BRITISH COLUMBIA
FERRY COMMISSION

ORDER
NUMBER: 05-06 Preliminary

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IN THE MATTER OF
An Application by British Columbia Ferry Services Inc. Pursuant
to Section 42 of the *Coastal Ferry Act,* S.B.C. 2003, Chapter 14 for an Extraordinary
Increase in the Price Cap in Relation to an Increase in Fuel Prices and Costs

BEFORE: Alan Eastwood, Deputy Commissioner on December 21, 2005

PRELIMINARY DECISION

WHEREAS:

A. British Columbia Ferry Services Inc. ("BC Ferries") has, by a submission filed November 28, 2005, applied for an increase in the price cap (weighted average fare) applicable to six of the seven route groups designated in the Coastal Ferry Services Contract (the "Contract") between BC Ferries and the Province of British Columbia;

B. by Order 05-02 dated July 24, 2005, in response to BC Ferries' application dated June 13, 2005, the Commissioner authorized increases in the price caps applicable to the major route group and the remaining route groups by 4% and 6% respectively until the end of the current performance term on March 31, 2008 because of significantly higher prices for marine diesel fuel, both experienced to June 2005 and projected through 2008, than were expected when the Contract came into force. The surcharges were to end on March 31, 2008 or an earlier date if fuel oil prices warranted a reduction or an elimination of them;

C. fuel oil prices in the second half of 2005 have been significantly higher than forecast when Order 05-02 was passed and current forecasts indicate that BC Ferries can expect, for the next two years, to face marine diesel fuel prices about 20% higher than were forecast at the time of Order 05-02;

D. by Order 04-02 dated September 28, 2004, the Commissioner authorized BC Ferries to establish deferral accounts in order to diminish the effect on BC Ferries expenses of volatility in marine diesel fuel prices through the collection in the deferral accounts of variances between budgeted and actual fuel oil costs, with balances in the deferral accounts, if any, to be recovered through adjustments to price caps in the four-year second performance term starting April 1, 2008;

E. the current balances in the deferral accounts (deferred costs) and the expected balances to the end of fiscal year 2007/8 (“fiscal 2008”) exceed the expectations when Order 05-02 was passed;

F. it is desirable that further reduction of the balances in the deferral accounts should occur and continue through to March 31, 2008, in order to avoid major increases in fares for ferry customers in the future and to provide BC Ferries with certainty regarding the disposition of the deferred costs; and

G. the Commission has publicized BC Ferries’ application of November 28, 2005 and is providing one month for the public to comment on the application through January 8, 2006;

NOW THEREFORE the Commissioner’s preliminary decision is as follows:

1. the price caps applicable to route groups one through six, as determined by the Commission, are increased **effective February 1, 2006** to the end of the first performance term at March 31 2008 as follows:

   (a) **by one and one-half per cent for the major route group**—comprising the Vancouver Island to Lower Mainland routes in group number one—using the price cap that would otherwise be in effect November 1, 2006 for route group one as the base for the calculation of the one and one half per cent increase to the price cap, and

   (b) **by three per cent for the remaining route groups** (the “other routes”) numbered two through six, using the price cap that would otherwise be in effect November 1, 2006 for each of the route groups numbered two through six as the base for the calculation of the three per cent increase to the price caps; and

2. in addition to the above, the price caps may be increased in a possible second step, subject to the Commissioner receiving information from BC Ferries by no later than June 7, 2006 that the actual and forecast fuel prices for the period from December 1, 2005 to March 31, 2008 have not declined by an amount equal to 6% or greater from the forecast of November 28, 2005 of fuel prices for that period:

   (a) for the major route group by **one per cent multiplied by a factor Y, and**
   (b) for the other route groups by **three per cent multiplied by a factor Y;**

$$\textbf{where } Y = 1 + \frac{X}{6}$$

and where X is the number of percentage points change**,** positive or negative, in the actual and forecast fuel prices for the period from December 1, 2005 to March 31, 2008, as determined by the Commission.

