff increases.

#### **Discussion Paper #7- Alternative Service Providers**

- If there is to be any consideration for engaging ASPs to provide service, it should be restricted to unique situations that are separate from the main system, and not part of the core operation.
- ASPs could also be considered for specific isolated applications augmenting existing service. Such service additions would still have to make sense under financial cost-benefit analysis, regardless of who provides the service.

#### **Discussion Paper #8- Cost Efficiency**

- The Commissioner should have a free hand to review all operations and not be limited by efficiencies identified by BCF which were clearly driven by the need to replace vessels.

#### **Discussion Paper #9- Regulation of Unfair Competitive Advantage**

- It seems appropriate for BC Ferries to use under-utilized capacity as one of the few options to derive revenue other than through increased fares or increased government contributions – especially as the

original rationale behind the Coastal Ferry Act included modest fare increases and reduced government contributions. Any issues that might arise around competitive practices should be addressed through other mechanisms and not through the Act.

## **5.4 Other Written Submissions**

The Commissioner received over 200 submissions from public entities and individuals. All submissions were carefully reviewed by the Commissioner. These submissions provide a number of perspectives to improve the current regulatory model. Selected submissions from public entities are posted on the Commissioner's website. The Commissioner has not posted submissions from individuals in consideration of privacy. A list of the public entities that have provided submissions is included in Appendix B.

## **5.5 Summary and Conclusions**

The oral and written responses received by the Commission are invaluable to the Review. They were wide ranging and in some cases divergent in their positions. The Commissioner is able to draw the following observations in relation to his review:

- Current ferry fares and the proposed increases have reached the tipping point of affordability and are imposing significant hardship on ferry dependent communities and the ability of people to visit family members and friends as frequently as they would like.
- The six “guiding principles” in the Act should be modified to place a greater emphasis on protection of the interests of users.
- There needs to be greater transparency and accountability for the operation of the ferry system. Governance and oversight of the ferry system is perceived to be weak. There needs to be some strengthening of the oversight role of the Commissioner particularly with regards to BC Ferries’ operating and capital costs without departing from the light- handed regulatory model.
- There needs to be a more effective process for consultation and input from ferry users. BC Ferries’ operating policies and procedures do not appear to ferry users to be serving their interests as a priority and there is a lack of a meaningful consultation process or recourse on decisions affecting them.

## 6 Price Cap Jurisdictional Review

### 6.1 Scope of the Review

A jurisdictional review was conducted by PwC under the direction of the Commissioner. The focus of the review was on the identification of relevant price cap regulation systems, in order to draw lessons applicable to the BC ferry system. The scope of the jurisdiction review focused on the following broad sectors:

**Public sector transport regulators** – Public transport services can also be regulated through public bodies or government departments where price caps are set for a range of public transport modes.

**Independent regulators in other sectors**– Independent regulators are also common across a range of infrastructure sectors. PwC reviewed the approaches taken by independent regulators with a focus on the UK where the regulatory approach is most developed.

While the issues identified by the Commission are broad in scope, they had a particular focus on the following:

- How user interests are defined
- How other jurisdictions balance interests of users and financial sustainability
- Best practices regarding the role of the regulator in approving the service provider’s capital expenditures
- Identification of how other jurisdictions, with comparable regulatory models, define equity and determine return on equity

The jurisdiction review seeks to identify how different regulatory models have addressed the issues identified by the Commissioner. This is a factual analysis underpinned by: the supporting regulatory legislation, the regulatory determinations made, supporting regulatory analysis and papers and other evidence as identified.

### 6.2 Interests of Users

The Bill 20 amendment to the Coastal Ferry Act requires that the Commission “consider the interests of ferry users”. The requirement is not specifically defined and there is considerable ambiguity regarding the application of this requirement in practice. This new requirement gives rise to the need for the Commission to determine an appropriate balance of the interest of ferry users with financial sustainability objectives of ferry operators.

This section considers the regulatory objectives that have been placed, through legislation, on independent regulators in the UK, including objectives (or duties) place on the regulator that have regard to user interests. The regulatory approach in the UK has a long history since the initial privatizations in the 1980s and the background to their evolution is set out.

A closely related topic to users interests is the issue of affordability, which is also covered in this section.

#### 6.2.1 UK Independent Regulators

The majority of UK regulators were established in the 1980s following privatisation of nationalized industries. The regulators were established under relevant Acts of Parliament establishing the duties and powers of the regulator.

Most regulators have evolved into large organisations often with over 100+ employees undertaking a range of functions including: economic (price) regulation, service quality monitoring and regulatory policy. Regulators also access external expertise, for example, technical consultants to assess capital plans.

Companies subject to regulation were initially issued with licences by government (now by the regulator), which normally set out their rights and obligations. The Acts set out the criteria for changes to the licence, allowing a right of appeal, normally (the CAA being an exception), to the Competition Commission.

The scope and type of regulator vary according to the sector being regulated:

- a) “Natural monopoly” sectors e.g. Gas and electricity networks, where the nature of the sector means regulation is always likely to be required.
- b) “Nationalized monopoly” sectors, where a nationalized industry was dominant in a particular sector, but where competition was expected to evolve over time, for example telecoms.
- c) Financial services sectors covering for example financial markets and pensions.
- d) Competition authorities with general powers to maintain competition and prevent market abuse.

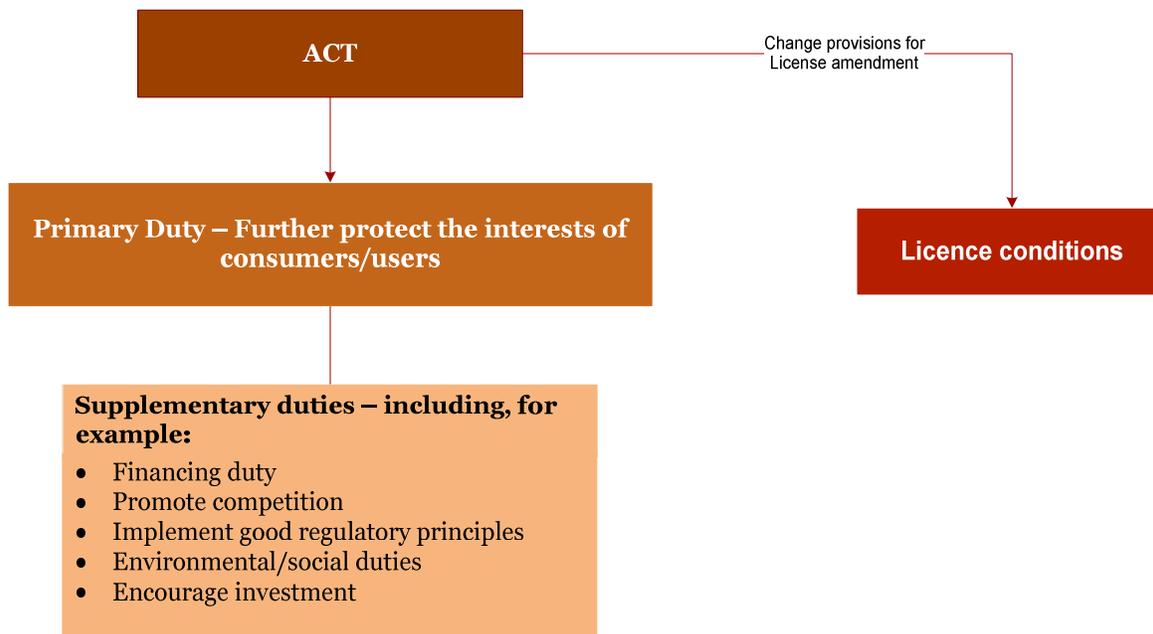
For the scope of the jurisdictional review, only a) and b) are likely to be relevant as these are sectors where price caps have most commonly been applied.

The table summarizes the regulatory landscape in the UK. It should be noted that the year of inception refers to the inception of the regulator in its current form. For example, there have been regulators in the energy sector since privatization in 1980s, but Ofgem has only been in its current form since 2000. The legislation refers to the latest legislation passed in the sector that applies to the particular sector. Most legislation is recent.

<b>Name of Regulator</b>	<b>Year of Inception</b>	<b>Legislation</b>
Postcomm	2000	Postal Services Act 2000
The Water Services Regulation Authority (Ofwat)	2006	Water Industry Act 1991, as amended by Water Act 2003
Office of Gas and Electricity Markets (Ofgem)	2000	Utilities Act 2000
Civil Aviation Authority (CAA)	Airports since 1986, regulation of Air Traffic Services from 2001	Airports Act 1986 Transport Act 2000
Office of Communication (Ofcom)	2003	Communications Act 2003
Financial Services Authority (FSA)	1997	Financial Services and Markets Act 2000
Office of Rail Regulation (ORR)	2004	Railways Act 1993, as amended by Railways Act 2005
The Pensions Regulator (TPR)	2004	Pensions Act 2004
Office of Fair Trading (OFT)	2003	Enterprise Act 2002
Competition Commission (CC)	1999	Competition Act 1998

In the diagram below, **there are clearly two tiers of duties that are given to regulators: a primary duty and a set of secondary duties.** The UK House of Lords in its review of economic regulators concluded that: *“Independent regulators’ statutory remits (i.e. those defined through legislation) should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how these duties should be prioritised”.* Where regulators have not had a priority of objectives, this can lead to confusion and a lack of clarity regarding how regulators should prioritise different objectives. In the UK, the Airports act 1986 places four equal duties on the regulator and there have been concerns that the regulator has placed too much emphasis on the fourth of these duties (minimum restrictions). A current draft bill for the airports regulation proposes a move to a clearer hierarchy of objectives as outlined below.

**Overview of UK Economic Regulation**



The table below summarizes the scope of different regulators’ duties in the UK. **The common primary duty is consistent for all regulators, namely to further the interests of consumers, but a range of other objectives have also been included depending on the policy context of the individual regulator.**

	Ofcom	Ofwat	ORR	Ofgem	CAA	PostComm
Further/protect interests of consumers	Yes	Yes	Yes	Yes	Yes	Yes
Further/protect interests of citizens	Yes	No	No	No	No	No
Promote competition	Yes	Yes	Yes	Yes	No*	Yes
Encourage market investment	Yes	No	Yes	No	Yes	No
Promote public awareness	Yes	No	No	No	No	No
Provide advice to the government	No	No	No	No	Yes	Yes
Implement regulatory good principle	Yes	No	No	Yes	No*	No
Facilitate market innovation	Yes	No	No	No	No	No

**The acts that define the duties of the regulator do not seek to define user interests in precise terms, leaving the precise interpretation to the regulator.** In some circumstances, the legislation defines particular groups that the regulator should take account of, for example disabled users. Another distinction that is commonly made is to refer to the interests of existing and future users, reflecting the fact that these interests may diverge.

In a policy document a broader definition of the difference between: consumer, public and citizen interests is made as follows:

- “the consumer interest (user) can be defined as the interest of a purchaser or other user of a good or service, normally based on an economic relationship between the individual and the supplier of the good or service in question”
- “Citizen interest may be defined as the interest of the individual in his or her capacity as a member of society”
- “Public interest as the interest or good of society as a whole”

**In the UK, regulators’ duties have moved away from just consumer interest from the narrow perspective of an economic regulator, to encompass wider policy objectives related to citizen/public interest issues, such as the environment.**

The extract of the Water Act of 2003 below highlights that no precise definition of user interests is given in the act.

“The Secretary of State or, as the case may be, the Authority shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner which he or it considers is best calculated —

- to further the consumer objective;
- (2c) For the purposes of subsection (2A)(a) above the Secretary of State or, as the case may be, the Authority shall have regard to the interests of:
  - individuals who are disabled or chronically sick;
  - individuals of pensionable age;
  - individuals with low incomes;
  - individuals residing in rural areas; and
  - customers, of companies holding an appointment under Chapter 1 of Part 2 of this Act, whose premises are not eligible to be supplied by a licensed water supplier, but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.”

Similar drafting is included in other acts and the general approach has been for regulators to interpret the interests of users in its regulator decision making process, with a process of open consultation to elicit users’ views. The process of defining user interests specifically in the act is likely to be challenging and could also lead to a requirement for frequent modification to the legislation, if user interests change over time.

**There is limited evidence that UK regulators have had affordability defined as part of their regulatory objectives and duties. Generally there has been reluctance for regulators to be involved in issues relating to affordability considering it a social issue.** For example Ofwat notes:

“Questions of which customers are deserving of help, how much they get and who pays, are all social policy issues. So they are for Government to decide.”

Where regulators have considered affordability it has been in relation to providing advice and research to government on affordability (for example on which groups are most vulnerable) or looking at how regulatory proposals affect affordability within different groups.

The only example of affordability being considered in legislation is in the UK Postal Services Act 2000, which requires all prices of universal service products to be “affordable”. The Act does not, however, provide a definition of affordability. Postcomm have therefore developed the following definition of affordability:

“A universal postal service product, would be ‘unaffordable’ if a potential residential customer was entirely excluded from purchasing it or face significant hardship from purchasing it because of the price”.

It was however noted that in the postal sector this definition was unlikely to be a binding constraint on the prices set currently or in the foreseeable future, and therefore it is not possible to understand how the regulator has responded to this constraint in the setting of its price cap.

**The regulatory duty to ensure the business can be financed may also limit the extent that regulators can implement any duty relating to affordability, as it can be argued that it is in the user interest that the company is financially viable and the service is provided to all users.**

### 6.2.2 Role of User Groups

Input from users in the BC ferry system is accomplished in two primary ways: through customer satisfaction surveys and through Advisory Committees that are managed by BC Ferries. As part of its regulatory review, the Commission has also independently undertaken its own extensive public consultation process.

**In the UK regulatory system, user groups are used in a range of regulated industries to represent the needs of consumers in the regulatory process.** This reflects the fact that where there are a wide range or large number of users understanding the key interests of users can be challenging for regulators.

The groups can be a more technically focused panels of experts, where there are technical issues that require consumer interest considerations, for example in the telecoms or energy sectors, or be consumer advocacy groups which consider issues relating to observable service quality, for example in the transport sector.

The structure and design of the user groups varies according to the particular needs of the sector and the legislation governing the sector. In some sectors, for example UK rail, the role of the user group is clearly specified in the legislation, for which government provides funding and has powers to appoint members. In other sectors, there is no legislated body to represent the needs of users, but regulators have established informal groups to allow for feedback into the regulatory process, for example Ofgem’s consumer challenge group.

Another feature of user interest groups under UK legislation is that they can have super-complainant status under the Enterprise Act 2002. A super-complaint, as defined in section 11(1) of the Act, is a complaint submitted by a designated consumer body that ‘any feature, or combination of features, of a market in the UK for goods or services is or appears to be significantly harming the interests of consumers’.

Super complaints give a fast track status to the complaint and ensure that the Office of Fair Trading or the regulator give a response within 90 calendar days. There are a range of possible outcomes that could emerge from a super complaint ranging from an enforcement action to a full market investigation by relevant competition authorities.

**User groups can also be given responsibility for conducting surveys regarding user satisfaction with the services provided and report these findings to the regulator.**

## **Airports**

- Users interests at specific airports are generally represented through airlines and at airports through specific user groups consisting of airlines. In addition, the Civil Aviation Authority has recently established the Aviation Consumer Advocate Panel (ACAP), which has up to 10 members and receives funding and secretariat support.

## **Water**

- Consumer Council for Water (established in the Water Act 2003) – acts as a “strong national voice for consumers”. They have also commissioned research on price-cap decisions, for example on the appropriate cost of capital. Funding is provided by user charging bill payers directly with no tax payer or regulator support.

## **Gas and Electricity**

- Consumer Direct is the government funded telephone and online service offering information and advice on consumer issues, which is funded by the Office of Fair Trading and delivered in partnership with Local Authority Trading Standards Services.
- The Energy Ombudsman can investigate complaints for domestic and micro-business consumers that the energy supplier or network operator cannot resolve.
- For the latest Price Control Review process, Ofgem are planning on engaging with the Consumer Challenge Group (CCG). The CCG was first used successfully on the last Electricity Distribution Price Control (DPCR5) and consists of a number of professional consumer advocates. The CCG will meet with both the Ofgem teams working on the Price Control reviews as well as a Committee of the Authority to raise important consumer concerns.

## **Rail**

- The 2005 Rail Act identified that there would be a body to represent users called the Rail Passengers’ Council, which has subsequently been renamed Passenger Focus. The appointment of the chairman to the group is controlled by the Secretary of State for Transport, with members appointed by the Scottish and Welsh Minister and the Mayor of London. The Council has a maximum of 12 members with additional members agreed by the chairman and the Secretary of State.
- The aim of the group is “to protect the interests of Britain’s rail passengers and England’s bus passengers outside London, coach passengers on scheduled domestic services and tram passengers”. Funding is provided by the Department for Transport, but the operations and policy-making functions are independent of government. It has been debated as to whether air passengers might also be covered by Passenger Focus.
- The current objectives of Passenger Focus are to:
  - Make a difference for all passengers
  - Tackle examples of poor passenger service
  - Improve access to services for passengers with particular needs
  - Promote good practice in complaint handling and provide advice and advocacy to complainants
  - Increase awareness of Passenger Focus and our influence with stakeholders
  - Build and deliver effective passenger representation for bus and coach passengers
  - Boost Passenger Focus’s capacity and capability to get the best deal for passengers

## Communications

- In the communications markets, Ofcom established a Communications Consumer Panel to advise on the consumer interest in the markets it regulates. The Panel is independent of Ofcom and operates at full arm’s length from it, setting its own agenda and making its views known publicly.
- The Communications Consumer Panel is an independent group of experts established under the Communications Act 2003. Its role is to provide advice to Ofcom to ensure that the interests of consumers, including small businesses, are central to regulatory decisions. The Panel also provides advice to Government and champions consumers’ communications interests with industry.
- The Panel is made up of independent experts with experience from many different fields: consumer advocacy, regulation, the third sector, academia, the trade union movement, market research and industry. The expert nature of the panel, rather than appointment of users, reflects the fact that the issues are generally technical in nature.
- A memorandum of understanding in place with Ofcom sets out the principles for engagement between the panel and Ofcom across the following areas: consultation and advice, collaboration, openness, information provision and confidentiality, and resource provision including budget.
- In an attempt to increase transparency of Ofcom’s consideration of the interests of users, the panel working with PwC, developed a “Consumer Interest Toolkit”. The toolkit attempted to provide regulators with a practical means of assessing how regulators:
  - Identify and take account of consumer interests in regulatory policy development and implementation
  - Demonstrate what they have done in addressing consumer interests and the basis for their actions
- The toolkit was subsequently used to review how the consumer interest was taken into account in three regulatory determinations made by Ofcom and identify lessons that could be learnt and applied.
- User groups have been used by regulators in other jurisdictions to allow the regulators to have a focus for their consideration of user interests. These groups are set up to be independent of the regulator with the group often receiving funding for its work.

