British Columbia Ferry Commission

BRITISH COLUMBIA FERRY COMMISSION

ORDER
NUMBER: 05-02

P.O. Box 1497, Comox, B.C. V9M 8A2
Telephone (250) 339 2714

http://www.bcferrycommission.com
info@bcferrycommission.com

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 Oil Prices and Costs

BEFORE: Martin Crilly, Commissioner

PRELIMINARY DECISION

WHEREAS:

A. British Columbia Ferry Services Inc. ("BC Ferries") has, by a submission filed June 13, 2005, applied for an increase in the price cap (weighted average fare) applicable to six of the seven route groups through which it operates the ferry routes designated in the Coastal Ferry Services Contract (the "Contract") between BC Ferries and the Province of British Columbia.

B. BC Ferries has experienced significantly higher prices for fuel oil than expected when the Contract came into force and has made reference to forecasts showing that higher fuel oil costs will continue for some time. These higher costs, or a portion thereof meet the requirements to be termed an extraordinary increase under Sec. 42 (2) (b) of the Act.

C. By Order 04-02 dated September 28, 2004, the Commissioner authorized ferry operators to establish Deferral Accounts (the "Accounts") in order to diminish the volatility of fuel oil costs through the collection in the Accounts of variances between budgeted and actual fuel oil costs, with the balances in the Accounts, if any, to be recovered through adjustments to price caps in the term commencing April 1, 2008.

D. The current balances in the Accounts and the expected balances to the end of fiscal year 2007/8 ("fiscal 2008") exceed the expectations when the Accounts were established.

E. It is desirable that the recovery of the deferred costs represented by the balances in the Accounts should commence promptly, 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.

F. It is reasonable that there be a sharing of forecast risk regarding fuel prices between ferry customers and BC Ferries; the burden of increased fuel costs should be shared by ferry customers and BC Ferries in a way that is seen to be equitable and enables the increased costs to be recovered, if possible, between the present date and the end of fiscal 2008.

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

1. The price cap applicable to route groups one through six is increased effective July 24, 2005 or as soon thereafter as practicable, as follows:
   (a) **by four per cent for the major route group** - the three routes comprising the Vancouver Island to Lower Mainland routes in group number one, and
   (b) **by six per cent for the remaining route groups** (called the "minor routes" hereafter) numbered two through six.
2. The price for fuel **charged to BC Ferries operations (the "set price") shall increase by five per cent** on July 24, 2005 thereby increasing fuel costs charged to operations by the same percentage for the balance of the current fiscal year and for the two succeeding years. This will reduce the projected amount added to the Deferral Account balance for those years by an amount equal to the increase in the fuel operating costs.
3. The fuel surcharge to ferry customers shall, as long as it remains in effect, **be shown on the fare ticket** and the amount collected shall be used to reduce the balances of the Deferral Accounts for the respective route groups.
4. The Deferral Accounts shall continue to be operated in all other respects in accordance with Order 04-02.
5. The fuel surcharge shall be reduced or eliminated as and when the balances in the Deferral Accounts are eliminated and fuel oil prices have declined to a level within the adjusted set price**. It shall cease no later than March 31 2008**. The reductions or eliminations of the fuel cost surcharge shall be carried out separately for route group one (the majors) and for all other route groups together.
6. If the Province proposes to make adjustments to the service fees it pays to BC Ferries for operating the minor routes, those adjustments will be taken into account in the final decision made in respect of the Application.
7. The Commissioner acknowledges that BC Ferries intends to undertake a fuel cost hedging program and, without approving a specific level of hedging, agrees that gains or losses from hedging should be credited or charged to the Deferral Accounts.
8. The increase in the route group price caps authorized by this Order shall be excluded from inclusion in the price cap indexes for purposes of calculating future annual statutory increases in the price cap indexes.
9. The Commissioner encourages BC Ferries to take all reasonable fuel saving measures, including discussing with the Province alterations to the route schedules set out in the Contract.

This preliminary decision is provided to the Province and BC Ferries for their joint consideration. Under Section 5 of the Coastal Ferry Services Contract the parties have 20 days to advise the Commissioner of any changes to the service fees, after which time the Commissioner will issue a final decision in accordance with the terms of Section 42 (6) of the Act.

A detailed Review of the Application and Reasons for this Preliminary Decision are attached in Schedule A.

Dated in Comox, in the Province of British Columbia, this 24th day of June, 2005.

BY ORDER

Martin Crilly
British Columbia Ferries Commissioner

SCHEDULE A
REVIEW OF APPLICATION AND REASONS FOR PRELIMINARY DECISION

Background

On June 13, 2005 BC Ferries filed an 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 with the exception of 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.

The Application provided a forecast of the expected growth in the Deferral Accounts (described below) through to March 31, 2008 and **requested approval from the Commissioner for increases of 8 per cent in the price cap for route group one (the "majors") and of 13 per cent for the price caps applicable to the other five route groups**. The increases were requested to take effect as soon as possible with July 1, 2005 as the target date.