For example, if fuel prices (actual and forecast between December 1, 2005 and March 31, 2008) change by -2%, then X=-2 and Y=0.66, so a second step price cap increase equals 0.67% and 2.00% for the major and other route groups respectively.

Both increases, if put into effect, will be effective June 12, 2006 or such other date determined by the Commissioner, and will use the price caps that would otherwise be in effect November 1, 2006 for the respective route groups as the base for the calculation of the increases to the price caps.

3. The fuel surcharge to ferry customers shall, as long as it remains in effect, be shown on the fare ticket, combining the surcharges authorized by the Commission. The amount collected shall be used to reduce the balances of the deferral accounts for the respective major and minor route groups.

4. The provisions of Order 05-02 relating to the operation of the deferral accounts, interest on the balances in the deferral accounts, hedging operations and the reduction and/or elimination of the fuel surcharges, remain in effect.

5. The increase in the route group price caps authorized by this Order shall be excluded from the calculation of future annual statutory increases in the price cap indexes.

6. The Commissioner requires BC Ferries to provide a plan by June 1, 2006 showing the fuel saving measures taken and those planned to be taken in the following two years.

7. As a fuel conservation measure, BC Ferries is expected, for the two fiscal years commencing April 1, 2006, to reduce the volume of actual fuel consumption by one per cent cumulatively for each year from the actual amount of fuel consumed in fiscal 2006. The cost of fuel used in excess of these targets (99% and 98% respectively of the fuel consumed in fiscal 2006) shall not be included in any calculation of the costs transferred to the deferral accounts but shall be charged to BC Ferries' operating costs.

A detailed review of the application and reasons for this preliminary decision are attached in Schedule A.

Dated at North Saanich, in the Province of British Columbia, this 21st day of December, 2005.