## 6.3 Financial Sustainability

The Coastal Ferry Act provides that: “Priority is to be placed on the financial sustainability of the ferry operators”. The Act does not provide a definition of the “financial sustainability”.

BC Ferries has been successful in raising over \$1.4 bn in long-term debt through the issuance of investment grade bonds. Debt proceeds have been used to purchase large and intermediate size vessels and to upgrade terminals.

While preferred dividend and debt service charges have been met, profitability targets and rates of return have not been achieved. The rate of return on equity during PT2 was well below the prescribed rate of 13.16% used to establish the price cap for the second performance term, despite the significant increases in fares.

	F’09	F’10	F’11
BC Ferries’ ROE	2.87%	1.10%	1.23%

The low rate of return may pose a threat to financial sustainability of the company.

In the UK, Ofgem in its RPI-X@20 review<sup>1</sup> defines its interpretation of financial sustainability (“financeability”) as follows:

“Our principal objective is to protect the interests of existing and future consumers. Following on from this is our duty - “to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them.

This means that efficient network companies should be able to secure financing in a timely way and at a reasonable cost in order to facilitate the delivery of their regulatory obligations. It is important that the regulatory framework does not provide excessive returns, reward inefficiency or bail-out”

A more general interpretation of approach adopted to assessing financial sustainability is given by Cambridge Economic Policy Associates in its work for Ofgem:

“whether a company is able to fund its investment programme and meet basic financial ratio tests, based on the way credit rating agencies assess whether a company is investment grade, given the expected cash-flows generated by the regulatory price determination”.

An assessment of financial sustainability generally takes into account the following areas:

- **Weighted average cost of capital** – In a Regulated Asset Based (“RAB”) type price cap one of the key regulatory decisions is the allowed return (generally an estimate of the weighted average cost of capital) on investment. To estimate the WACC (weighted average of return on equity and cost of debt) regulators benchmark against companies with similar risk characteristics.
- **Estimation of appropriate operating costs** – The regulator will look to ensure there is sufficient allowance for operating costs, whilst setting an efficiency target for the company to achieve.
- **Capitalization and depreciation of the RAB** – The capitalization policy of the regulator determines when investments can be capitalized and a return allowed on the investment. Investments in the RAB will also be amortized over time through a range of approaches (e.g. straight line, reducing balance) and according to different estimates of the useful life of the asset.
- **Calibration of the regulatory package, assessment of finance ability and the role of the credit rating agencies** – The final element is to assess the cash flows and risks coming out of the overall package. The general approach taken by UK regulators for assessing financial sustainability (“financeability”) is to assess the cash flows from the regulatory decisions taken across the various regulatory building blocks against various financial ratios considered by credit rating agencies. In the UK, regulators have generally looked at a range of financial ratios and compared these ratios to a target credit rating (e.g. investment grade).

To assess the implications from the cash flows generated from the proposed price caps regulators will assess a range of financial metrics arising from the notional capital structure (i.e. the capital structure the authority has assumed in its price determination and to calculate the WACC). The particular financial ratios that will be considered will depend on the particular risk characteristics of the regulated company, but could for example cover:

- Adjusted Interest Cover ratio (funds from operations (FFO) less capital expenditure to maintain the assets in a steady state / interest)
- Funds from operations / interest;
- Funds from operations / debt;
- Retained cash flow/net debt;
- Net debt/Regulated assets; and

- Regulated assets/EBITDA ratio.

These ratios are compared against the ratios expected for a particular credit rating, generally investment grade that is defined as a minimum BBB+/Baa1 credit rating. Where there are shortfalls in a particular period, a common approach taken by regulators is to adjust the profile of amortization (in a NPV neutral way to ensure that in real terms the regulated company is not better off and the adjustment is purely a cash advance) to smooth the cash flows of the company. BC Ferries currently targets a strong investment grade credit rating in order to access credit at reasonable rates.

**The balancing by regulators of the company’s financial sustainability on the one hand and the interests of users on the other is an important topic. The general approach by regulators is to ensure that the regulatory building blocks are carefully considered and set at a level to give the company enough cash flow to finance their activities, but with strong incentives to improve.** A key factor in this process is setting the cost of capital at its most appropriate level.

**The general structure of regulatory objectives for UK regulators, with a primary duty to further the interests of use and a secondary duty to ensure that the company can finance its activities, means the balance between these objectives is generally clear.** It also recognizes that it is in the interests of users that the company can finance its activities and does not become insolvent or is forced to pay an excessive price to access capital markets. It is also in the interests of users that the company can finance its activities efficiently and that risks are appropriately allocated. Under some regulatory regimes, risks have been passed to users (for example traffic risk) to reduce the risks to the company and hence the cost of equity, through regulators applying a lower equity beta than would be the case without the traffic risk.

The interpretation of financial sustainability can vary depending on the sector and the preferences of users. In the UK air traffic sector, following privatization of the air traffic provider (National Air Traffic Services), under a highly leveraged structure, after 9/11 National Air Traffic Services became under financial distress and had to be “bailed out” by its regulator in the interests of providing this essential service for its users. To protect the interests of users (for a critical service with no alternative provision) and reduce the risk of future financial distress, the regulator has placed a limit on the level of debt the company can raise by placing a cap on the debt to 65% of total capitalization. This compares to the normal regulatory practice whereby the regulator assesses the notional capital structure of the regulated company, but does not seek to place any limits on the ability of the company to develop an appropriate capital structure. This demonstrates that the assessment of user interests can be beyond the prices charged to encompass wider considerations such as service resilience.

## 6.4 Capital Expenditures

There are two sections of the Act that reference capital expenditure approvals:

“41(3)(c) determine whether it was reasonable, in the Commissioner’s opinion, acting reasonably, for the ferry operator to have incurred capital expenses in relation to a designated ferry route included in the route group, and take into account only those capital expenses that

a) are determined under this paragraph to be reasonable, or

Had been approved under section 55. Before deploying capital assets on, or incurring capital expenditures in connection with, a designated ferry route or terminal, the ferry operator may apply to the Commissioner and the Commissioner must, within one month of the application, declare whether the capital assets proposed to be deployed on, or capital expenditures proposed to be incurred in connection with, the designated ferry route or terminal are reasonably required.”

BC Ferries have made a number of submissions to the Commission regarding capital plans including the acquisition of three Super C vessels and intermediate class vessels, vessel retrofits and terminal upgrades. However, currently the review of long term capital plans is outside of the scope of the Commission’s mandate.

This section covers the approach that other regulators have taken for reviewing and approving capital investment plans, along with any wider policy approaches that have been taken with regard to capital investment, for example user consultation.

**The general interpretation of the regulatory duty to protect user interests is for the regulator to take a very active role in reviewing the capital investment plan. The review of the capital plan is to ensure that the appropriate level of investment is made that meets the requirements of users, both for the next control period and for the medium to long term.**

The statutory objectives of the regulator can also make reference to investment, for example the Civil Aviation Authority's ("CAA") statutory duties include a duty for the CAA "To encourage investment in new facilities at airports in time to satisfy anticipated demands by users of such airports" (Airports Act 1986). The duties for Ofcom also make reference to "the desirability of encouraging investment and innovation in relevant markets".

The role of the users will vary according to the nature of the sector: in some sectors users may have a strong level of input into their needs for capital investment (e.g. airports through the airlines they serve) while in other sectors the technological complexity and the number of users may mean that the involvement of users in the capital approval process is not possible (e.g. energy). In this case, the regulator has to play a more active role in reviewing the investments made (although expert users groups will still have a role to play in the process and user attitudes may be factored in, for example through consumer surveys).

**The general process for a regulatory price-cap determination requires that the regulated company submits its capital plan for the forthcoming control period (in addition to its longer term view of capital investment requirements) to the regulator.** The regulator will then review the capital plan, using technical consultants etc. and come to a final determination on the capital investment plan.

In some instances the regulator may require clarification on government policy (e.g. on planning or environmental policies) which impacts on capital investment or make recommendations on the approach Government should take to wider policy objectives that are outside of the remit of the regulator.

The approach taken by regulators to capital investment at Stansted airport during the Q5 price control for the airport provides an interesting overview of some of the regulatory tools used with regard to capital investment.

The initial approach taken by the regulator was to use a process of "constructive engagement" between the airport British Airport Authority ("BAA") and the airlines (as a proxy for the ultimate users of the airport i.e. passengers formed as the Stansted Airline Consultative Committee (SACC)). The aim of this process was for the two parties to agree a programme of capital investment, which would ensure that the interests of users were taken into account and the appropriate investments made. Despite the attractions of this model, it was not successful as the airlines argued that insufficient information was provided to them to reach a decision. There was also disagreement regarding significant future capital investment programme for the construction of a new runway and terminal.

Due to the failure of the constructive engagement process, the regulator was required to review BAA's capital investment plan. The initial capital plan for Stansted proposed by BAA was £535.3m, but SACC suggested that the programme should be much smaller in scope and cost £92.4m. There was extensive discussions around minor capital programmes (<£2m) and it was agreed that these would be capped at £10m a year. Following extensive discussions with BAA, users and an independent review of capital investment the final determination of capital investment was £104m – a considerable reduction on the initial investment plan.

The key lesson from regulators is that while getting user involvement in the capital investment process is desirable, they may not always be able to develop a mutually agreed capital plan and they regulator may have to take a role. There may also be cases where some groups of users have vested interests to favour a particular outcome and may attempt to steer the capital investment plan in a certain direction.

In addition to reviewing the capital investment plan regulators need to develop rules governing the entry of the asset to the Regulatory Asset Base ("RAB") that cover all of the assets on which the regulated company can

make a return). These rules are critical for ensuring there are incentives for efficiency of investment and that changes in costs are not simply passed through to users.

The regulator also needs to consider its policies for assessing capital investment made during the previous control period. This process is required because the capital investment plan outlined to the regulator is unlikely to exactly match the capital investment made during the period (for example if an investment gets delayed to the next period).

**Regulators have also applied various adjustments to protect users and ensure that the regulated company is incentivized to deliver capital projects in the most efficient way possible and at the lowest cost (for example by allowing the company to keep a proportion of its efficiency gains).**

It is important to recognize the link back to user consultation. If during the control period, following user consultation, the users required more (or more expensive) capital investment then it would be appropriate to adjust prices for this additional investment. Similarly if additional investment was undertaken in the control period (anticipating an adjustment at the next review), but that was not supported by user consultation, then the regulator may look to disallow that investment and it would not be included in the RAB.

## **6.5 Summary**

The jurisdictional review has determined the following common themes in terms of regulatory roles:

- a primary duty of the regulator towards protecting or furthering the interests of users; and
- a secondary duty towards financial sustainability of the regulated monopoly. Financial sustainability generally translates to the ability to meet operational requirements and financing of capital.

In comparison to the regulatory model for BC coastal ferries, the role of the regulator in other jurisdictions is generally more active in addressing user interests and long-term capital planning.

In addressing the interests of users, the regulatory role often includes considerations that go beyond regulating fares to include more independent monitoring of customer satisfaction and other interests such as environmental considerations. Regulators have an active role in reviewing capital investment plans and have powers (in relation to a primary interest to protect users) to approve or reject capital investment plans.

In addition there is more clarity around the role of government and the regulated entity, with affordability issues typically addressed by government.

## 7 Review of Other Ferry Systems

The commissioner requested PwC to conduct research on other ferry systems with the view of understanding the following:

- trends with operating and governance models for ferry systems; and
- the relative efficiency of BC Ferries.

As part of its assessment, PwC reviewed a number of industry reports, annual reports of ferry companies, case studies, government reviews and ferry benchmark studies, some of which have included BC Ferries.

### 7.1 Trends with Operating and Governance Models for Ferry Systems

PwC's review of operating and governance models of ferry systems indicates the following:

- **Independent ferry regulators** – Regulators with specific responsibility for ferry price regulation are quite rare, with Australia being the main country to develop an Independent Pricing and Regulatory Tribunal (IPART) with responsibility for setting a price cap for ferry services.
- **Other ferry sector regulation** – Based on the review of ferry regulation in North America and Europe, ferry regulation is carried out through others means in these jurisdictions, such as through the concession agreements (e.g. the Isle of Mann Steam Packet Company (“IoM”)) or through competitive tenders with subsidy support.

Within these systems there is a wide range of delivery models in place as well as subsidy formulas.

Four publicly subsidized systems and their relevance to the BC ferry system are described in the following subsection.

#### Scottish Ferries

The Scottish ferry system is of particular interest as it is a large system with routes of varying lengths serving a range of communities in a network of islands. The current structures used to fund Scottish Ferry services are as follows:

- Clyde and Hebrides Ferry Service (“CHFS”) and Northern Isles Services – currently tendered on a 6-year basis with a contract awarded to lowest subsidy bid to deliver the specification, with revenue risk allocated to the operator. On the CHFS, the subsidy currently contributes approximately 50% of the total revenue. The subsidy is assessed on a yearly basis to offset the operating deficit of delivering the services specification. The subsidy payments are specified monthly to reflect the seasonality of revenues.
- Argyll & Bute, Highland, Shetland and Orkney councils are operated by local authority staff with funding provided to cover the differences between costs and revenues (with revenue risk generally retained by the local authority).
- Other local authority services that are put out to tender include: Ardnarmurchan-Morvern-Mull passenger only service, Camusnagaul-Fort William, Mallaig-Knoydart services.
- All of the above services require subsidy support and there are only a limited number of privately run services, such as the western ferries service linking Hunter’s Quay and McInroy’s Point.

The Scottish government has been undertaking a long-term review of the funding and policy arrangements for the provision of ferry services in Scotland. A consultation considering a range of issues relating to ferry fares, funding and policy was launched in June 2010. A Draft Plan for Consultation issued December 2010 identified

a number of areas for in-depth review including affordability, type of service and service levels, required levels of investment and funding approaches. The intent is to publish a Final Ferries Plan in 2012.

The table below summarizes the options considered in the Scottish Ferries Review for changes to fares policy.

**The review highlights the fact that to date there has not been a consistent policy to fares across the different ferry services provided in Scotland.**

Description	Rationale
a) Increase all fares	To reduce overall public sector support by increasing fares revenue
b) Increase visitor fares	Targeting specific group of visitors who are less likely to change behaviour in response to fare increase
c) Reduce fares for island and peninsular residents	To boost the economic performance of island and remote communities and improve social inclusion of residents
d) Reduce fares for commercial vehicles	To promote economic activity and affordability for residents through lower cost of goods
e) Road equivalent tariff or other distance-based fare	Fares based on distance travelled are more transparent than other systems
f) Set fares to manage demand for travel	Variable charges could be used to better manage demand on services where there is fixed capacity
g) Mixed approach	Aim to target different types of fares depending on the needs of the local communities

The key issues raised in the review and which are of relevance to BC Ferry regulatory review are as follows:

- Fares are not set to recover costs or in most instances to provide for a return on capital.
- It is recognized that there is a policy issue around replacing ageing vessels and port infrastructure – there are concerns around the future strategy for funding any fleet replacement or overhaul.
- Funding is required to support rising operational costs (mainly fuel price increases).
- EU policies for example on state aid influence procurement decisions including the length of contracts.
- No price cap regulation of fares – subsidy is effectively set on a cost-plus basis where services are competitively tendered.
- Long-term social demographics, with an ageing population, means that a number of services are unlikely to be viable in the future as there is a decreasing propensity to travel.
- Some evidence that commercial revenues can be increased even with static demand – CalMac Ferries Ltd. (“CFL”) has grown retail revenue by 64% over the last 6 years while passenger volumes have grown by 5%.
- Pilots of road equivalent tariff schemes have shown that there are wider social and economic impacts from providing additional subsidy to ferry services to remote island communities, however the pilot has demonstrated that a move towards a road equivalent tariff approach is not self-financing and that additional subsidy is required to support the move.

## Sydney Ferries

Commercial ferry services in Sydney, Australia commenced in 1861. Forty years later, Sydney Ferries Limited was formed and was, at the time, the largest ferry operator in the world. In 1951, the New South Wales (NSW) Government took over Sydney Ferries Ltd due to financial difficulty. Ferry services remained in Government hands until 2004, when Sydney Ferries Corporation was formed. Due to continued financial challenges and customer issues (including a number of highly publicized safety incidents), Sydney Ferries was returned to a NSW Government agency in 2009.

Sydney Ferries operates in a complex environment. It has a fleet of around 30 vessels in six classes, each of which vary significantly in age, capacity, crewing requirements, maintenance profiles and draught. There is little flexibility in terms of vessel assignment to the eight routes it currently operates.

The routes can be broadly grouped into inner harbour, Manly and River services. The latter services are unique, with both being longer distance journeys (30 min – Manly and 60 min – River) while the former requires the larger Freshwater class vessels, due to ocean going conditions encountered, while the River services require catamarans with lower draughts due to the tidal nature of the route. Moreover, particular routes have very low levels of demand (vs. capacity), particularly during the off-peak period, different capacities for revenue protection (e.g. un-gated wharves) and there has been a tendency for Government to continue to operate unprofitable services/frequencies in politically marginal/high socio-economic areas. This has resulted in historically low levels of farebox cost recovery of 50%. The Pricing Regulator has also resisted calls for a differential pricing approach to services on equity grounds and despite some potential issues surrounding competitive neutrality on particular routes.