BY ORDER

Alan Eastwood

Alan Eastwood
Deputy Commissioner
British Columbia Ferry Commission

SCHEDULE A

REVIEW OF APPLICATION AND REASONS FOR PRELIMINARY DECISION

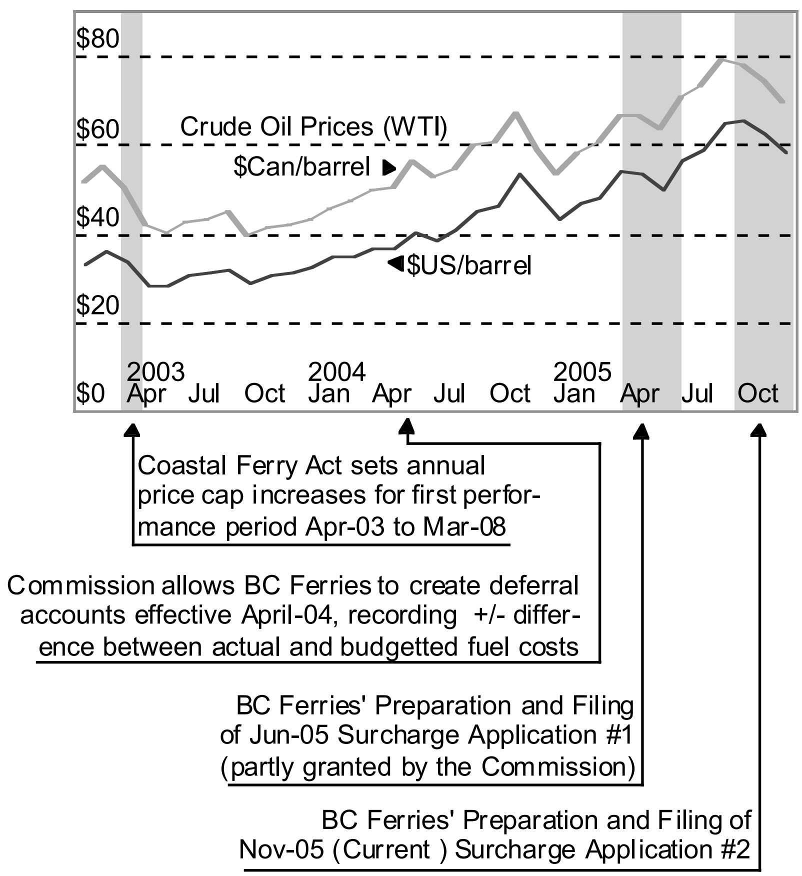
Background: Actions to Date in 2005

In the Coastal Ferry Act, passed April 2003, the initial price caps were defined as being the average of the fares payable as at April, 2003. They were set to increase annually at 2.8% for the major route group and 4.4% for other route groups for the first performance term ending March 2008. As seen in the chart below, at that time crude oil prices were in the $US30 range.

BC Ferries, in establishing its budget for the year ending March 31, 2005 ("fiscal 2005"), based its forecast for fuel oil costs on the world energy forward contract prices for fuel oil. World markets were forecasting fuel oil prices at US$30 per barrel (CDN$40) at that time.

Chart 1

Price Caps and Oil Prices



In September 2004 BC Ferries proposed, and the Commissioner approved, the establishment of deferral accounts effective April 1, 2004 to reduce the impact of fuel price volatility on BC Ferries' operating costs. The deferral accounts, one for each route group, were intended to collect the effect of variances in the price of fuel oil, both positive and negative to the budget price. It was forecast at that time that the totals in the deferral accounts would be $5.3

million by the end of fiscal 2005, that is, fuel costs of that amount would not have been charged to operations. The Commissioner's Order stated that any balances remaining in the deferral accounts at the end of fiscal 2008, being the end of the first performance term, would be eligible to be recovered through price cap increases (fares), in subsequent performance terms.

In summary, BC Ferries operating costs were insulated against the effect of fuel price volatility to the end of fiscal 2008 and the company was assured that the deferred costs would be recovered through price cap adjustments (fares) in a later time period. Subsequent to the Order, world energy prices increased further and the balances in the deferral accounts at the end of fiscal 2005 were $8.0 million compared to the forecast of $5.3 million.

Further increases in energy prices in the first half of 2005 caused BC Ferries to file an Application on June 13, 2005 for a fuel surcharge to be imposed on all route groups except route group seven (the Langdale-Gambier-Keats route). In that Application BC Ferries used a forecast of US$55 per barrel for 2005, with declines to $50 and $45 for subsequent years. The price BC Ferries pays for fuel generally follows world energy prices. Total annual fuel costs for fiscal 2006 were forecast to reach $72 million compared to a budget of $50 million.

The Commission's Order 05-02 approved increases of 4% and 6% for the major and other route groups respectively, effective July 24, 2005. The deferral account balances were forecast to decline to $6.9 million by March 31, 2008 as a result of the fuel surcharges resulting from that Order.

Second Application for Fuel Surcharges

On November 28, 2005 BC Ferries filed a second Application with the BC Ferry Commissioner (the "Commissioner") under Section 42 of the *Coastal Ferry Act* (Act) for extraordinary price cap increases in relation to six of the seven route groups, comprising all of the designated routes operated by BC Ferries again with the exception of group 7, the Langdale-Gambier-Keats route. The Application stated that an extraordinary situation existed with respect to the price of an uncontrollable input, namely fuel, and that this situation is expressly identified in Section 42 (2)(b) of the Act.

This review addresses the questions raised by this second Application.

- What accounts for the change in BC Ferries' actual or forecast fuel costs since July 24, 2005?
- If there has been a change in expected fuel costs, is it sufficient to warrant an increase in the fuel surcharge?
- Does the situation meet the conditions of Section 42 of the Act?
- Is the calculation by BC Ferries of the further increases required in the price caps reasonable?

The reasons for the Commissioner's preliminary decision are given.

What Accounts for the Change in BC Ferries' Actual or Forecast Fuel Costs?