In response to Sydney Ferries' many challenges, the NSW Government commissioned a Special Inquiry in 2006/07. The Inquiry made 17 recommendations, the key one being that the Government undertake to pay a price fixed by a service contract to a private enterprise corporation for the provision of ferry services pursuant to a service contract as required by the *Passenger Transport Act 1990*.

Sydney Ferries has iconic status for the Sydney community (even among those who do not use the service or use it infrequently). It also has a highly unionized workforce, which over many years has negotiated conditions that have seen costs of operation, according to numerous benchmarking reviews, exceed an 'efficient level'. Instead of acting on the recommendation to privatize, the NSW Government returned Sydney Ferries to a statutory authority. While it continues to operate the 'slow' Freshwater class service to Manly (one of the profitable routes), it did privatize the fast service to Manly, discontinuing its own JetCat service, due largely to the costs of operating the vessels, rather than a first step to completely privatising the network.

In early 2010, the NSW Government began a wide ranging restructure of its transport portfolio. A key aspect of this was the implementation of the new "MyZone" fare structure which reduced the number of fare products and improved multi-modal ticketing. This essentially removed the Ferry Fare Determination responsibility from the Independent Pricing and Regulatory Tribunal ("IPART") for an indefinite period.

Prior to this, IPART was responsible for setting ferry fares. It did so by considering a range of factors in Sydney Ferries' annual fare submission. These included costs growth, quality of customer service, improvements in farebox and its forward looking investment program. In simple terms, IPART would grant CPI based fare rises where it could be demonstrated that Sydney Ferries was operating at efficient cost. In recent times, the outcomes tended towards an approach involving CPI less a productivity factor (CPI-X), with IPART indicating that cost savings/productivity improvements are a more desirable way of increasing cost recovery than fare rises. Allowances for more than CPI increases for particular inputs such as fuel were considered.

In March 2011, a new Government implemented a recommendation to concession Sydney Ferries. It sought registrations of interest from private companies which will ultimately enter a service contract with the Department of Transport, setting out all its obligations. Expressions of Interest closed in July 2011, attracting 28 responses from companies in Australia and abroad. The NSW Government is now reviewing submissions to develop a short list.

It is expected that the successful operator will commence in early 2012. Under the franchise model, the government would retain ownership of the ferries and control over fare structures (i.e. determined by IPART), routes and services, while the operator would run and maintain the fleet.

**The Sydney Ferries example points to a number of the common challenges with public ferry systems, including addressing cost efficiency and the need for regulatory support under various operating and governance models.**

**Washington State Ferries**

Washington State Ferries (“WSF”) is the largest ferry transit system in the United States. It operates 22 vessels on 10 ferry routes from 20 terminals and runs nearly 500 sailings per day, moving 23 million passengers and vehicles per year. WSF is both a marine highway provider, with 200 miles of marine highways connecting many communities and rural destinations on the Olympic Peninsula and San Juan Islands to the mainland; and a transit service provider, moving people between terminals.

WSF, as a Division of the Washington State Department of Transportation (WSDOT), is subject to government and public scrutiny regarding use of the State’s financial resources. Current economic conditions have resulted in significant investigation and review of WSF, in an effort to balance demand for ferry services with financial constraints. According to the approved Long-Range Plan for WSF for 2009-2030, some of the critical challenges facing WSF include:

*Long-term Funding* – legislation from 10 years ago substantially reduced dedicated funding for the ferry system. The funding shortfall was filled by allocating funds from the landside highway system, but that has created an unsustainable shortfall for the landside highway capital program, so the ferry system needs to find alternate revenue sources.

*Role of fares in long-term funding* – Fares have increased between 37% and 122% since 2000, in an effort to make up for lost State funding.

*Vehicle capacity limitations* – ongoing pressure to increase capacity in vessels and terminals, however, the capacity constraint only occurs during peak periods.

*Aging asset base* – four vessels were retired in 2007 and eight more need to be retired by 2030. In addition, many of the terminals were built 60-70 years ago.

*Long lead time for capital investments* – WSF vessels have an anticipated lifespan of 60 years, but the lead time requires anticipation of future needs.

*Growth, ridership demand and service needs* – WSF ridership has dropped 13% since its peak in 1999. Ridership has declined from 2000 to 2006 despite population growth in the communities served by WSF. Future population growth is expected, so total demand is forecast to increase 37% between 2006 and 2030.

*Changing customer base* – WSF is experiencing a decline in commuter trips and an increase in discretionary trips. Discretionary ridership means less frequent trips with more flexible travel plans, therefore pricing strategies are helpful. In addition, while fares have increased significantly in recent years, fares are only a small factor in the decision to use ferry services more or less.

The WSDOT approved Long-Range Plan for WSF includes recommendations and strategies for 2009-2030. The plan builds on steps already being taken to reduce WSF costs without jeopardizing safe, reliable and efficient service. Administrative staff reductions, fuel conservation measures and reduced expenses throughout the system have already resulted in cost savings. However, WSF must also adopt operational and pricing strategies to maximize the use of its existing assets and provide the most cost effective service, while responding and adapting to the changing characteristics of its customer base.

The research supporting the approved Long-Range Plan included comparisons to other global ferry operators, one of which was BC Ferries. The Plan is built on the following key strategies that are designed to spread vehicle demand and/or increase walk-on use:

*Vehicle reservation system* – manage demand and reduce necessary terminal space.

*Transit enhancements* – facilitate more walk-on passengers getting to terminals.

*Pricing strategies* – two significant proposals – one to provide reservations at no cost, in order to encourage riders to use the reservation system and focus on demand management; the second to mitigate fuel price risk and implement a fuel surcharge mechanism.

*Marketing* – implement program to increase non-peak ridership.

Based on implementation of the 2009 Long-Range Plan, WSF forecasts annual fare increases of 2.5% to 2030 and an overall ridership increase of 37% is expected to lead to 78% of all operations costs being funded by fares through to 2030.

**In summary, there are several similarities between BC Ferries and Washington State Ferries as they each strive to become more self-sufficient in terms of cost recovery.** Changes to funding formulas for WSF have resulted in a number of challenges including how to replace an ageing fleet. **It appears that BC Ferries is further ahead than WSF in its implementation of cost containment and pricing strategies, having started in 2003.** One noticeable difference between BC Ferries and WSF is the focus on ancillary revenue by BC Ferries, including catering and on-board revenue. WSF has not had the same emphasis, likely because of WSF's 10 routes, seven are eight miles or less (approx 30 minutes) and only one is well over an hour, therefore passengers have less time to benefit from available services. BC Ferries also appears to be significantly further ahead with its fleet renewal program.

### **Marine Atlantic Inc.**

Marine Atlantic Inc. (MAI) was established in 1986 as a federal Crown Corporation in conjunction with the constitutional guarantee that Canada will maintain a year-round freight and passenger service that meets traffic demand between North Sydney, Nova Scotia and Port aux Basques, Newfoundland.<sup>1</sup> In 2010, an estimated 27% of all passengers, 50% of all freight and 90% of all perishable goods between Newfoundland and the Canadian mainland were carried by MAI.

The Corporation's mandate was refined in 1995, under the direction of the National Marine Policy, when it began to focus on providing constitutionally mandated, year-round passenger and commercial ferry service between the Island of Newfoundland and the Province of Nova Scotia to connect the Province of Newfoundland and Labrador with mainland Canada. MAI also operates a second ferry service route (which is not required by the constitution) from mid-June to late-September (the "Peak Season") between Argentia, NL and North Sydney, NS.

It became evident to the MAI Board and management team, as early as 2004, that additional fleet capacity would soon be needed. To address these concerns, a long-term fleet renewal plan was submitted to Transport Canada in 2007. The 2007 fleet renewal plan was not fully accepted and MAI was asked to conduct further examination of fleet options. As an interim step, \$100 million was committed to MAI in 2008 to charter a vessel for a five year period.

In March 2009, the Office of the Auditor General of Canada (OAG) issued a special examination report on MAI. This report identified "two significant deficiencies in Marine Atlantic's systems and practices: one relating to unresolved strategic challenges and the other relating to operational systems and practices in operational planning and capital asset management". The OAG also suggested MAI improve its practices in corporate governance, human resources, operations, safety, security and environmental stewardship.

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<sup>1</sup> The ferry service was accorded special constitutional status when Newfoundland joined Canada under term 32(1) of the Terms of Union (The Newfoundland Act, 1949)

The culmination of pressing management/governance needs, operational and vessel deficiencies and deteriorating customer service caused MAI to develop a revitalization plan which was submitted to the Government of Canada in October 2009. This plan was accepted by the Government of Canada and funding was reflected in the 2010 budget. The revitalization plan was meant to address specific issues. Following acceptance, its longer term implementation has been reflected in the annual five-year corporate planning process.

The longer term strategy adopted focuses on achieving a cost recovery of 60-65% within the first five years, implementing revenue generating strategies and executing a fleet renewal plan and a capital plan to improve infrastructure. Cost recovery is expected to increase substantially over time.

**The MAI example illustrates some of the inherent challenges with crown corporation models, including extended capital planning and decision making processes. However, the recent revitalization initiative that established cost recovery targets and an approved capital plan as part of a five-year planning process has greater transparency.**

### Norwegian Ferry System

The ferry system in Norway carries over 20 million vehicles and passengers per year over 1.5 million trips. The ferry system is part of the road system and is controlled by the Norwegian Public Roads Administration which is subordinate to the Norwegian Ministry of Transport and Communications.

The role of the Administration includes:

- responsibility for the ferry sector on a national level;
- development of regulations issued by the Norwegian Maritime Directorate;
- responsibility for supervising the competition between ferry operators - today there are three major operators and one smaller one;
- responsibility for managing fees and permits; and
- acts as a knowledge base for the Ministry and society.

In the Norwegian ferry sector, competitive tendering has been applied for fifteen years. Through mergers and acquisitions of ferry operating companies, the structure of the Norwegian ferry sector has changed from about 15 operating companies to four larger operators with stronger bargaining power. Some routes are also bundled.

Subsidies are approximately 50% of total costs and have increased somewhat in monetary terms since the tendering process began. There have been major improvements in the quality of services such as increased capacity, new ferries, increased frequencies and extended opening hours.

**Norway is the world leader in passenger vessels fuelled by Liquefied Natural Gas (“LNG”) and today operates the only LNG-fuelled ferries in the world.** The discovery of large quantities of natural gas on Norway’s west coast in 1997 allowed LNG to be available at an acceptable cost for ferry operation to be feasible. The first Norwegian LNG ferry, Fjord’s Glutra, was built in 2000 with government assistance. It was built at a higher cost than a conventional diesel powered vessel. Since then costs have reduced. While the costs are higher, Norwegian ferry operators are eligible for capital subsidies for projects that reduce NOx emissions. They are also able to avoid carbon taxes on natural gas that is used in lieu of diesel, which lowers the operations cost for LNG fuelled vessels.

In 2011, Fjord1 has 12 LNG ferries operating in Norwegian waters and more under construction. Tide Sjø has three and Fosen Namos Sjø has one. The other operator, Torghatten Nord, is undertaking a program to build three new LNG ferries and convert four existing vessels to LNG.

## 7.2 International Practices in Ferry Contracting

Contracting of ferry services is common in Europe. There is value in understanding aspects of them in relation to risk sharing, fare setting and subsidies. The nature of contracted services varies considerably. In some cases the operator assumes the revenue risks while in others the operator is responsible for the revenues it collects with any difference between revenue and costs being met by a public subsidy. Key features include:

- Gross versus net contracts:** Where contracts are let on a “Gross” basis the operator of the services is not responsible for revenues, with revenue risk being retained by the public sector. The operator may still collect the revenues, but they are remunerated on the basis of the costs they incur in delivering the service. Under a “net” contract, the operator is responsible for the revenues that it collects, with any difference between revenue and costs (including an operating margin) being met by public subsidy. Where there is no formal contract in place between the public sector and the operator, for example if services are operated on a commercial basis, this is indicated by “n/a”.
- Contract length:** The length of the contract granted by the public sector for the right to operate the service. These are generally short in length varying between 1 and 6 years.
- Approach to setting fares:** A range of different fares setting systems are in place from the state set fares directly to fares being set on a commercial basis. Examples of state regulation appear to be on the basis of approval or pre-determined price caps (e.g. IoM), but are not on a price-cap model as applied by the Commission. The capacity maximising fares on “open routes” between France and Corsica relate to the subsidy conditions designed to ensure a certain number of passengers per crossing, whereby the operator must guarantee a specified number of passengers before it receives public subsidy for the operation.

The following table summarizes the nature of contracted ferry services in various European countries.

Country	Gross/Net Contract	Contract Length	Fare System
Estonia	Gross	Unknown	State set
Denmark	Net	5 Years	State set
Finland	n/a – state run	n/a	State set
France/Corsica (open routes)	n/a	n/a	Capacity maximising
France/Corsica (closed routes)	Net	5 Years	State set
Germany	n/a	n/a	Commercial
Greece	Net	1 Year	State set (use of cross-subsidization)
Isle of Man	Net	Currently runs to 2026	State regulated
Japan	Gross	1 Year	State set
Italy	Gross	5 Years	State set
Malta	Net	6 Years	State set
Netherlands	n/a	n/a	Commercial
Portugal	n/a	n/a	Commercial
Northern Ireland (Rathlin Island)	Net	6 Years	State regulated
Norway	Both	Unknown	State set
Spain	Net	5 Years	State regulated

Source: Scottish Government Lifeline Ferries Review Funding, MVA Consultancy, June 2010.

While tendering is common, there are no obvious patterns as to how service levels are defined and how subsidy levels are developed. Obtaining accurate figures on subsidies is challenging – in general there is a lack of transparency regarding the approach to setting fares and subsidies in European ferry sector. Evidence shows they can represent a high proportion of costs, with subsidy in Sweden around 75% of operating costs and in Scotland around 50% of costs.

The review also suggests the following:

- There are some demographic trends highlighted in other jurisdictions that may also become an issue for BC Ferries in the medium-long term. In particular, the changing demographics and aging populations in a number of remote island communities may reduce the propensity to travel and reduce levels of ferry patronage, increase reliance on subsidy or fares.
- Fares for the commercial and non-commercial sector are set differently. In the commercial sector, operators will generally set fares in order to maximize profits, whereas in the non-commercial sector fares may be set to achieve a range of social, economic and environmental objectives.
- Fares primarily tend to be set by government and a regular competition (at least every 6 years) is held for the right to operate the services. There remains a number of services, particularly “life-line” type services that are operated either directly by government or by wholly government-owned operators. These publicly subsidized systems are all subject to regular reviews to address value for money.
- Subsidy formulas vary significantly. They include discounts for seniors, children and the disabled. Discounts for residents are also common. Governments also use a variety of other levers to support commerce and lower environmental impact of ferry systems, the latter through capital subsidies for fuel efficient vessels and relief from carbon taxes. It is also common for various levels of government to contribute subsidies. Some examples of subsidy formulas are shown in the following table.

Ferry Operator	Subsidy Formula
Marine Atlantic Inc.	Annual subsidy covers operating and capital expenditures. The subsidies are planned based on operating cost recovery targets and an approved 5-year capital plan.
CalMac Ferries Ltd (Scotland)	<p>The main subsidy is provided to meet the difference between costs and expected revenue (with an allowance for profits).</p> <p>A separate subsidy is provided for roll-on/roll-off freight, agricultural products and harbour facilities.</p> <p>Special fuel adjustments are in place to hedge against increases in fuel costs.</p> <p>Vessels are leased from Caledonian Maritime Assets Ltd. (wholly owned by the Scottish Ministers).</p>
TT Line (Tasmania)	<p>The main subsidy comes from equity injections from the Ministers of the State of Tasmania (i.e. financial assistance to retire debt).</p> <p>The federal government subsidizes the costs of transporting passenger vehicles across the Bass Strait (e.g. \$168 for a standard passenger vehicle).</p> <p>The Tourism Ministry has provided a marketing subsidy for 2 years for the amount that is just under 2% of annual revenues for TV advertising.</p>
Washington State Ferries / Alaska State Ferries	The state governments subsidize operating deficits and the majority of capital expenditures. The federal government subsidizes some of the capital expenditures.
Norwegian Ferries	<p>The national government provides subsidies to operators through competitive tendering.</p> <p>Norwegian ferry operators are eligible for a subsidy of up to 80% of the cost for projects that reduce NOx emissions from the NOx Foundation. These projects can include the cost differential of LNG vs. diesel construction.</p> <p>Norwegian ferry operators are also eligible for relief of carbon taxes on natural gas that is used in lieu of diesel.</p>

### 7.3 The Relative Efficiency of BC Ferries

BC Ferries operates one of the largest ferry systems in the world. BC Ferries carries over 21 million passengers per year. Within the global ferry industry, only Transtejo-Transportes from Portugal and Washington State Ferries carry more passengers within a car ferry environment.

The efficiency of ferry operators is challenging, as comparisons across jurisdictions are complicated by regulatory factors affecting the number of crew on vessels and other operational requirements. Historically the fleet has been designed to meet peak capacity which influences the cost structure. The Coastal Ferry Services Contract also establishes the levels of service for each regulated route. When the current model was created there were no reductions in sailings introduced on any route.

The Contract and other charter documents of the BC Ferry Authority are otherwise silent on the objectives for the corporation. BC Ferries' stated objectives include providing a continuously improving west coast travel experience that consistently exceeds customer expectations and reflects the innovation and pride of its employees. BC Ferries is also committed to generating sufficient capital and retained earnings to revitalize its fleet, facilities and infrastructure while minimizing fare escalation.