Previous Forecast of Fuel Prices and Costs

At the date of the first application for a fuel surcharge BC Ferries supplied a forecast of fuel prices based on a forecast provided by the major Canadian banks (the "bank syndicate")in April 2005. That document provided a forecast of oil prices for the years 2005 to 2007. For 2005 the forecast price was US$55 per barrel (for West Texas Intermediate or WTI), followed by $50 for 2006 and $45 for 2007. BC Ferries obtains most of its fuel—about 82%—at a price based on "Edmonton par", which, in turn, tracks closely to the WTI price. The rest of BC Ferries' requirements are obtained through Vancouver at a rate known as the "Vancouver Rack rate". This price is generally higher than the Edmonton par price and shows greater volatility, especially in tight markets.

Based on these forecast prices BC Ferries fuel costs were expected to rise to $72 million in the current year fiscal, 2006. In the following two years, fuel costs were expected to decline slightly but the cumulative increase over budgeted fuel costs was forecast to be $54 million. This situation met the conditions of Section 42 of the Act to be described as "extraordinary".

The Commissioner's decision of July 24, 2005 responded to the first Application in the following ways:

- the bank syndicate's forecast of future oil prices was accepted as a reasonable forecast, although the risks inherent in any forecast of oil prices were recognized ;
- BC Ferries was required to increase the amount of fuel costs charged to operations by 5%, in recognition that a portion of the fuel oil price increase could be described as "ordinary" and, therefore, part of the expected fluctuation of costs;
- fuel surcharges of 4% for the major and 6% for the other route groups were authorized, with the anticipation that this level of surcharge would meet the extraordinary increase in fuel costs expected through to March 31, 2008;
- as the deferral account balances, which represent the extraordinary fuel costs, were expected to rise significantly and as they represent unrecovered costs, BC Ferries was allowed to charge interest on the deferral accounts, at their general borrowing rate; and
- BC Ferries was encouraged to undertake fuel conservation measures.

Outcome to Date for Fuel Prices and Costs

Since the July 24, 2005 decision fuel prices have been significantly higher than the forecast level of US$55 per barrel (WTI). Because prices peaked in the high sixty dollar range in August, September and October and have since declined to the high fifty dollar range, there may be a general impression that prices have declined from their July level. In fact, through the end of November there were no days on which fuel prices were as "low" as US$55 (the price used in the forecast) and the average for the months of June through November was US $62. In Canadian dollar terms the price was $75 a barrel for "Edmonton par" in the five months starting in July, 17% higher than in the first six months of 2005. The peak prices coincided with the months of highest fuel usage by BC Ferries.

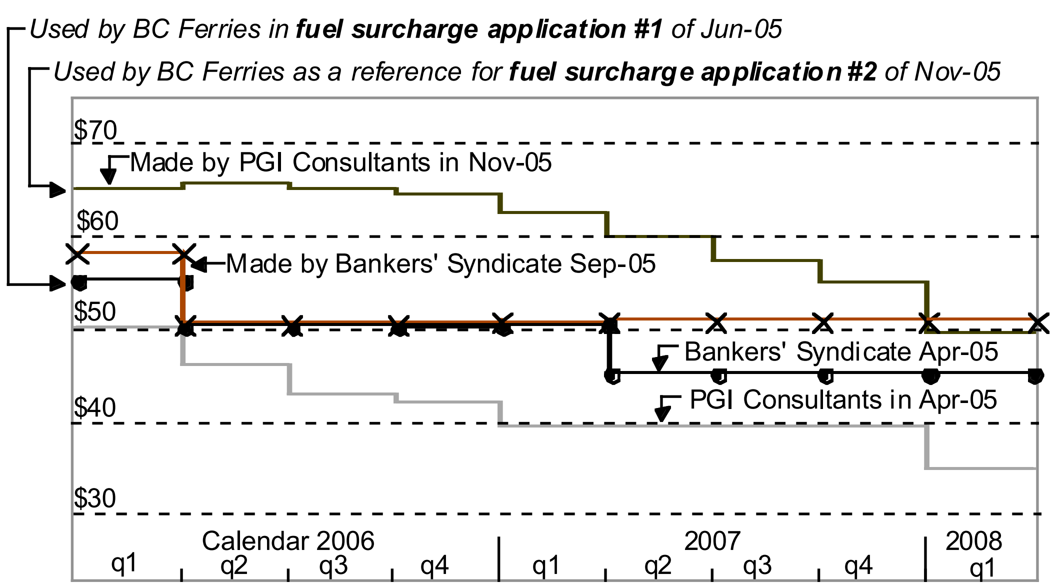
As a result BC Ferries now expects to incur fuel costs of approximately $76 million in the current fiscal year, compared to $72 million at the time of the first application and to $50 million budgeted for this fiscal year.

The fuel surcharges authorized by the Commission in July, 2005 will produce revenue of approximately $11 million by the end of the current fiscal year and $17.3 million in a full year. Because of the higher fuel prices, the deferral account balances at October 31, 2005 were $2.6 million higher than forecast in July, 2005. This amount is insufficient by itself to warrant another fuel surcharge at this time.

Forecast of Fuel Oil Prices for the Next Two Years

BC Ferries has retained an energy consulting firm, Purvin and Gertz Inc. (PGI) to provide forecasts for West Texas Intermediate (WTI) ,"Edmonton Par" and "Vancouver Rack" fuel oil prices for the next three years. These latter two are the prices used in BC Ferries fuel oil contracts and are more representative of the prices that BC Ferries will pay over the next three years than the WTI price used in the previous application. The PGI forecast provides a basis for an average price of US$67.70 for 2006, US$66.18 for 2007 and US$56.98 for 2008. These forecasts show a significant increase from the prices used in the first application for a fuel surcharge, which were US$50 (2006) and US$45 (2007). Part of the increase is the result of including a specific forecast for the Vancouver price, at which approximately 18% of BC Ferries fuel requirements are priced. The Vancouver price was not specifically forecast in the first application.

Chart 2
Oil Price Forecasts for Remainder of the First Performance Term
for West Texas Intermediate (WTI) Crude Oil in US$



The PGI forecasts are higher than the revised forecast of the bankers' syndicate, which shows increases of just under three dollars a barrel for fiscal year 2006, less than one dollar increase for fiscal 2007 and almost six dollars more for fiscal 2008. They are also considerably higher than

PGI's own forecasts made in April 2005. The contrasts between the forecasters' opinion for a common benchmark crude oil (WTI), and the changes in a given forecaster's opinion are illustrated in Chart 2 above.

Effect of the Forecast Fuel Oil Prices on the Deferral Accounts

As previously described, fuel costs above the adjusted budget price ("adjusted set price") are accumulated in the deferral account for each route group and revenue from the fuel surcharge reduces the deferral account balances, with the intention that the balances will be reduced to zero by March 31, 2008. The July 24, 2005 decision on the surcharge application would have caused the deferral accounts to decline to approximately $7 million by March 31, 2008 and this amount would have been taken into account, that is, recoverable, in the price caps set for the performance term commencing April 1, 2008.

Use of the PGI forecast for the remainder of the current performance term in the second application leads to large increases in the deferral account balances at the end of each fiscal year. At the March 31 year-ends, the forecast balances are now $22.2 million (2006), $32 million (2007) and $33.2 million (2008), up from $6.9 million (2008) in the previous forecast.

If There Has Been a Change in Expected Fuel Costs, is it Sufficient to Warrant an Increase in the Fuel Surcharge?

The deferral account forecast balances of $33.2 million at March 31, 2008 represent approximately 10% of BC Ferries' annual revenue from fares. If the fuel oil price forecast proves to be accurate, and no change is made in the fuel surcharge, recovering these balances through fare increases in the second performance term commencing April 1, 2008, would require a one-time fare increase of approximately 2.5% to be held in place for the four-year duration of that performance term. The required increases for the minor routes would be greater than this percentage and for the major routes smaller (as explained below).