The approach to assessing the efficiency of BC Ferries includes the following:

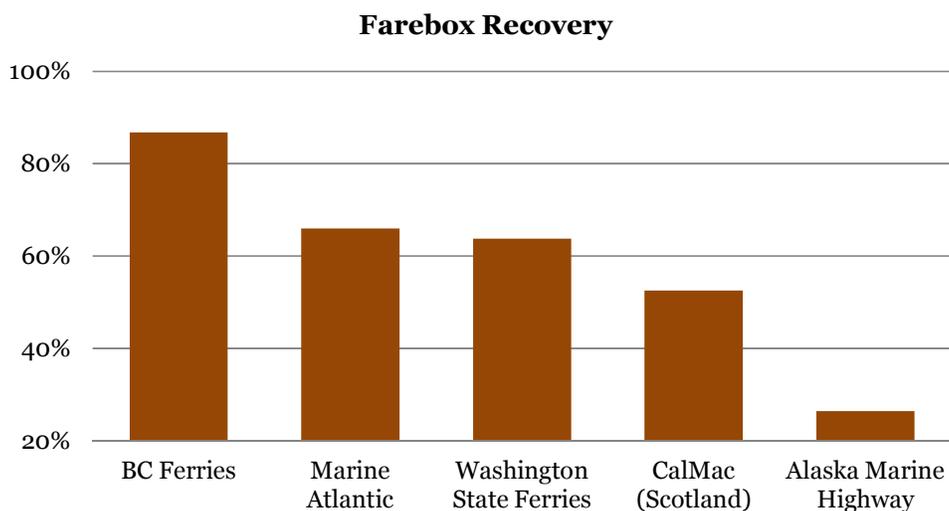
- Assessing against other ferry operators where possible
- Assessing BC Ferries against its own stated performance metrics
- Assessing BC Ferries’ performance over time

Comments on the relative efficiency of BC Ferries are made in the following paragraphs.

### 7.3.1 Revenue Generation

#### Tariff Revenue

Farebox Recovery is a key metric for ferry operators. Farebox Recovery indicates the ability of an operator to cover its operating costs through passenger and vehicle tariffs, which are expected to be the main source of revenue for operators. The following table indicates that BC Ferries’ Farebox Recovery (tariff revenue/operating expenses) is one of the highest in the industry:



Source: BC Ferries, Marine Atlantic and CalMac data calculated based on publicly available financial statements for fiscal year ending 2009. Operating expenses are before amortization and interest. Washington State Ferries and Alaska Marine Highway data is from a June, 2010 study commissioned by Washington State Ferries.

Passenger and vehicle fares charged by BC Ferries are compared to a number of other ferry operators in the following chart. The chart compares fares with available discount for a standard vehicle with one passenger, based on short, medium and long routes. The fares are based on posted rates as at November, 2011. **The results suggest that tariffs charged by BC Ferries are not excessive.** They are neither the highest nor the lowest in any of the categories.

Increasing utilization has been an objective of BC Ferries as well as other ferry operations. This typically involves innovations aimed at improving the ferry user’s experience and therefore encouraging more ferry trips to increase ferry usage. In Washington State Ferries’ June 2009 Final Long Range Plan, the company is recommended to fill under-used non-peak capacity. It points to some of the innovations already implemented by BC Ferries to increase ferry usage that include:

- Drop trailer service

- Partnership agreements with Tourism BC to promote travel on BC Ferries
- Vacation planning center to encourage and assist with BC Ferries travel
- Demand management – price differentiation to manage seasonality of travel (reduced fares in off-peak times)
- Reduced fares for seniors, to encourage off-peak travel

### **Ancillary Revenue**

BC Ferries has been implementing changes in its service delivery model to generate ancillary revenue and contribute to a more financially self-sufficient entity. Over the past eight years, BC Ferries has:

- introduced a reservation system that has been well received based on take-up;
- significantly increased its catering and on-board (i.e. gift shop) revenue;
- invested heavily in terminal retail outlets that have generated significant retail revenue; and
- redesigned vessel interiors to optimize passenger flow and improve onboard passenger spending.

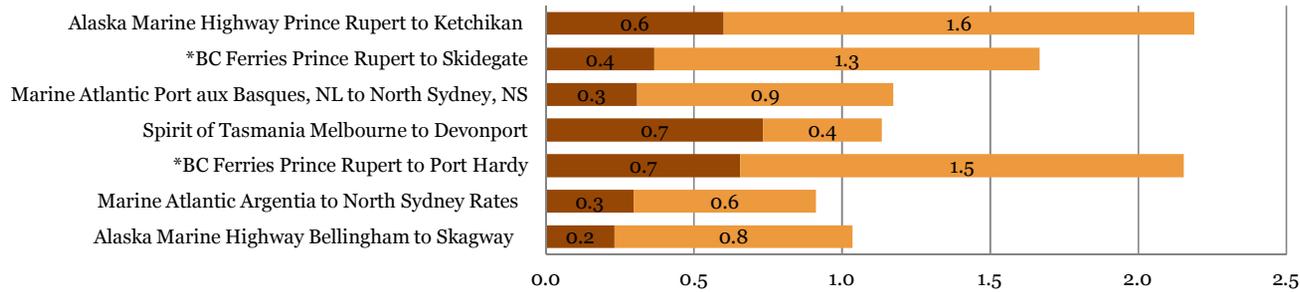
In a February 2008 study commissioned by the Washington State Transportation Commission, the study's authors acknowledged several new products and ferry services implemented at BC Ferries that are deemed both successful and world class, including:

- Food/beverage – more variety and better quality
- Expanded retail – on board and at terminals
- Bars/lounges – especially on longer routes
- Premium services – private lounges, seat upgrades

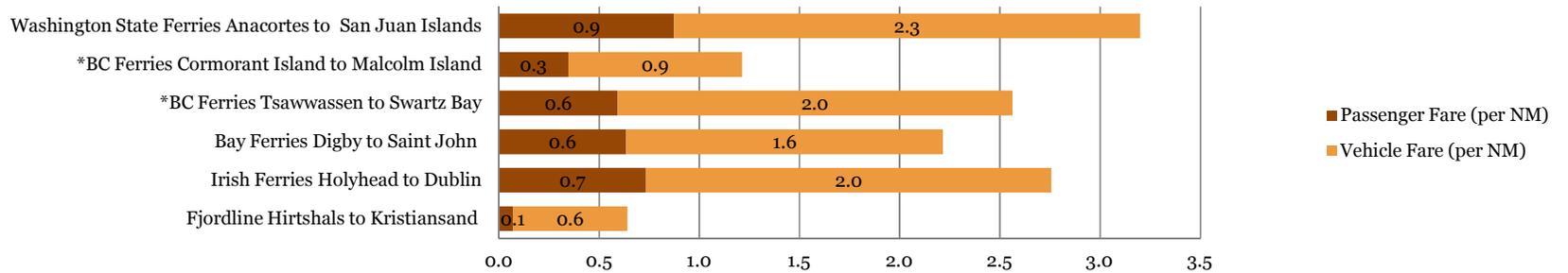
In WSF's June 2009 Final Long-Range Plan, BC Ferries was reported to have ancillary revenue of \$480,000 per minute of weighted average sailing time, while WSF had only \$85,000.

### Passenger and Vehicle Fares per Nautical Mile Including Applicable Discounts

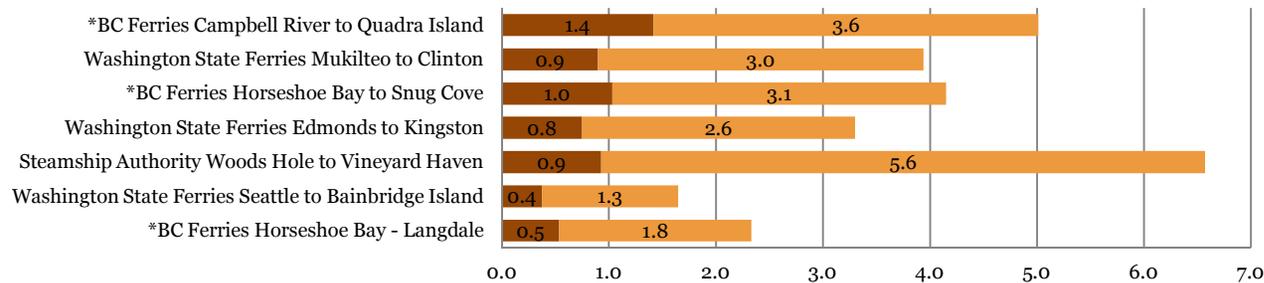
#### Passenger and Vehicle Fare \$CAD / NM (Long Routes with Discounts)



#### Passenger and Vehicle Fare \$CAD / NM (Medium Routes with Discounts)



#### Passenger and Vehicle Fare \$CAD / NM (Short Routes with Discounts)



Fares are calculated based on a standard vehicle with one passenger, with applicable frequency or resident discounts. Discounts exclude social discounts as they apply to seniors, youth and persons with special needs.

### 7.3.2 Cost Efficiency

Benchmark studies suggest the relative efficiency of BC Ferries. A June 2010 ferry benchmark study conducted for the Washington State Department of Transportation estimated BC Ferries average cost per passenger at \$24.24 (based on total costs) compared to the sample average of \$20.51. BC Ferries results were slightly below those of Fjord 1, a large ferry operator in Norway which carries nearly as many passengers as BC Ferries.

Salaries and wages are the largest category of costs for BC Ferries, and are upwards of 60% of direct operating expenses. Excluding fuel, BC Ferries' direct cost of operations have increased an average of 2.5% per year, for the past eight years, compared to an average 1.7% annual increase in BC's CPI.

In 2003, BC Ferries negotiated a nine-year agreement with its union that expires on October 31, 2012. The long term agreement has provided labour stability to BC Ferries, something that is recognized as a relative strength in the global ferry industry.

- As part of the labour contract, BC Ferries was granted approval to exclude 155 senior management positions from the bargaining unit while continuing to enable an increased management presence on board the vessels.
- BC Ferries negotiated changes to the collective agreement that streamlined vacancy postings and provided increased flexibility regarding multi-tasking of workers between departments
- In response to the economic downturn experienced in 2009 that led to a decline in utilization, BC Ferries restructured its business to align expenses with reduced revenue. 77 administrative positions were eliminated from the company.

BC Ferries has reduced its fuel consumption by over 3.7 million litres per year, from 122.5 million litres consumed in 2004 to 119 million in 2011. This overall reduction was achieved despite the relative fuel inefficiency of the new Northern Adventure vessel deployed on the northern route.

#### **BC Ferries' success at minimizing cost increases has been recognized by several independent sources:**

- The reviews conducted of BC Ferries' Price Cap Submissions for PT2 and PT3 by the Commission which were conducted with the support of external consultants found that the cost estimates were reasonable with few exceptions.
- With the exception of board and executive compensation, the review by the Office of the Comptroller General in 2009 found BC Ferries to be well managed and reasonably efficient.

### 7.3.3 Operational Efficiency

BC Ferries has been successful in introducing asset management plans for the majority of its vessels and terminals. As part of its long range capital plan, BC Ferries has been investing in its vessels and facilities to reduce costs through improved efficiencies. For example:

- Facility upgrades to reduce energy consumption, water usage, emissions and garbage disposal
- Upgrade ferry berth designs to eliminate berth/vessel incompatibilities and reduce maintenance and labour costs associated with managing multiple varieties
- Invest in technological advancements to reduce administrative costs – e.g. Auto ticketing kiosks, electronic Experience Card

A 2010 global benchmarking study commented favourably on a number of BC Ferries' policy features and operational strategies, including its partnerships and business ventures, the introduction of the BC Ferries

Experience Card, the use of fuel surcharges, administration restructuring that has led to reductions of 77 staff, and a new operations and security centre to enable increased coordination of responses to service disruptions and occurrences.

The BC Ferries Board and management have implemented long-term performance measures to gauge the progress of its operations. Key Performance Indicators (KPIs) include measures that address safety, service reliability, customer service, cost per passenger and earnings. The results suggest improvement in several areas including:

- Improvements in employee and passenger safety since 2008
- Improvements in reliability, ferry user satisfaction and earnings from operations since 2004

In contrast, the Company has also experienced higher cost per passenger and overall earnings that have missed targets.

### BC Ferries Key Performance Indicators

		F'04	F'05	F'06	F'07	F'08	F'09	F'10	F'11	F'12
<b>Employee Safety <sup>(1)</sup></b>	<b>Actual</b>	3.34	2.71	2.02	3.69	3.40	2.48	1.54	1.53	
	<b>Target</b>				2.27	2.20	3.42	2.50	1.56	1.31
<b>Passenger Safety <sup>(2)</sup></b>	<b>Actual</b>						22.54	20.16	18.11	
	<b>Target</b>						22.80	21.50	21.50	18.11
<b>Reliability Index <sup>(3)</sup></b>	<b>Actual</b>	99.01%	99.69%	99.48%	99.66%	99.63%	99.67%	99.60%	99.53%	
	<b>Target</b>	99.60%	99.60%	99.60%	99.60%	99.60%	99.60%	99.60%	99.60%	99.60%
<b>Customer Satisfaction <sup>(4)</sup></b>	<b>Actual</b>	80%	82%	82%	84%	82%	86%	91%	89%	
	<b>Target</b>	82%	82%	82%	82%	82%	82%	84%	84%	83%
<b>Cost per Passenger <sup>(5)</sup></b>	<b>Actual</b>	17.49	17.56	16.45	17.07	18.35	20.69	20.96	21.90	
	<b>Target</b>				16.81	17.96	20.34	20.67	21.66	23.29
<b>EBITDA <sup>(6)</sup></b>	<b>Actual</b>	98	112	128	124	137	152	186	181	
	<b>Target</b>			134	134	135	162	189	189	176

met or exceeded target  did not meet target

Source data is extracted from BC Ferries' annual reports. Definitions of KPIs are listed below:

- (1) Employee Safety = employee injury frequency rate \* severity rate divided by 1,000. Note that FTE was changed to 2,000 hours per year from 1,827 hours per year, effective 2009.
- (2) Passenger Safety = number of passenger injuries per one million passengers. Note that the definition changed in 2009 to include only those injuries caused by internal (i.e. BC Ferries related) factors, therefore Passenger Safety Indices reported in prior years are not comparable.
- (3) Reliability index = scheduled # of round trips less cancelled sailings divided by scheduled # of round trips
- (4) Customer Satisfaction rating = average overall score (out of 5) on annual customer satisfaction survey undertaken on a sample basis by an outside firm
- (5) Cost per Passenger = total operating cost less ancillary revenue, divided by total passengers. Note: Cost per PAX differs by < 1% from the cost calculated based on publicly available information
- (6) EBITDA = Earnings before interest, taxes, depreciation and amortization, in \$ millions

BC Ferries' safety record and on-time departures were less than many of its peers in 2004 but these measures have improved significantly. On time performance has increased every year since 2004.

### 7.3.4 Capacity Utilization

There is limited availability of data on utilization with many ferry systems due to commercial confidentiality issues. Also different characteristics of routes will result in varying utilisation making comparisons difficult.

BC Ferries' average capacity utilization has been declining, from 55-56% in 2004 to 53% in 2011. There are some parallels between BC Ferries and the Scottish ferry system, with a large seasonality element in Scottish ferries system – higher utilization in summer season, lower in winter. CalMac Ferries in Scotland experienced only a 39% utilization in 2010, suggesting that BC Ferries' overall utilization may be relatively high within the industry.

The range of utilization at BC Ferries is wide; there are a limited number of routes where utilization exceeds 65% and several with less than 40%. The minor routes tend to have utilization in the range of 40-50%, with some as low as 30% (weighted average of 40-45%). The northern routes experienced utilization of 70% up until the economic downturn of 2009, which was unfortunately timed with the sinking of the Queen of the North. The major routes enjoy 65-70% utilization.

### 7.3.5 Earnings

While BC Ferries' earnings in PT2 have been seriously eroded by declines in traffic in the 2009 – 2011 period, this pattern is consistent trends in the global ferry industry and the global shipping industry, as suggested by a 2011 Global Shipping Industry Survey conducted by PwC that measured Return on Capital Employed (ROCE or return on total assets) for 19 ferry operators and over 100 shipping companies, respectively.

ROCE	2006	2007	2008	2009	2010
BC Ferries	7.85%	5.82%	3.1%	.6%	.23%
PwC Ferry Industry Benchmark	9%	4%	1%	2%	0%
Global Shipping Industry	13%	15%	10%	2%	3%

Source: *Riding the Storm - Global Shipping Benchmarking Survey 2011, PricewaterhouseCoopers LLP, 2011.*

## 7.4 Summary

**Many ferry operating and governance models, both public and private, are in place around the world.** An important trend with publicly-subsidized systems in the past 20 years has been contracting out in order to reduce subsidy levels. Contracting out is a common method to derive value for money by controlling labour and other operational costs and sharing revenue risk. It is most commonly employed in European ferry systems.

Subsidy formulas for 'life-line' type ferry services reflect a wide variety of public policies including subsidies for residents. It is common for various levels of government to contribute to subsidies. There appears to be some pressure from European Union competition rules to reduce subsidies, which may have the effect of reducing sailings, particularly during off-peak periods, in order to increase capacity utilization.

Measuring the relative efficiency of ferry operators across multiple jurisdictions poses many challenges. Factors which influence the relative efficiency of ferry operators include: mandated crew levels, capacity, sea route condition and age of vessels. The review identified, more often than not, publicly-owned systems that are in and out of crisis and which require periodic government interventions, instead of any obvious 'best-in-class' ferry operators.

**Amongst the publicly-owned systems, BC Ferries' appears to be relatively efficient based on the analysis.** Indeed, many ferry operators appear to want to emulate some of BC Ferries' practices. The company compares well with farebox recovery and ancillary revenue. Costs appear to be reasonable based on a number of independent reviews and on substantial improvement in several areas since 2003.

However, there is large variability with route utilization within the BC Ferries' route groups, with the lowest utilization serving remote communities. Similar patterns are observed in jurisdictions like Scotland and Alaska.

The weak earnings performance experienced by BC Ferries during the last three years is consistent with the global ferry industry.

## **8 Principles of the Act**

### **8.1 Introduction**

As covered in Section 2, the main elements of our review included an extensive public consultation process and a review of other jurisdictions which have a price cap regulatory model in place. In both these elements a major focus of submissions and analysis was the underlying principles contained in the enabling legislation. In the case of the Coastal Ferry Act, Section 38 of the Act states that the Commissioner must undertake regulation of each ferry operator in accordance with the following six principles:

- Priority is to be placed on the financial sustainability of the ferry operators
- Ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery
- Ferry operators are to be encouraged to seek additional or alternative service providers on designated ferry routes through fair and open competitive processes
- Ferry operators are to be encouraged to minimize expenses without adversely affecting their safe compliance with core ferry services
- Cross subsidization from major routes to other designated ferry routes is to be eliminated
- The designated ferry routes are to move toward a greater reliance on a user pay system so as to reduce, over time, the service fee contributions by the government

The Act was created to deal with a number of specific problems with the former operating and governance model. The embedded principles in the Act were intended to remove “political” involvement from ferry operations, apply a commercial approach to the business with a focus on efficiency, and leverage private sector financing for fleet renewal. It can be argued that many of these goals have been achieved through the light-handed approach to regulation and the application of the above principles.

However, the issue with this model has been its effect on affordability. Due to a combination of factors, including a downturn in the economy, a decline in ridership, reduced tourism and particularly the application of the greater reliance on the user pay principle, ferry fares have risen sharply across the system, and especially so in the less populated parts of the BC coast. Projections for the next performance term currently indicate four more years of high fare increases, with every reason to expect even larger fare increases in the following performance term, when a large bulge in fleet replacement is scheduled to occur.

Our objective for the review was to determine ways in which the benefits of the current model can be retained while also delivering affordable, predictable fare increases in future. The following list sets out the high level goals which we believe need to be achieved to make the model successful:

- affordable, predictable fares;
- acceptable taxpayer contributions;
- reasonable levels of service;
- a financially sustainable operator;
- no political involvement in operating decisions of the company;
- continued access to private sector financing for fleet renewal on the minor routes;
- effective governance;
- an accountable operator, with effective oversight and controls;

- a way for government to provide appropriate, high level public policy direction; and
- a light-handed (i.e. low cost) regulatory model.

This is a daunting list of goals and makes something very clear: all of the principal stakeholders need to be part of the solution. As the ferry system is costly to operate and requires significant capital investments on an on-going basis, ferry users need to be receptive to changes in the delivery of ferry services and have realistic expectations for levels of service, the operator needs to have a focus on cost control and revenue generation. The Province is responsible for defining the public interest in this critical piece of transportation infrastructure and will continue to have an ongoing role in providing financial support to ensure financial sustainability of the ferry operator.

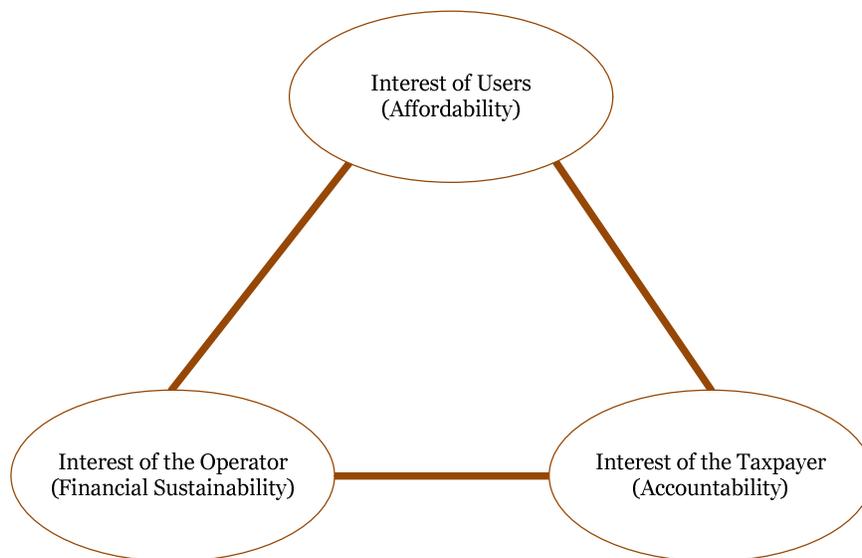
We'll start by defining the interests which exist and need to be either considered or protected in this model.

## 8.2 Redefining the Principles of the Act

There are three principle “stakeholders” in the BC ferry system whose interests need to be considered, and kept in a reasonable balance with the interests of the other two. The first is the user of the ferry system, broadly defined as riders, commercial operators who use the ferries to transport their products, tourism operators who depend on the ferries to transport their customers, and the extended families of the residents of ferry dependent communities. The interests of these collective users are for affordable and reliable transportation, safe vessel operations, and reasonable levels of service.

The second “stakeholder” is the ferry operator, which needs to be financially sustainable in order to meet service level obligations, cover operating costs, borrow money for capital investments in vessels and terminals, meet debt obligations and retain the staff necessary to operate the system.

The third “stakeholder” is the taxpayer. All of the comparable ferry systems we’ve looked at depend on public funding to survive. The BC ferry system is presently less dependent than many others, but the re-investment that’s needed over the next decade is going to cause pressure for more contributions from the taxpayer. The interests of the taxpayer are to keep public funding at an acceptable level and to ensure that there is effective governance, full transparency and accountability in the operation of the ferry system.



In 2010 an amendment to the Act (Bill 20) introduced a requirement for the commissioner to “consider the interests of ferry users”. This Bill was a response to the Comptroller General’s report of October 2009. That report stated, “A regulator’s role would normally include protecting the interests of customers in balance with protecting the financial and operational sustainability of the regulated organization”. The pursuant recommendation was as follows: “We recommend the Province consider amending the legislation to change the Commissioner’s required responsibilities to include a seventh guiding principle, protecting the interests of ratepayers and customers”. The Province amended the Act to require consideration of ferry user interests but didn’t provide any new tools to do that, or change the existing priority on the interests of the ferry operator.

The “interests” of ferry users which the Commissioner is required to consider are undefined, and furthermore, there are no provisions in the Act for the Commissioner to take any specific action after considering those interests. All six principles are generally perceived by the public to speak to the interests of either the ferry operator or government.

The Commissioner attempted to consider the interest of ferry users in his determination of the preliminary price cap for PT3. The methodology for determining price caps is specified in the Act and is quite formulaic. The resulting increases for each route group were initially very high, so in consideration of ferry users’ interests, the Commissioner made several adjustments to the price caps. The Commissioner applied a smoothing calculation, set efficiency targets, disallowed specific categories of expenditure and elected to use book values rather than replacement value in determining the allowable rate of return on equity. The intent was to at least partially mitigate the size of price cap increases faced by each route group. After the preliminary price cap decision was made public, the ferry operator provided a legal opinion which challenged the basis for all four of these adjustments based on a legal interpretation that the Act does not permit them.

Our analysis of what the increases would be if the company’s position on all of the jurisdictional issues were accepted, are as follows:

Route	First Year Price Cap Increase
Majors (excluding Langdale)	16.4%
Northern	81.1%
Minors	43.1%
Provincial CPI Forecast for 2013	< 2%

The Coastal Ferry Act is perceived to have put priority on protecting the interests of the operator. We can find no other examples where the primary responsibility of the regulator is to put the interests of a monopoly operator before those of the public.

The term “ferry user” is also not defined, and has been open to interpretation. It could have a very narrow definition, which would include only those who actually ride on the ferries. It can also be interpreted broadly, to include others who “use” the ferry system to transport products, to bring customers to tourism businesses, or extended families that may not ride the ferries but “use” them to maintain family connections.

- 1. The primary responsibility of the Commissioner should be to protect the interests of ferry users and the taxpayer. The term “ferry user” should be interpreted broadly, to include ferry customers, their families, ferry-dependent communities and businesses which depend on ferry services to be affordable and reliable.**

A responsibility for the Commissioner to protect the interests of users and the taxpayer must not remove or even diminish the responsibility to protect the financial sustainability of the operator. It is very clear that a financially sustainable operator is in the interests of both ferry users and taxpayers. What is required is a careful and thoughtful balancing of these “interests” and an understanding that they will at times be in some

degree of conflict with each other. Accordingly, the Commissioner should encourage the operator to operate efficiently, to take a commercial approach, to be innovative, and to minimize its operating expenses, all subject to maintaining compliance with safety requirements.

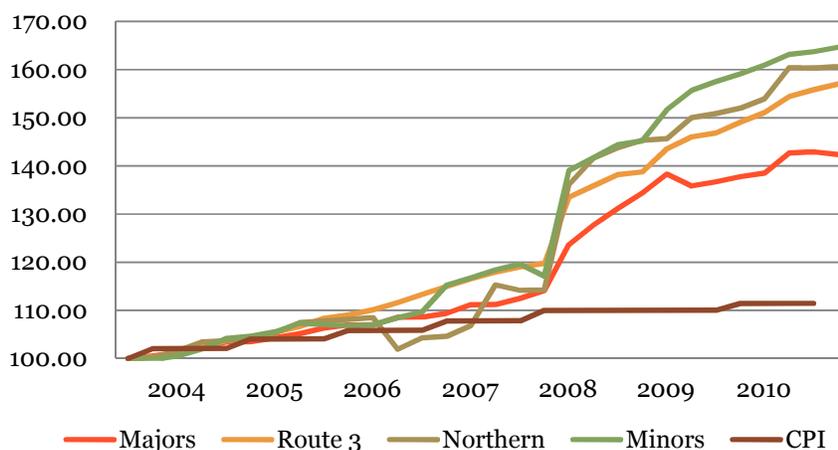
The first four principles in the Act should be collapsed into one new principle as follows:

2. **The secondary responsibility of the Commissioner is to protect the ongoing financial sustainability of the ferry operator by encouraging the ferry operator to:**
  - a) **operate efficiently;**
  - b) **take a commercial approach;**
  - c) **be innovative; and**
  - d) **minimize its operating expenses.**
3. **The Commissioner should also have the authority to determine the respective interests of the ferry users, the taxpayers and the ferry operator and how best to balance those interests.**

### Cross Subsidization of Route Groups

The legislation presently prohibits cross subsidization from major routes to other designated routes. This policy has been the reason for different price cap percentages in each route group. For example, the preliminary PT3 price cap increases for northern and minor routes are double that of the major routes. High volume routes do well in this model, and the low volume ones suffer. The following graph illustrates the actual fare index history in each route group over the first eight years. It is clear that the cumulative impact of rising fares over the eight years has been especially hard on the northern and minor routes.

**Actual Fare Indices**



Normally public policy tools are used to achieve a levelling of costs for public infrastructure between areas of higher population and areas of lower population. It was pointed out to us that liquor prices in government run outlets is standardized across the province, even though costs to ship product into remote communities is undoubtedly higher.

Opposition to removing this principle is likely to come from ferry users on the major routes which benefit from the current policy. Later in this report we make recommendations which may improve affordability on all routes which, if accepted, should remove any opposition to eliminating the prohibition on cross subsidization.

- 4. The principle of elimination of cross subsidization from the major routes to other routes should be removed from the Act. Future price caps should be set at one level for all routes or all route groups as may be established by the Commissioner.**

### **Greater Reliance on User Pay**

The sixth principle in the Act directed ferries to move toward a “greater reliance” on a user pay system so as to reduce, over time, the service fee contributions by government. It’s fair to say that this principle has been achieved. Service fees on all subsidized routes except the northern routes have increased marginally since 2003, while fares have risen quite substantially. The savings to government from not inflating service fees at CPI over that period, amount to over \$100 million. This policy has come at some cost to ferry users, but has put BC in a uniquely advantageous position compared to any other publicly-owned ferry system we’ve looked at. The BC ferry system is now covering 100% of operating costs from fare and ancillary revenues. This puts BC in a relatively sound financial position by comparison.

On the other hand ferry users clearly believe this policy has passed a tipping point, and if retained in future will cause serious harm to financial well being of ferry dependent communities and individuals.

- 5. The principle of a greater reliance on a user pay system should be removed from the Act.**

## 9 Affordability

### 9.1 Inflation-based Price Caps

The overwhelming issue which came up at every public meeting and in virtually every written submission during this review has been that of the affordability of fares. Over the first eight years that the Act has been in place, fares on all routes have gone up significantly.

Route Group	Price Cap Increase 2003 – 2011
Majors	47%
Langdale	73%
Northern	78%
Minors	80%
Provincial CPI	14%

Many submissions to the Commission highlighted the impact fares are having now, and the level of concern at what people see coming if fares are allowed to continue rise at comparable rates in future. We read or heard about financial hardship, community decline, loss of businesses, loss of residents, loss of contact with family members, tourism declines, and so on. These comments came from residents, business operators, local governments, truckers, seniors, educators, First Nations leaders and many others. There seems to be a broad consensus that a tipping point has been reached. The preliminary price cap decision for PT3 was for 8.23% in minor and northern routes, and for 4.15% on major routes. Provincial CPI is presently sitting at about 2%.

The increases in the minor and northern route groups have gone up by the largest percentage, as a result of the two principles which required elimination of cross subsidization from the major groups, and the greater reliance on user pay. Costs on these routes have to be spread over a much lower volume of riders. It is pretty clear that this outcome is not what government intended or expected when the act was created. Quotes from the Minister of the day, indicate an expectation that fares would be more affordable in the future, based on many factors, including a more businesslike approach by the new company which would keep costs down, and allow it to operate independently from political involvement in key decisions.

Direct cost have risen significantly over this time period, some due to factors beyond the control of the company, such as fuel prices, introduction of the carbon tax and new Transport Canada safe manning regulations. Fuel prices went from roughly \$50 per barrel in 2003 to over \$140 before falling back to today's prices in the \$100 range. Indirect costs, such as amortization and interest have risen sharply as well, due to capital investments in vessel replacements and terminal upgrades. During this period, fares have risen at rates considerably higher than the cost of living, and have been apportioned to the various route groups in a way that has resulted in remarkably high increases for residents of communities in the northern and minor route regions.

Our review of price cap models in other parts of the world shows that most are based on price caps which are allowed to grow at CPI-X, where CPI is the consumer price index. The "X" factor is intended to make provision for increasing levels of efficiency over time, producing price caps which are at or below CPI. During the life of the Act, price cap increases have exceeded CPI by quite large margins. In fairness to BC Ferries, they haven't been operating in a "steady state" situation. The cost of bringing the average age of the fleet down in a condensed period of time is very high. The service contract has not provided for service adjustments, and has at times limited the ferry operator's ability to consider opportunities to enhance efficiency or productivity.

Despite the challenges referred to above, the public expectation is that ferry fares should be affordable, and should grow at rates which are reasonable and predictable over time. The question is what constitutes "reasonableness" in ferry fares, and in their future growth?

We heard several suggestions for altering the fare structure or setting fares. Most of these ideas were about different ways to calculate fares which might be advantageous to one community, but could result in offsetting fare increases in another. For example, there was a suggestion that fares be based on miles travelled. That would provide an advantage for shorter routes and a disadvantage for longer routes. Furthermore, there is no evidence that the cost of providing service is directly tied to the miles travelled, except on very long runs. Regardless, we have viewed these suggestions as largely a zero sum game, and therefore haven't pursued them in this review.

Another suggestion we heard and were previously aware of is the Road Equivalent Tariff (RET) proposed for the ferry system in Scotland. We understand that the proposed RET structure is intended to result in fare decreases but it isn't apparent that ferry operator costs will be reduced, so the plans for making up lost revenue will presumably be coming from a source other than ferry users. We intend to continue monitoring the Scottish experiment in future, but for now, consider it to be an unproven approach, and have not pursued it as an option for the coastal ferry system in BC.

Based on what we see as common practice in other jurisdictions, CPI seems to be the generally accepted definition of reasonableness for fare increases. Limiting price cap increases in BC to CPI will mean a significant reduction to the rate of growth that has been experienced to date. As for the "X" factor, until fleet renewal is caught up to where it needs to be for a sustainable system, and there is greater flexibility for BC Ferries to match capacity with demand, "X" factor reduction to CPI for efficiency gains is not likely going to be realistic.

We heard a great deal about the decline in economic activity in coastal communities which is being attributed to the rapid rise in ferry fares over the past nine years, and fears about how much they might increase in future. Restoring confidence in the future viability of coast communities will require some certainty about future fare increases and a long enough time horizon to support investments in new businesses, tourism operations, and home ownership. We think a commitment to holding fares to the rate of inflation, or CPI, for the last three years of PT3 and the four years of PT4, will go a long way toward restoring confidence and stimulating new investment decisions by businesses and homeowners.

## **9.2 Fleet Renewal and the Long-Term Capital Plan**

Capital costs for vessels, terminals and other assets represent one of the biggest drivers of cost in the ferry system. Over the first two performance terms over \$1.9 billion will have been invested. Over the next three performance terms, BC Ferries plans to invest an additional \$2.5 billion in new vessels and supporting infrastructure mostly on the minor routes. These are significant investments, with vessels which can be expected to stay in the fleet for 40 years or more. Given the magnitude of these investments, the Commissioner is concerned that there does not appear to be a long-term vision for coastal ferry services nor any forecast of long-term demand.

A clear vision of where the ferry system should be going is important so we don't saddle our future with a fleet designed to serve the needs of the past. The current long-term capital plan is essentially a "like for like" plan. When one large car ferry is removed from service, it is replaced with another large car ferry. At present the ferry operator is mainly in the business of moving vehicles from one ferry terminal to another. In future, it is quite possible that user needs could be different.

The ferry business could be more about moving people rather than vehicles, and delivering them to communities where they work and shop rather than to vehicle terminals which are often many kilometres from a town or city. The ferry system could possibly be better integrated with other forms of public transportation. There could be a place for other kinds of service, such as passenger-only ferries, barges, water taxis and shuttle buses to connect ferries with other forms of transportation. If fuel prices continue to rise and demographics change, we may want to think in terms of different business models.

We aren't presuming to know the answers to the questions raised by these possibilities, but the Commissioner is concerned that we don't see evidence that this kind of long term thinking is guiding investments of hundreds

of millions in infrastructure. Among other things, the vision should speak to the desirability of standardization and interoperability of vessels and terminals, a vessel size policy which will enable flexible deployment of equipment, and guidance on how BC should respond to future innovations in ferry services. The vision should address whether the intent is for the company to be a risk taking leader, a more conservative early adopter, or to be risk averse.