Does The Projected Situation Meet The Requirements Of Section 42 Of The Act?

The new forecast of fuel prices shows that BC Ferries expects the price it pays for its marine diesel fuel to average some 20% more for the period from November 2005 to March 2008 than previously projected. If the actual fuel costs for this period are as projected in the second application, then the Commission concurs with BC Ferries position that this situation is extraordinary and the expected increase in fuel costs meets the requirements of Section 42 (2)(b).

Is BC Ferries' Calculation of the Required Extraordinary Price Cap Increases Reasonable?

BC Ferries has used the revised forecast of fuel costs and deferral account balances to calculate the required increases in the fuel surcharge in this second application. The proposed fare increases are expected to produce revenue of $27.9 million between February 1, 2006 and March 31, 2008. This revenue yield is slightly higher than the increase in fuel costs and, as a consequence, the deferral account balances are forecast to be reduced to $3.3 million at March 31, 2008 compared to $6.9 million after the first surcharge.

The Commission accepts that BC Ferries' calculations of the future balances in the deferral accounts are reasonable and based on the forecast price for fuel oil provided by the energy consulting firm PGI.

Commission Comments On The Application And Preliminary Decision

The application shows that actual and expected fuel costs will rise by 13% from the previous forecast for the full three years to March 31, 2008. This amounts to an increase of $26.3 million in the deferral account balances, which is to be offset, according to the application, by price cap increases (fares) that will generate $27.9 million. Of the fuel cost increase, only $2.6 million, or 10%, had actually been incurred at the date of the application; the remaining 90% increase results from the expectation of higher fuel oil prices over the remainder of the period.

The fuel oil price forecast is based on the projections of a highly reputable firm but the Commission notes that, in general, accurate forecasts of changes in fuel oil prices have been difficult to attain. Fuel oil price forecasts in November 2005 showed significant increases from forecasts prepared just six months earlier as illustrated in Chart 2 above. At this date, there are more uncertainties than usual, including: the effect of higher prices in the last two years on future demand; Canada/US exchange rate movements; the volatility shown in the Vancouver price over the last few months, and BC Ferries' need to negotiate a new fuel price contract starting in April 2006.

These factors suggest that a deferral of part of the requested increase is appropriate until the situation is more certain. Accordingly, the Commission has decided to take a two-step approach to the requested increases.

Effective February 1, 2006 the Commission authorizes increases of 1.5% for the major route group and of 3% for the other route groups. These increases are justified on the basis of fuel cost increases over the previous forecast that have occurred and are expected in the near future.

It is necessary to have a larger percentage increase for the other route groups because, for those route groups fare revenue covers, in general less than one-half of the operating costs with the remainder made up by service fees from the provincial government. Thus, a 2% increase in fares is required just to match a 1% increase in costs.

The second step will be taken, if necessary, in early June, 2006 and will authorize further increases as required. No further application is needed. The Commission will review the fuel cost experience and any change in the forecast for fuel oil prices to that point. At this date, it appears that, if the actual cost experience and forecast of fuel oil prices (for the period December 1 2005 through March 31 2008) declines by 6% or more from the levels projected in the second application by the end of May, 2006, a second increase will not be necessary. If the decline is less than 6%, the second step increase is scaled according to the Commission's determination of the departure from BC Ferries forecast as presented in its November 28 2005 application.

By deferring this second step, the Commission will not cause a major change in the recovery of the deferral account balances by the end of March 31, 2008. The deferment will reduce the recovery by $1.8 million through May, 2006 from the amount forecast in the application.

Fuel Conservation Measures

Fuel conservation is an important management strategy being undertaken by BC Ferries. The application provides a list of fuel efficiency measures, including replacing vessel engines, improving the management of fuel consumption and operating at slower speeds where possible. Past actions have reduced fuel consumption by 4.2% over the last four years. BC Ferries is projecting a further small reduction of 0.3% in fuel consumption in the current year and using this year's fuel consumption in its forecast of fuel costs for the following two years.