- 6. The Province should work collaboratively with BC Ferries to develop a long-term vision of coastal ferry services in BC. A draft discussion paper should go out for public consultation. The resulting vision should be formally adopted by the Province and provide the basis for the long-term capital plan of the ferry operator. Ideally the vision would be in place before major capital decisions are made regarding PT4.**

The vision should be based on a long-term forecast of demand and consider the potential use of alternative service providers, new innovations in fuel alternatives and integration with other transportation systems. It's entirely possible that a long-term vision may result in a new long-term capital plan which could be less costly and offer better overall service.

The Commissioner believes there needs to be a set of policy directives flowing from the vision setting out clear objectives, covering fuel efficiency, and greater standardization and interoperability of vessels to optimize efficiency of the fleet. Ideally there would be no more than three classes of vehicle ferry - large, medium and small. They would use standard parts and equipment to reduce costs for inventory and maintenance. Training could be standardized, and crews could be more easily deployed within a class of vessels. If other types of vessel are added to the fleet in future, (cable ferries, passenger-ferries, barges, etc), those too should be standardized to the greatest extent possible. The policy directive should give clear guidance on vessel selection criteria, as well as the desirability of maintaining a targeted average age of vessels in the fleet.

Traffic forecasting has been a serious challenge, and has not been a reliable tool for predicting future demand. During the PT3 preliminary price cap setting process, the Commissioner wasn't satisfied with the reliability of the forecasting model, and decided to obtain a separate analysis, using a different model than the one used by the ferry operator. The end result was not significantly different, but was still considered to be less than optimal. The real issue isn't so much the model itself, as the poor quality of the data available to do the forecasting. This can be attributed to the ferry operator's outdated systems for managing point of sale and reservations. The ferry operator is aware of the failings of the existing system and has a replacement in the medium term capital plan. It is suggested that the operator put a high priority on upgrading these systems, and ensure that the replacement be able to capture data necessary for reliable traffic forecasting in future.

There should be an effective mechanism to ensure that once established, the objectives of the long-term capital plans are adhered to, and cannot be overtaken by special interests. Presently the Commissioner is not explicitly required to approve capital plans, although there is a provision for the ferry operator to ask for approval on specific investments in new vessels or terminal upgrades.

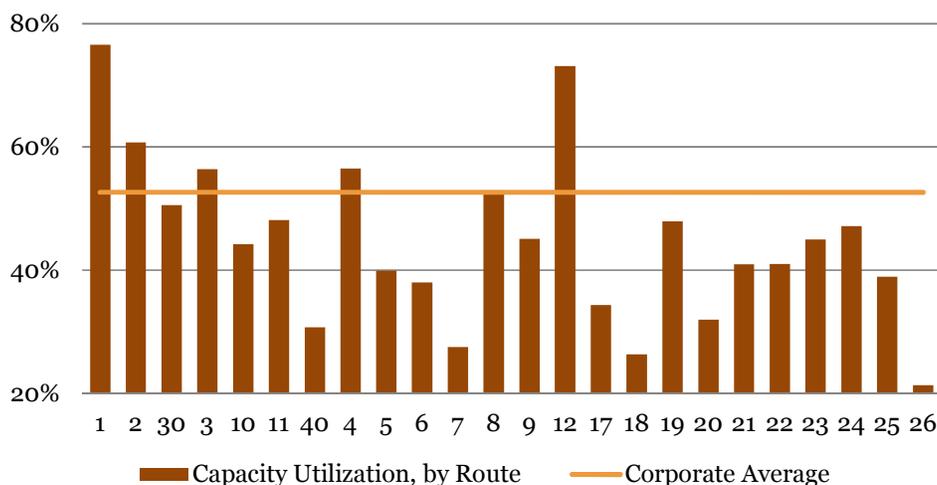
- 7. The Act should explicitly require that the Commissioner must approve the long-term capital plan and any modifications thereto and that the Commissioner's approval be based on a determination that the capital plans are compliant with the long-term vision and its guiding principles.**
- 8. The Act should require that all major capital investments (i.e. new vessels and mid-life upgrades, and terminal upgrades above a threshold determined by the Commission) should be approved by the Commissioner based on a determination that such investments are reasonable, prudent and consistent with the long-term capital plan.**

### **9.3 Capacity Utilization**

The average capacity utilization of the ferry fleet is about 53%, and has been declining as ridership drops off. Some routes have high utilization, with Vancouver – Victoria the highest at over 75%. Some of the minor routes have low utilization, and this drives significant cost in the system. There are some sailings where there are very few, if any, passengers or vehicles. Operating those sailings burns fuel, adds to the carbon footprint of the ferry fleet, and provides little benefit to the users.

On the other hand, the biggest operating cost in the ferry system is for labour, and removing one or two round trips from a route, and especially the shorter ones, provides very little in the way of real cost savings. The biggest cost savings occur when a whole shift is removed, or the schedule is adjusted so that overtime costs can be eliminated. These approaches don't necessarily target sailings which have the lowest ridership.

### Capacity Utilization - Fiscal 2011



**Corporate Total**  
Average Utilization = 52.6%

**Major Routes**  
Average Utilization = 64.7%

- 1 = Swartz Bay - Tsawwassen
- 2 = Horseshoe Bay - Departure Bay
- 30 = Duke Point - Tsawwassen

**Route 3**  
Average Utilization = 56.4%

- 3 = Langdale - Horseshoe Bay

**Northern Routes**  
Average Utilization = 44.5%

- 10 = Port Hardy - Prince Rupert
- 11 = Skidegate - Prince Rupert
- 40 = Port Hardy - Mid-coast

**Minor Routes**  
Average Utilization = 41.7%

- 4 = Fulford Harbour - Swartz Bay
- 5 = Swartz Bay - Four SGIs
- 6 = Crofton - Vesuvius Bay
- 7 = Earls Cove - Saltery Bay
- 8 = Horseshoe Bay - Bowen Island
- 9 = Tsawwassen - Long Harbour
- 12 = Mill Bay - Brentwood Bay
- 13 = Langdale - Gambier/Keats
- 17 = Little River - Powell River
- 18 = Texada - Powell River
- 19 = Nanaimo Harbour - Gabriola Island
- 20 = Chemainus - Thetis Island
- 21 = Buckley Bay - Denman West
- 22 = Denman East - Hornby Island
- 23 = Campbell River - Quadra Island
- 24 = Quadra Island - Cortes Island
- 25 = Port McNeill - Alert Bay
- 26 = Skidegate - Alliford Bay

The ferry operator recently applied to remove 4% of round trips from the major routes. This level of service adjustment was intended to achieve maximum cost savings with minimal disruption to riders. 393 round trips would be removed from the major routes and be spread across this route group from a current total of 9,709 trips. That is an average reduction of one round trip per day for 1/3 of the year for each route. If the same level of service adjustment was applied to the minor routes, it would remove 2618 round trips on 14 routes, from a total of 66,032. This is an average of one round trip per day for 1/2 of the year. There would be no reductions on northern routes, or minor routes 4, 5, 9 or 25, due to the small number of sailings currently provided. These measures would provide savings of approximately \$5.4 million per year.

At present service fees are directly tied to the number of round trips provided by the ferry operator. A reduced number of round trips intended to improve capacity utilization, should not result in a reduction in the total subsidy provided for the route, as that would be a disincentive to looking for such savings.

Another way to improve capacity utilization is to increase ridership. By way of an example, the ferry operator has considered adding a new route from Tsawwassen to Prince Rupert as a way to encourage increased ridership on northern routes. The current option to get from the lower mainland to Prince Rupert is to take a ferry to Vancouver Island, drive six or seven hours to Port Hardy, spend a night in a hotel, and arrive at the ferry terminal by 5am. A more convenient alternative may well increase ridership in the north, with spin off benefits to the tourism sector in that region.

During the public consultations we did hear concern about the possibility of reductions in the number of sailings presently available. There were two common aspects to this concern. One is that higher capacity utilization would reduce the number of spaces available for vehicles without reservations (on routes where they're presently available). For people who are already struggling with fare levels, the prospect of having no option but to pay an additional fee for the reservation is a real concern. The second issue is that wait times for high demand runs could be even longer than they are now. If capacity utilization improvements are going to be viable and earn support from the public, the strategy would need to deliver improved service and increased certainty of getting to a destination. That may be possible with an expanded reservation system.

Right now, reservations are mostly available on the major routes for an additional fee. People who don't pay for a reservation are boarded on a first come first served basis. Multi-sailing waits are common at peak travel times, with long line-ups at the terminals. The ferry operator doesn't know how many vehicles are going to show up, other than through historic experience. This necessitates very large marshalling lots, capable of holding several sailings worth of vehicles. If the ferry operator doesn't anticipate high traffic volume on a particular day, they may decide to run with reduced crew levels. If the traffic unexpectedly shows up, the vessel can't be filled to capacity because of mandatory safety requirements for specified crew to passenger ratios. Passengers are frustrated to be left behind when a vessel has empty space on the car deck. This kind of situation is a result of having to manage without an ability to plan, or any advance knowledge about ridership demand, which would be addressed in a reservation based model.

By turning the current reservation model upside down, the outcomes might be quite positive. If reservations made a day or more in advance did not require a reservation fee, we could expect the majority of ferry users to make a reservation. The ferry operator would know how many vehicles to plan for, and how many crew to schedule. Ferry users would be able to arrive at the terminal a reasonable amount of time before a sailing, and would have certainty that they will be boarded (obviously subject to weather and mechanical breakdowns). Ferry users who arrive at the terminal without a reservation would be charged the additional fee. This is the model used by airlines and many other transportation providers. It rewards people who plan ahead.

We heard numerous stories about the problems people have when reservations aren't available. Most of the minor routes presently don't offer reservations. People told us about having to get to the ferry terminal several sailings early to ensure they could make it to a doctor's appointment. People park their cars over night in the ferry line-ups to make sure they can connect with an appointment or an air connection. People who have to use two ferries to get home can't be sure they'll get boarded on both before the last sailing. The heart of this idea is to improve service for passengers who plan ahead and improve the company's ability to prepare for and serve those ferry users.

With a "free" reservation system in place, we think there could be significant opportunities to improve capacity utilization without impacting service to ferry users. The sailing schedule could have some round trips each day designated as "optional", which would be used if reservations on the non-optional sailings exceed a target utilization level. They could be positioned in the schedule to allow for maximum cost savings.

The current reservation system generates a significant amount of revenue, which could be at risk in a free reservations model. The question is whether the premiums paid by standby passengers would generate an offsetting amount of revenue. Experience in other transportation sectors would suggest that there are always ferry users who have to travel at the last minute, and the change would very likely be revenue neutral. It isn't possible to manage a ferry system to 100% utilization either, due to the varying length of vehicles and the

inability to perfectly control spacing between vehicles. There will always be some unreserved space on vessels, even during peak travel times.

The ferry operator's existing point of sale and reservation system is badly outdated, and isn't robust enough to handle the kind of model we're suggesting at this point in time. There are plans to upgrade both these systems within the next few years. At present there are no reservation systems in place on most of the minor routes, and some real challenges exist to physically deal with two streams of traffic for reserved and unreserved ferry users. Until these shortcomings are addressed it will be difficult to make serious inroads on capacity utilization and yield management.

In conclusion, we believe the current level of capacity utilization is inefficient on some routes and needs to be improved. Service reductions need to focus on sailings which produce the largest cost savings, in order to minimize the total number of sailings which might be affected. The ability to do this in the short term is constrained by the lack of robust systems for reservations and point of sale. Once those systems are up-dated, it should be possible to offer an equal or improved level of service on a fewer number of total sailings. In the meantime, the Coastal Ferry Service contract should make provision for modest improvements to capacity utilization on sailings with an established history of low ridership. The contract should set a target, and empower the Commissioner to approve changes to the schedule to meet the target, following public consultations and with consideration for the best interests of ferry users and taxpayers.

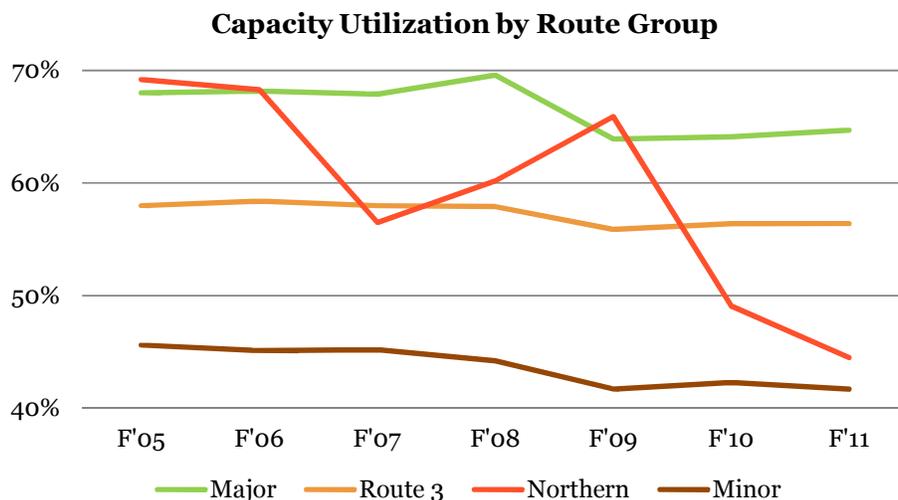
- 9. The Province should make provision for some improvements to capacity utilization within defined parameters. Subject to those parameters, the Commissioner should be given authority to approve specific changes to service levels, based on a consideration of the interests of ferry users, the taxpayer and the financial sustainability of the ferry operator.**
- 10. The Province should empower the Commissioner to approve additional services which have been approved by the BC Ferries board, if the Commissioner is satisfied that adding a new route is in the interests of ferry users, the taxpayers and the ferry operator and can be accomplished without creating an expectation for additional subsidies.**

It may be possible to better manage travel demand by having a more robust or dynamic yield management system in place. Yield management is a widely used tool in other transportation sectors, including airlines and public transit to stimulate travel and maximize revenue. Ferry operators set fares at varying rates in order to incentivize riders to travel at off peak times. This tool has particular benefits to the ferry user in a price cap situation. Price caps require average fares to remain at or below a target. If some fares are above the target, others must be below the target so the average still stays within the cap. The ability to charge higher fares on high demand sailings will generate additional revenue from those who are not able or willing to be flexible around travel times, and provide an offsetting fare benefit to those who are able to be more flexible. BC Ferries presently has little ability to use yield management to full advantage again, because its point of sale system is out of date and it hasn't got a system wide reservation system in place.

BC Ferries already implements differential pricing on a limited scale with a resident fare on the northern routes and with Experience Cards on the minor routes. The objective for BC Ferries should be to develop a more comprehensive pricing structure which could deal with the daily, weekly and monthly variations in ferry demand to optimize system performance. The chart below shows the capacity utilization by route group and it indicates the following:

- Major routes and Route 3 (Horseshoe Bay to Langdale) show the highest levels of utilization (resulting in the highest proportion of sailings overloaded), suggesting those route groups have the highest potential for yield management by increasing fares on selected routes at particular times.
- Minor routes have the lowest capacity utilization and limited number of sailings overloaded, suggesting they serve much more local markets where less discretionary trips being made and there is potential for fare decreases to increase demand levels.

- Data on the northern routes is more conflicting, as there are no overloadings (likely due to the longer length of the routes and the very small number of discretionary trips) and the steep decline in utilization over the last few years.



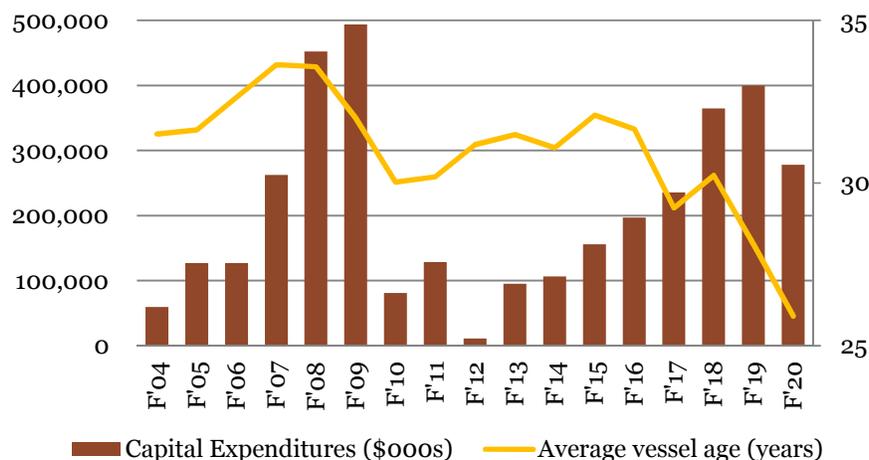
It is important to note that yield management can be used as a capacity utilization tool by ‘flattening’ demand levels at peak sailing times. A true yield management system will consist of a range of fares, reflecting demand levels, and therefore the ferry user has a choice between fare level and service convenience.

### 9.4 Closing the Revenue Gap

Getting to a cap of CPI on future price cap increases is going to be a challenge. Operating costs are rising. Fleet replacement is driving huge cost increases for amortization and debt servicing. Fuel costs make up approximately 20% of direct operating costs and they continue to be highly volatile. Ridership is down, and the trend is in the wrong direction. Capacity utilization of the vessel fleet is low and inefficient, and with declining ridership, is getting worse. Subsidy increases, particularly on the minor routes, have not kept pace with cost increases. These moving parts need to be addressed if a goal of holding price caps to the rate of inflation is going to be possible. We’ll discuss each of them in the following subsections of this report.

The biggest challenge to constraining fare increases in the BC ferry system is the huge increase in capital spending that is forecast over the next three performance terms. The ferry operator has plans to spend \$2.5 billion to replace vessels that will have reached the end of their useful lives, and to upgrade terminals over the next 12 years. The following table shows capital spending over the past two performance terms and plans for the next two performance terms. Capital expenditures grow from about \$100 million at the beginning of PT3, peak in PT4 at \$400 million per year and then fall back to about \$100 million again at the end of PT5. The chart illustrates how the capital plan tracks with the average age of the fleet. The average age of the fleet increases over PT3 and then begins to decline as new vessel acquisitions come on stream. By the end of PT4, the average vessel age is less than 25 years; better than where we are now, but still above the optimum of 20 years.

### Capital Expenditures vs. Average Fleet Age



PwC has performed an extensive modelling exercise to assist the Commissioner in determining what the operator will need by way of cash flows from operations. The assumptions used in the modelling are explained below. The bottom line is that additional revenues will be required to meet the shortfalls we see coming.

The financial modelling from PwC and is based on the following assumptions:

- Tariffs and operating expenditures increase by estimated annual CPI of 2%. Our concern is that a continuation of fares at higher levels is very likely to result in traffic declines, reducing revenues and further increasing the need for other sources of revenue.
- Traffic growth is assumed to be flat on all routes. This is an important variable. Ridership has actually been declining, which users attribute to the rapid rise in fares in recent years. The modelling assumes that holding fares to a more affordable level will prevent further declines. We'll discuss the implications of that not coming true later in the report. However, if ridership actually turns upward again, the requirements for additional subsidy could be reduced considerably.
- Capital expenditures estimated by BC Ferries beyond PT3 are based on asset management plans and are preliminary in nature and subject to change. The capital plan has not been approved by the board of BC Ferries (to our knowledge) nor has it been reviewed by the Commissioner.
- Existing bond debt is retired at maturity and renewed under similar terms. Other debt is repaid according to schedules provided by BC Ferries. Long-term bonds are used to finance new capital expenditures based on current yields for "A" rated bond debt. In short, we are assuming the ferry operator can continue to access capital in the private sector at comparably favourable rates.

The results are shown in the following table. They demonstrate the size of the gap which is looming between total revenue and expenses. The financial sustainability of BC Ferries is at considerable risk. The revenue shortfall is \$58m per year for the last three years of PT3.

	<b>PT3 (Last 3 Years)</b>	<b>PT4</b>	<b>PT5</b>
Average annual additional revenue requirements	\$58m	\$114m	\$143m
Capital Expenditure Estimates	\$553 million	\$1.279 billion	\$728 million

For PT4 and PT5, the additional revenue requirements (assuming a commitment to hold price caps to CPI continues) increase by an additional \$56 million per year in PT4, and an additional \$29 million per year in PT5. It should be noted that these figures are speculative, and are intentionally conservative levels (i.e. on the high side). They assume that nothing changes in terms of key assumptions - price caps are held at provincial CPI, service levels don't change, the current capital plan proceeds in full, ridership remains flat, and the economy remains as is.

However, there are number of things which could change, which would reduce the size of the gap in PT4 and PT5. If the economy improves and tourism begins to increase again, ridership could rise. Every 1% increase in ridership will reduce the size of the gap by \$5 million per year. A different vision for the future of the ferry fleet could result in a less costly capital plan. Cost-saving initiatives from a switch to LNG fuel could save as much as \$30 million per year. New revenue initiatives could improve the financial situation. If the ferry operator gets a new point of sale and reservation system up and running, there could be opportunities to improve capacity utilization. We aren't assuming that any of these things will come to pass though, and are quite aware that things could just as easily go in the other direction if the economy stays weak or ridership falls further.

For PT 3 the options for dealing with this revenue shortfall are limited. We have already discussed the importance of restoring affordability to fares. We don't believe further increases to fares is realistic. If fares continue to rise at an unaffordable rate, the risk is that ridership will decline further. If net revenue falls, the result could easily be an increase to the size of the gap. Large fuel surcharges could have the same result.

We've discussed the possibility of reducing service levels. The 4% reduction discussed will provide a \$5.4 million cost saving. A 10% service reduction only brings that up to \$7.5 million. The only way to make significant savings from service reductions is to remove whole routes, or at least whole shifts from the schedule, in order to achieve labour cost savings. If the entire \$58 million gap had to come from service reductions, it could require complete elimination of three or four routes.

We've made suggestions for new sources of revenue, and further cost reductions. The best possibility is a shift to LNG fuel, with a potential saving of \$28 million per year. Here again, it will require several years to make the transition, and the capital costs to do so will have at least a five-year payback period.

In summary, and as stated earlier, we believe the solution is going to require things to give a little in all of these areas. In the meantime, it is very clear that fares, ancillary revenues, service reductions and cost saving initiatives on their own have little hope of keeping pace with this capital challenge. We see little alternative but for the Province to consider additional service fees or subsidies.

**11. The Province should consider an increase in subsidies together with other initiatives to hold price cap increases to the rate of inflation for the balance of PT3.**

## **9.5 Cost Containment Through Fuel Cost Management**

Fuel represents about 20% of direct operating costs. Volatility in oil prices has had a huge impact on the transportation sector in recent years, and we have to assume that volatility will be a reality for the foreseeable future.

The Act presently allows the operator to apply for extraordinary price cap increases during the price cap term. This section would apply to an extraordinary increase in non-controllable inputs such as fuel or unanticipated and extraordinary change in traffic levels. During PT1, this provision was exercised numerous times to address extraordinary increases in the price of fuel as fuel prices rose rapidly from around \$50 per barrel to over \$140 per barrel. One problem with dealing with fuel price volatility with the Act's present wording is that extraordinary price cap increases remain in place for the balance of the performance term, as there is no provision allowing for a subsequent reduction to the price cap. After hitting the high of \$140 per barrel, fuel prices did in fact drop again, to below \$50 per barrel, and today are hovering in the \$100 per barrel range. The Commissioner decided to deal with fuel price volatility as part of the price cap decision for PT2, establishing the mechanism of a deferral account to manage fuel surcharges and rebates. The major benefit was the ability,

on a timely basis, to put temporary fuel surcharges in place as prices rise, and fuel rebates should prices then fall again.

**12. The Act should explicitly authorize the Commissioner to establish fuel deferral accounts and to have discretion to set terms and conditions for their use.**

Many businesses which are fuel dependent use forward purchasing and hedging to manage fuel cost. The risk of hedging is that a company can lock itself in a price which turns out to be higher than what would have been available in the open market. The trade-off for this risk is certainty about fuel costs, regardless of what happens in the open market, with the benefit of stable pricing, and long term predictability. BC Ferries does manage its fuel cost by hedging on an opportunistic basis.

Another way to reduce fuel cost is to look at alternatives to fuelling vessels with marine diesel oil. We note that BC Ferries has recently announced its intention to convert one of their vessels to LNG. LNG-powered ferries is a growing trend in the industry as there are several vehicle ferries operating now in Norway using LNG gas and Washington State and the Statten Island Ferries are in various stages of introducing LNG ferries into their fleets. BC Ferries has estimated potential operating savings to the ferry system of more than \$28 million if the whole fleet were to be converted to LNG. The Commission is not qualified to judge the suitability of LNG technology on vessels. We simply note that if LNG gas can provide long-term savings and greater certainty about fuel costs, it merits serious consideration.

The Province presently covers the cost any fuel surcharges and recovers any rebates that would otherwise apply on the northern routes. If the Province agrees to support a goal of a CPI limit on future price caps, it will be necessary to deal with fuel price volatility. There is obviously a fair degree of uncertainty about how much it might cost. If oil prices stabilize there could be very little cost, and if they get even more volatile, costs could be quite high.

It will be very unlikely that a goal of a CPI limit on price cap increases can be achieved without addressing fuel price volatility risk from the equation. That risk would be completely removed if the Province would extend its current arrangement for northern routes to all routes. Alternatively, the Province could manage a portion of fuel cost volatility. If a fixed amount is exceeded it would require fuel surcharges on fares to make up any additional shortfall. Risk management of \$10 million will minimize the likelihood of fuel surcharges for ferry users.

**13. The Province should consider extending its policy of absorbing at least a portion of both fuel surcharges and rebates on northern routes to all routes for the balance of PT3.**

## **9.6 Role for Regional and Municipal Governments**

We met with several municipal and regional governments during our tour of ferry dependent communities. We heard their concern with the high ferry fares and the impact they are having on their communities and the inability of local governments to “do anything about it”. We were interested in a point made in one community that the cost of reducing ferry fares could be more than offset by an expected increase in economic activity in the community. If this is true, it could well be in the interests of a local government to invest in reducing ferry fares for their community, if the investment could be recouped from additional business activity, population growth, housing and so on. It may also be possible that local residents would be willing to shift some of the cost of ferry travel from fares to municipal taxes, if doing so would produce a net benefit from increased tourism.

**14. The Act should empower the Commissioner to authorize a municipal or regional government to “buy down” ferry fares on routes to and/or from their communities, to set whatever conditions are considered appropriate, to provide oversight on the arrangement, and to make orders as necessary to**

**ensure that all funds contributed by a local government are used for the exclusive benefit of the intended routes.**

## **9.7 Traffic Risk Management**

Traffic forecasting has been a serious challenge, and has not been a reliable tool for predicting future demand. During the PT3 preliminary price cap setting process, the Commissioner wasn't satisfied with the reliability of the forecasting model, and decided to commission a separate analysis, using a different model than the one used by the ferry operator. The end result was not significantly different, but was still considered to be less than optimal. The real issue isn't so much the model itself, as the poor quality of the data available to do the forecasting. This can be attributed to the ferry operator's outdated systems for managing point of sale and reservations. The ferry operator is aware of the failings of the existing system and has a replacement in the medium term capital plan.

We are particularly concerned that the \$2.5 billion capital plan is not supported by a comprehensive long term forecasting of demographic changes, ridership trends, or cultural shifts occurring as a result of technology which is changing the way people work and shop.

The subsidy estimates are based on an assumption that traffic level will be flat for the foreseeable future. This is intended to be a conservative assumption, in an expectation that if traffic volumes change it will be in the direction of increased travel. This should be a reasonable assumption based on projections for GDP growth over the next 12 years and our recommendation to hold price cap increases to provincial CPI over the next two performance terms. However, if these assumptions are not correct, and traffic actually declines further, the pressure on the financial sustainability of the ferry operator will be considerable. The capital spending requirement of \$2.5 billion would be a financial liability for the ferry operator for decades, regardless of what happens to ridership.

**15. A high priority should be placed on upgrading BC Ferries' traffic forecasting capabilities, including upgrades to the reservation and point of sale systems.**

## **9.8 Additional Tools Required for Price Cap Setting**

### **Final Price Cap Determination**

The following is our recommendation for a revised approach to the final price cap decision, which incorporates additional tools for the Commissioner to protect the interests of ferry users and taxpayers, while balancing the financial sustainability of the ferry operator. At present, the Commissioner is only able to address price caps if costs are rising and service fees are constrained. Price cap increases may not be the solution which best serves the interests of users. The ability to also consider service levels and capital plans are viewed as important additional tools.

**16. In determining the final price cap decision, the Commissioner should have the option to consider:**

- a) adjusting the price cap;**
- b) ordering a change to service levels on specified routes with whatever terms and conditions the Commissioner considers appropriate;**
- c) ordering a reconsideration of upcoming capital projects; or**
- d) any combination of a) through c).**

### **Extraordinary Price Cap Changes**

Section 42 of the Act makes provision for extraordinary price cap increases during a Performance Term, including unexpected and significant changes to such things as operating, construction and interest costs or traffic levels. At present the Commissioner's only option is to approve an extraordinary increase to the price cap, and thereby an increase to fares. Furthermore, there is no provision to reverse a price cap increase during a performance term. The automatic default to an increase in fares may not be the solution which is in the best interests of ferry users.

- 17. The Commissioner should be provided with additional options for dealing with an extraordinary situation, including the ability to order a temporary reduction to service levels, or a temporary delay to capital projects, without compromising safety or operational reliability. As well, extraordinary decisions by the Commissioner should be able to be reversed or modified if the extraordinary circumstances change, or no longer exist.**

## **10 Financial Sustainability**

### **10.1 Financial Requirements of the Operator**

The Act requires the Commissioner to place priority on the financial sustainability of the ferry operator, but does not explicitly define the term. The Act goes on to spell out a number of requirements which are presumed to give effect to the sustainability priority. There are provisions for cost recovery, a pre-tax return on equity, extraordinary price cap increases, and replacement cost valuation of assets.

Our review of price caps in other jurisdictions points to one particularly noteworthy difference between the BC model compared to most others. In most cases the entities being regulated are privately-owned businesses operating in a regulated environment. They have shareholders that expect profitability and dividends, and they use private capital which requires a return on equity. Provisions for full cost recovery and a return on equity make perfect sense in those circumstances. The BC situation is quite different. The common shareholder is the BC Ferry Authority which is not motivated by profitability, a return on equity or an expectation of dividends from the ferry business. The ferry system has always and continues to require taxpayer subsidies to be viable. It seems unlikely when it put this model in place that the Province had any expectation for a return on its investment other than the dividends from its preferred shares. Rather the Province appears to have been more interested in a ferry system which is run efficiently, able to finance itself with private capital, requires the minimum contribution from the taxpayer and is affordable to ferry users.

The regulated rate of return on equity provisions of the Act illustrate this point. The Act entitles the ferry operator to earn an ROE and spells out the formula for setting a pre-tax return. Given that BC Ferries doesn't pay tax, this means the 13% return is actually an after-tax return. If this return is achieved, the equity will double every six years and there is no mechanism for the shareholders to take excess equity out of the company. This could lead to potential "runaway" equity.

The requirement in the Act for capital asset valuation based on full replacement cost, especially given the fact that much of the fleet is fully depreciated, imposes additional upward pressure on price caps. Its potential impact on fares is so large that, to date, it has not been applied.

Section 9.0 described the price cap increases which would be required with no changes to the Act. It's difficult to imagine that the Province had increases of that magnitude in mind when the Act was enacted.

The question is then, what are the objectives of the shareholders in terms of return on equity and dividends from BC Ferries? The Commissioner believes it is possible to reduce price caps down considerably if this question is answered the way we think it could. It is possible that the Province's objectives could be restated as follows:

- minimize demands for service fees;
- cover all operating costs;
- maintain access to private sector capital for major capital projects;
- meet all debt obligations; and
- maintain a credit rating which provides for favourable cost of capital.

BC Ferries has been successful at obtaining an "A" credit rating with its long-term bond debt. This rating has resulted in reasonable financing costs. The "A" rating is above the minimum investment grade rating required by institutional investors and is considered a reasonable target on a go-forward basis.

- 18. The section of the Act which prescribes a pre-tax return on equity as the basis for determining price caps should be amended to direct the Commissioner to set targets for equity levels and cash flows sufficient to meet debt requirements to allow the company to maintain its current rating for long-term bonds.**

## **10.2 Arms Length from Government in Operations**

The current model was intended to remove the political involvement in decisions regarding ferry service operations and capital investments. In the former model, many key operating decisions were made by cabinet, including fares and capital acquisitions. Political lobbying was frequently quite intense, and made it very difficult for elected officials to make difficult decisions. To deal with this issue, the new model removed fare setting from the purview of government and replaced it with the price cap mechanisms and an independent regulator to provide oversight. However, government still manages the contract with BC Ferries directly, and through the contract determines service levels on each route and specifies such things as terminal locations and home porting of vessels. These are controversial issues, and can be difficult for government to deal with.

As a result, the contract is perceived to be rigid, and slow to respond to opportunities which could save money, improve service or both. The fact that service levels are essentially the same on every route today as they were in 2003 illustrates this point.

Improvement to capacity utilization in the system was discussed earlier in this report. In future this could mean some reductions to service levels on some routes, in order to achieve higher levels of utilization. This process needs to be moved somewhat further from the political arena if it's going to produce timely decisions, and deliver savings needed to support lower fares in future.

## **10.3 Ability to Increase Revenues**

### **10.3.1 Increased Ridership Revenue through Advertising and Marketing**

The company has been criticized for its advertising of the "BC Ferries" brand in Rogers' arena. There is a perception that a monopoly should not need to advertise, and that hockey advertising in particular is expensive, poorly targeted and unlikely to generate increased ferry travel.

We believe advertising by a monopoly may well be appropriate if focused on the right audience and with a well conceived marketing strategy. BC Ferries competes with other forms of transportation, and if advertising can increase ridership, it would reduce pressure on fares and service fees.

BC Ferries has opportunities to lever its advertising dollars by partnering with other businesses that run destination marketing programs, for restaurants, hotels, B&B's, fishing guides, tour operators, entertainment events, sports tournaments, music festivals, farmers markets and a host of other activities. Levering dollars to attract visitors to ferry dependent communities benefits both the ferry operator and the local community. It was suggested at one of the public meetings that some communities might even support a modest fare surcharge on their routes, for the purpose of funding local destination marketing programs. If ridership were to increase as a result, there would need to be a fare benefit to the sponsoring community.

- 19. Municipal and regional governments should be empowered to pass resolutions requesting the Commissioner to establish a marketing surcharge on ferry routes which lie within their boundaries, for purposes of promoting destination marketing which is reasonably likely to increase ferry ridership. The surcharge would be collected by BC Ferries and remitted to a designated regional tourism entity. Surcharges would only apply to specified routes, and the proceeds would need to be used entirely for the benefit of the community which pays for them. The Commissioner should be authorized to set conditions on use of the surcharge, and to limit the time periods that a surcharge will remain in effect.**

### 10.3.2 Increased Ancillary Revenues

We heard criticism of the new BC Ferries Vacations initiative, and particularly the expensive storefront location in downtown Vancouver. The ferry operator's purpose is to generate new ancillary revenue, which would contribute to keeping fares lower in future. As long as this kind of initiative makes a positive contribution to the bottom line of the company, we can see no purpose in interfering or regulating such activity. It is also understood that there is a necessary period of investment before a new business venture can reasonably be expected to show a profit. So far, BC Ferries Vacations shows a reasonable promise of success, and deserves sufficient time to prove itself.