Beyond the actions taken by BC Ferries to date, and bearing in mind that BC Ferries is insulated from the impact of fuel prices by being able to pass most of the price increase through to its customers, the Commission wishes to assure itself that conservation actions are continued in a methodical and planned fashion. The Commission wishes to see a comprehensive plan by June 1, 2006, describing measures taken and promising measures planned with timeframes, quantified benefits in terms of reduced fuel consumption, with associated costs, risks and obstacles, the return on investment or effort, and appropriate rankings.

As a further incentive for BC Ferries, the Commission is basing the fuel costs on which the transfer to deferral accounts are calculated for the next two fiscal years on consumption decreases of 1% cumulatively for each year. The effect of this measure is that ferry passengers will not be required to pay for any fuel costs that result from a failure to meet these targets. Fuel consumption above the target levels will be entirely for BC Ferries' operating expenses and not recoverable through surcharges. The base for the fuel consumption target in volume will be the actual consumption for fiscal 2006. In order to avoid penalizing BC Ferries for operating additional sailings, if they are required, the target will be adjusted to reflect increases or decreases in the number of sailings by route.

As one of the fuel conservation measures, the Commission encourages BC Ferries to continue exploring with its contracting partner, the Province of British Columbia, the merits of adjusting core service patterns, including capacities and schedules to pace vessels for reduced fuel consumption on individual routes, where feasible and judged desirable considering the service impact on customers.

After careful consideration the Commission decided not to require BC Ferries to absorb the additional fuel costs through an increase in its operating costs, thereby leading to a reduction in net income from its operations. In arriving at this decision the Commission took into account the following matters:

- the Commission's order on the first application required BC Ferries to absorb a portion of the increased costs
- all the net income is reinvested in capital requirements of the ferry fleet and infrastructure, which will require large amounts of capital investment in the coming years
- the application meets the requirements of Sec. 42 of the Act that an extraordinary situation exists respecting fuel costs and the condition for a price cap increase has been met.

Safeguards Against Over-Recovery

The Commission's decision to use a two-step process for dealing with the increased fuel costs, with the first surcharge increase to take place on February 1, 2006 with a possible second increase at the beginning of June 2006 after review of available information on actual and projected costs reduces the chance of imposing an unnecessary increase in fares.

In the event that actual and forecast fuel prices decline between now and March 31, 2008 such that all or a portion of the two surcharges are not required, the surcharges will be reduced or eliminated. By recording the surcharge separately on the fare ticket a record of the cumulative revenue is maintained and credited to the deferral accounts in which the increased costs are collected. This process allows the unrecovered balance to be examined on a monthly basis.

Public Comment

The public is being given an opportunity to comment on BC Ferries application until January 8, 2006. The Commission's final decision will include a summary of those comments with responses.

Summary Of Decisions

In response to BC Ferries application dated November 28, 2005 for a second fuel surcharge, the preliminary decisions of the Commission are:

- increases of 1.5% for the major route group and of 3% for the other route groups are authorized, effective February 1, 2006;
- any second-step increases will be decided shortly after May 31, 2006 when the Commission has reviewed the actual experience to that date and any new forecast information;
- such second-step increases would be scaled so that, if actual and forecast (as of May 2006) fuel prices were equal to BC Ferries forecast (as of November 28 2005) they would be 1% for the major route group and 3% for the other route groups; but if actual and forecast prices were 6% below BCFS forecast, the second step increase would be zero;
- BC Ferries is required to absorb into operating costs all fuel costs for fiscal 2007 and 2008 that result from fuel consumption volumes greater than target levels set at 1% and 2% respectively below the actual fuel volume consumed in fiscal 2006; and
- BC Ferries is requested to provide by June 1, 2006 a plan showing conservation measures taken and planned, the potential saving in fuel volumes and costs, and the return on investment of such measures.

Those measures authorized by Order 05-02, dated July 24, 2005, and not altered by this Order, remain in effect.