An idea that came out of the public consultation was for BC Ferries to consider operating on-board reservation and booking services for passengers, including things like car rentals, connecting buses, seaplanes, tours, fishing charters, hotel accommodations, B&Bs, etc. The idea is for BC Ferries to be able to make the reservations, collect the fees or deposits, collect a surcharge for their services and remit net payments to the tourism operators.

There may be a revenue opportunity for additional on-board advertising sales. The ferry system carries over 20 million passengers per year, and has those passengers somewhat captive in their line-ups and on the vessels for several hours at a time. Many vessels have television monitors, and lots of locations where advertising could be placed.

**20. The Act should be explicit that the Commissioner be expected to encourage the ferry operator to generate new ancillary revenue, if doing so is considered to be in the interests of ferry users and taxpayers.**

### 10.4 Vessel Procurement Leverage and Process

The federal government's recent procurement process for new military and Coast Guard vessels achieved an unprecedented result which appears to be very much in the interests of both taxpayers and the ship building industry. The ability to procure multiple ships at the same time will result in lower costs than if each vessel were to be procured separately. The procurements processes are very expensive, so a multi-ship deal offers considerable savings over time. The flexibility to negotiate individual contracts within an umbrella agreement provides the federal government with the opportunity to ensure value for money. The certainty that comes with this deal for the shipbuilders is also significant, and can be expected to allow them to invest in the capacity needed to construct vessels efficiently.

Given the potential for savings and economic development, the procurement model used by the federal government should be examined carefully when BC Ferries begins the next phase of vessel construction.

## **11 Accountability**

### **11.1 Role of the Commissioner**

The Act currently states in Section 67 that the ferry operator must provide information reasonably required by the Commissioner. The Act therefore gives the Commissioner a great deal of authority to request information from the ferry operator, to make determinations and issue rulings or orders which cannot be challenged except on a matter of law. However, it is often either silent or ambiguous about what the Commissioner is empowered to do if the interests of ferry users are not being served. The intention of the Act was a light-handed approach to regulation, with a minimum of intrusion into the day to day operations of the business. Any additional powers given to the Commissioner should keep this intention in mind, and only provide powers which are necessary, and put appropriate checks and balances in place to preclude an excess of regulatory enthusiasm which goes beyond what the Act intends. With that caution in mind, the following recommendation suggests some additional authority for the Commission to ensure an appropriate level of accountability on the ferry operator, and effective tools to ensure that the interests of ferry users and taxpayers are protected and in balance with the need for a financially sustainable ferry operator.

- 21. The Act should be more explicit that the Commissioner may issue an order which requires the ferry operator to:**
  - a) prepare a plan;**
  - b) review a policy;**
  - c) undertake a public consultation; or**
  - d) cause information to be made public.**
  
- 22. The Commissioner should be authorized to approve or reject a plan or a policy which has been submitted, but should not be authorized to impose an alternative plan or policy created by the Commissioner.**

### **11.2 Accountability to the Taxpayer**

The Auditor General routinely conducts performance audits on ministries and other bodies which are within the government reporting entity. These are distinct from financial audits, and look specifically at performance related to efficiency, effectiveness and value-for-money. Such audits are a routine part of the oversight process, and are managed within a specific budget line, sufficient to fund a reasonable amount of performance auditing each year. BC Ferries doesn't fall within the purview of the Auditor General so the Act should explicitly authorize the Commissioner to conduct performance audits as deemed necessary and in the interests of ferry users and taxpayers. This would be a new responsibility for the Commissioner which is not presently provided for in the Commission's funding formula. Accordingly, we are therefore recommending a change in the funding formula contained in the Act for the Commissioner.

- 23. The Act should explicitly authorize the Commissioner to conduct routine performance audits on an on-going basis as deemed necessary and in the interests of ferry users and taxpayers.**

## 11.3 Accountability to the Ferry Users

### 11.3.1 Ferry Advisory Committees

At present Ferry Advisory Committees are appointed by BC Ferries and are an important channel for consultation between the ferry operator and users. The committees provide a valuable service not only to the operator, but also to government, the Commission and the communities they represent. From our review of how user or public interests are addressed in the regulation of monopoly enterprises in other jurisdictions we have found that user groups or committees are a common feature of almost all of them. They exist primarily as advisory bodies to assist the regulator in understanding and protecting the interests of users. Some have been assigned direct powers but most are purely advisory and have no governance role. The ones that are advisory generally are appointed and overseen either by a government agency or by the regulator.

At present the committees exist at the pleasure of the ferry operator. There is no provision for them in legislation. There are no committees in place on the major routes. As a key component of the accountability framework and in the protection of the ferry users, we recommend:

**24. Ferry Advisory Committees should be appointed by the Commissioner and remain advisory. The terms of reference, structure of and appointments to the Committees should be at the discretion of the Commissioner, with the intention of ensuring that each committee includes people with a range of perspectives on the various users of the system, including a resident, a commuter, a tourism operator, a commercial operator and a local government official.**

The proposed change is not intended to constrain Ferry Advisory Committees from continuing their present engagement with the ferry operator or government as a primary point of consultation on regional ferry issues.

### 11.3.2 Policies and Procedures of the Ferry Operator

One of the main reasons for regulating monopolies is to ensure they don't take advantage of a lack of competition in their pricing or fail to provide services that meet the reasonable expectations of customers who have no other alternatives. BC Ferries has a vision statement in their annual performance report which talks about their commitment to high quality service. However, there were many examples cited during the review which would suggest that at times the commitment at times falls short.

Businesses which operate in a competitive environment recognize the importance of customer service. This translates to understanding customer needs, earning loyalty from existing customers, and implementing strategies to develop new ones.

During our public consultation process we heard many complaints about customer service, and were often surprised at the nature of the issues and concerns being raised. In fairness to the company, we were hearing one side of the issues, and realize there may be reasonable explanations. We also recognize that the company's policies may say one thing but what actually happens on the front line could be quite different. Rather than listing the complaints we heard about in this report, we decided to put a list of questions to the executive about company policy, so we could make some judgements about whether there are problems with the policies themselves, or if not perhaps with employee training, internal communications, complaint handling, or something else. The list of questions and the company's response has been posted on our website.

Most of the ferry operator's policies appear to be reasonable, and customer focused. Clearly some policies suit one group of customers and frustrate another. On time departure frustrates the people who get left behind, and late departure frustrates the people who arrived on time. These kinds of conflicting expectations would be expected in any business.

We do believe there are a few policies in force which are more indicative of a monopoly attitude, where the customer's needs are secondary to the needs of the company or its employees. Home porting of vessels for

example, appears in some instances to give priority to where the employees prefer to live rather than the best service for commuters. A \$90 pre-payment for the Experience Card (and thereby access to reduced rates) is a hardship for ferry users on financial assistance or with fixed incomes. Requiring passengers to present a phone or hydro bill to prove residency is seen by some as an invasion of privacy. Charging over-height rates for an under-height trailer is perceived as unfair. Requiring passengers who are travelling on a Travel Assistance Pass (for medical treatment) to arrive at the terminal three hours before a sailing is seen as uncaring.

The question is, would these policies be in place if there was a competitive market for ferry services? It seems unlikely that a customer focused service provider would be likely to have policies in place which are viewed by their customers as invasive, uncaring or unfair.

We've discussed these issues with management and believe the company is sincere about its commitment to customer service and has a strong desire to provide service excellence. It is noteworthy that there were numerous comments made at public meetings about the good service provided by individuals in the company, and examples of employees who go above and beyond.

However we do suggest that the company could do several things to improve its customer service. It could implement a process to regularly review its policies to ensure they are putting the customers' needs first to the extent possible. The Ferry Advisory Committees are an obvious vehicle to assist in this process. BC Ferries could also communicate their policies more effectively to their employees, and make them more transparent to the public. There may also be a need for additional employee training where there is evidence that policies are not being interpreted as intended. As covered elsewhere in this report we recommend that the Commissioner have the authority to issue an order to require the operator to review its policies if they do not appear to meet the reasonable expectations of customers.

## 12 Recommendations

The original vision for the current price cap model was a light handed approach to regulatory oversight. Having looked at other regulatory approaches, including more heavy handed versions, it is our view that the light handed approach is in the best interests of all three stakeholders and should be retained if any changes are going to be made to the Coastal Ferry Act. The light handed model is the most cost effective approach and is intended to give the company considerable latitude to manage the business as efficiently and effectively as possible. Price caps provide a considerable amount of freedom to adjust prices up or down within defined limits without prior regulator approval. The fact that ancillary revenue was not regulated was intentional, and permits freedom to be innovative and entrepreneurial. That responsibility resides with the management and board of directors. Collective agreements are not and should not be subject to oversight by the regulator. A more heavy handed approach would see the regulator involved in many of these matters, including for example, the setting of all individual fares, on all routes and for all segments or types of ferry users.

The regulators in “heavy handed” models tend to be relatively large, and resource heavy. Decisions can be slow coming, and the process of seeking approvals can restrict the ability of the company to be nimble, to seize opportunities or respond to challenges. The Commission is presently composed of two individuals, a Commissioner and a Deputy Commissioner, both appointed with an expectation of a 1/3 FTE time commitment and with an annual budget of \$0.5 million. There is provision in the Act for a second Deputy Commissioner which to date has never been filled. It is, by design, a very low cost regulatory model. If the result of this review is additional responsibilities for the Commission, it will likely necessitate some additional resources, but the goal of light handedness should not be lost.

As the authors of this review, the two Commissioners realize the possibility of a regulatory bias. Having a regulator conduct this kind of review creates a risk of “regulatory enthusiasm” where the solution to every problem could default to more regulation and more authority for the regulator. We felt it was necessary to be up front about this risk, and to be vigilant in the development of recommendations. We in fact make several recommendations which would give the regulator additional authority to hold the operator more accountable. These changes are intended to impose only the level of regulatory oversight necessary to protect the interests of the ferry users and the taxpayers, and preserve an appropriate balance with the need for a financially sustainable ferry operator.

This section summarizes the recommendations of the Commissioner’s review. The recommendations are listed in the order in which they appear in Sections 8-11. In addition, a number of other recommendations are listed which are administrative in nature.

### **Recommendations from Sections 8-11:**

#### **Principles**

1. The primary responsibility of the Commissioner should be to protect the interests of ferry users and the taxpayer. The term “ferry user” should be interpreted broadly, to include ferry customers, their families, ferry-dependent communities and businesses which depend on ferry services to be affordable and reliable.
2. The secondary responsibility of the Commissioner is to protect the ongoing financial sustainability of the ferry operator by encouraging the ferry operator to:
  - a) operate efficiently;
  - b) take a commercial approach;
  - c) be innovative; and
  - d) minimize its operating expenses.
3. The Commissioner should also have the authority to determine the respective interests of the ferry users, the taxpayers and the ferry operator and how best to balance those interests.

4. The principle of elimination of cross subsidization from the major routes to other routes should be removed from the Act. Future price caps should be set at one level for all routes or all route groups as may be established by the Commissioner.
5. The principle of a greater reliance on a user pay system should be removed from the Act.

### **Affordability**

6. The Province should work collaboratively with BC Ferries to develop a long-term vision of coastal ferry services in BC. A draft discussion paper should go out for public consultation. The resulting vision should be formally adopted by the Province and provide the basis for the long-term capital plan of the ferry operator. Ideally the vision would be in place before major capital decisions are made regarding PT4.
7. The Act should explicitly require that the Commissioner must approve the long-term capital plan and any modifications thereto and that the Commissioner's approval be based on a determination that the capital plans are compliant with the long-term vision and its guiding principles.
8. The Act should require that all major capital investments (i.e. new vessels and mid-life upgrades, and terminal upgrades above a threshold determined by the Commission) should be approved by the Commissioner based on a determination that such investments are reasonable, prudent and consistent with the long-term capital plan.
9. The Province should make provision for some improvements to capacity utilization within defined parameters. Subject to those parameters, the Commissioner should be given authority to approve specific changes to service levels, based on a consideration of the interests of ferry users, the taxpayer and the financial sustainability of the ferry operator.
10. The Province should empower the Commissioner to approve additional services which have been approved by the BC Ferries board, if the Commissioner is satisfied that adding a new route is in the interests of ferry users, the taxpayers and the ferry operator and can be accomplished without creating an expectation for additional subsidies.
11. The Province should consider an increase in subsidies together with other initiatives to hold price cap increases to the rate of inflation for the balance of PT3.
12. The Act should explicitly authorize the Commissioner to establish fuel deferral accounts and to have discretion to set terms and conditions for their use.
13. The Province should consider extending its policy of absorbing at least a portion of both fuel surcharges and rebates on northern routes to all routes for the balance of PT3.
14. The Act should empower the Commissioner to authorize a municipal or regional government to "buy down" ferry fares on routes to and/or from their communities, to set whatever conditions are considered appropriate, to provide oversight on the arrangement, and to make orders as necessary to ensure that all funds contributed by a local government are used for the exclusive benefit of the intended routes.
15. A high priority should be placed on upgrading BC Ferries' traffic forecasting capabilities, including upgrades to the reservation and point of sale systems.
16. In determining the final price cap decision, the Commissioner should have the option to consider:
  - a) adjusting the price cap;
  - b) ordering a change to service levels on specified routes with whatever terms and conditions the Commissioner considers appropriate;
  - c) ordering a reconsideration of upcoming capital projects; or
  - d) any combination of a) through c).

17. The Commissioner should be provided with additional options for dealing with an extraordinary situation, including the ability to order a temporary reduction to service levels, or a temporary delay to capital projects, without compromising safety or operational reliability. As well, extraordinary decisions by the Commissioner should be able to be reversed or modified if the extraordinary circumstances change, or no longer exist.

### **Financial Sustainability**

18. The section of the Act which prescribes a pre-tax return on equity as the basis for determining price caps should be amended to direct the Commissioner to set targets for equity levels and cash flows sufficient to meet debt requirements to allow the company to maintain its current rating for long-term bonds.
19. Municipal and regional governments should be empowered to pass resolutions requesting the Commissioner to establish a marketing surcharge on ferry routes which lie within their boundaries, for purposes of promoting destination marketing which is reasonably likely to increase ferry ridership. The surcharge would be collected by BC Ferries and remitted to a designated regional tourism entity. Surcharges would only apply to specified routes, and the proceeds would need to be used entirely for the benefit of the community which pays for them. The Commissioner should be authorized to set conditions on use of the surcharge, and to limit the time periods that a surcharge will remain in effect.
20. The Act should be explicit that the Commissioner be expected to encourage the ferry operator to generate new ancillary revenue, if doing so is considered to be in the interests of ferry users and taxpayers.

### **Accountability**

21. The Act should be more explicit that the Commissioner may issue an order which requires the ferry operator to:
  - a) prepare a plan,
  - b) review a policy,
  - c) undertake a public consultation, or
  - d) cause information to be made public.
22. The Commissioner should be authorized to approve or reject a plan or a policy which has been submitted, but should not be authorized to impose an alternative plan or policy created by the Commissioner.
23. The Act should explicitly authorize the Commissioner to conduct routine performance audits on an on-going basis as deemed necessary and in the interests of ferry users and taxpayers.
24. Ferry Advisory Committees should be appointed by the Commissioner and remain advisory. The terms of reference, structure of and appointments to the Committees should be at the discretion of the Commissioner, with the intention of ensuring that each committee includes people with a range of perspectives on the various users of the system, including a resident, a commuter, a tourism operator, a commercial operator and a local government official.

### **Other Recommendations Related to Administrative Matters:**

25. Section 26(1) of the Act should be repealed or amended to restrict its application to Part 2 of the Act.
26. Section 35 of the Act should be amended to create a public body known as the British Columbia Ferry Commission.
27. Section 38 should provide that the Commissioner may authorize the establishment of route groups for purposes of reviewing and monitoring performance of the ferry operator.

28. Section 41.3(c)(i) should be amended to add “and prudent” after “reasonable”.
29. Section 41.3(d) should be amended to give the Commissioner discretion to use replacement costs if the Commissioner considers it to be advisable.
30. Section 53(1) should be amended to require the Commissioner to make a report to the Lieutenant Governor within five months after the end of each fiscal year.
31. Section 59 should be amended to provide that the commissioner’s budget for the fiscal year does not exceed for each quarter  $\frac{1}{20}$  of 1% of the previous year’s tariff revenue.



# ***APPENDIX A***

## ***List of References***

## **List of References**

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# ***APPENDIX B***

## ***List of Public Entities which Provided Written Submissions***

## **List of Public Entities which Provided Written Submissions:**

### **Associations**

Bella Coola Valley Tourism  
British Columbia Hotel Association  
Denman Island Community Education  
Denman Island Residents Association  
Denman Works  
Galiano Health Care Society  
Gulf Islands Alliance  
Island Trust Council  
Mayne Ratepayers Association  
North Island Employment Foundation Society  
Powell River Regional Economic Development Society  
Saturna Island Property Owners Association  
Save Our Ferries – British Columbia Coastal Transportation Society  
Tourism Powell River  
Union of BC Municipalities

### **British Columbia Ferry Services Inc.**

#### **Chambers of Commerce**

Gabriola Island Chamber of Commerce  
Salt Spring Island Chamber of Commerce

#### **Ferry Advisory Committees**

Denman-Hornby Ferry Advisory Committee  
Gabriola Ferry Advisory Committee  
Keats Ferry Advisory Committee  
Northern Sunshine Coast Ferry Advisory Committee  
Penelakut Ferry Advisory Committee  
Salt Spring Island Ferry Advisory Committee  
Southern Gulf Islands Ferry Advisory Committee  
Southern Sunshine Coast Ferry Advisory Committee

#### **First Nations**

Hartley Bay Band Council  
Namgis First Nation Band Council  
Penelakut Tribe

#### **Municipalities, Regional Districts**

Bowen Island Municipality  
Coastal Regional District Chairs (representing 13 Regional Districts)  
City of Prince Rupert  
Powell River Regional District  
Strathcona Regional District  
Village of Alert Bay  
Village of Port Clements

#### **Other**

Quadra Island Artists