This review addresses the questions raised by the Application:

- Does an extraordinary situation exist?
- Does the situation meet the conditions of Section 42?
- Is BC Ferries calculation of the required extraordinary price cap increases reasonable?

Does an Extraordinary Situation Exist?

Under the Act ferry operators are **authorized to increase fares each November 1** in accordance with statutory increases in the price cap applicable to the route groups. For route group 1 (the three routes between Vancouver Island and the Lower Mainland) the increase is 2.8% annually and for the other route groups 4.4%. The price cap is measured by an index of the average weighted fare for each of the route groups and compared on a quarterly basis against the maximum allowed for that route group.

In addition to the allowable annual increase in the price caps, ferry operators may apply to the Commissioner for an **extraordinary price cap increase** in an extraordinary situation. In the Application under review BC Ferries state that such a situation exists due to an extraordinary increase in the price of fuel, which is one of the circumstances in which the Commissioner may authorize an increase in price caps under Section 42(2)(b).

BC Ferries, in establishing its budget for 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. In September 2004 BC Ferries proposed, and the Commissioner approved, the establishment of **Deferral Accounts** 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 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 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.

In the current year world energy prices have increased further, and were 35% higher in the first quarter of 2005 than in the corresponding quarter of 2004. In the Application BC Ferries has provided a forecast of energy prices for the balance of the current fiscal year and for the following two years to the end of fiscal 2008. The forecast for world oil prices that BC Ferries has provided is the forecast average price of the economic groups of major Canadian banks and shows a **forecast of US$55 a barrel for 2005, with declines to $50 and $45 for subsequent years**. BC Ferries has based its forecast of the balances in the Deferral Accounts on these prices and has projected the balances in the Deferral Accounts to reach $53.9 million by the end of fiscal 2008 without further action. Total annual fuel costs are now projected to reach $72 million by the end of fiscal 2006 compared to a budget of $50 million.

Does the Situation Meet the Requirements of Section 42 of the Act?

The Commission:

- makes no forecast of energy prices but accepts that **BC Ferries has relied on a reasonable forecast** provided by major Canadian banks in its projections of fuel prices and costs to the end of fiscal 2008.

- agrees that, in view of the major increase in fuel oil costs, **the situation is extraordinary** and the **increase in fuel oil costs has an extraordinary component** that meets the requirements of Section 42 (2)(b).

- accepts that BC Ferries **forecast for the future balances in the Deferral Accounts are reasonable** and in accordance with the banks' forecasts of oil prices.

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

BC Ferries has proposed fare increases (fuel surcharges) that would require increases for the major routes (route group 1) and all other routes (route groups two to six) separately. The major routes are self-supporting and receive no provincial service fees whereas all other routes recover, in total, less than one-half of their operating costs through fare revenue and, consequently, the fuel surcharge, as a percentage of fares, is required to be higher. Fuel prices are also generally higher for the minor routes than for route group 1 due to several factors, including delivery charges and local conditions.

BC Ferries' application proposes fare increases that would produce revenue of $25 million in the current year (July1, 2005 to March 31, 2006), with $16 million on route group 1 and the balance of $9 million on the other route groups. This amount would cover the expected increase in the Deferral Accounts this fiscal year of $21.5 million and reduce the balances in the Deferral Accounts to approximately $4.5 million by March 31, 2006 from $8 million at March 31, 2005.

On the above basis **BC Ferries' calculation of the required increases are 8% for the major routes and 13% for all other routes**. The increases would apply to all passenger and vehicle traffic, with the same fixed amount of increase applying to adults, children and passengers with pre-paid tickets. The increases would vary by route. BC Ferries intention in calculating the surcharges is to eliminate the balances in the Deferral Accounts and meet the forecast higher costs of fuel until the end of fiscal 2008.

Based on BC Ferries forecast of Deferral Account balances, the projected recovery of $25 million in fiscal 2005 (surcharge in place for three-quarters of the revenue year) and $30 million in each of the two subsequent years would exceed the amount required to eliminate the Deferral Account balance by more than $30 million. (Implementation later than July 1, 2005 would reduce the amount recovered by about $2 million). The reasons for this over-recovery are not stated but probably relate to uncertainty over future oil price – they may prove to be higher than in the forecast used by BC Ferries – and BC Ferries aim to avoid applying for another price cap increase in that event. Although the Commission understands the reason for this approach, it prefers that the price cap increases should be in line with the forecast of oil prices and Deferral Account balances presented in the Application.

The Application treats as "extraordinary" all of the fuel price increase over the budget price. Even under normal circumstances it could be expected that there would be some "ordinary" variance between the budget price for oil and the actual price paid.
If changes in fuel prices are allowed full pass through to ferry customers, then the BC Ferries loses the incentive to use fuels more efficiently. An increase in the price of fuel is the means by which a market economy signals the need for greater efficiency. The intent of price cap regulation has been to allow market price signals to operate as much as possible on regulated firms, while preventing exploitative returns. Thus, a regulatory

policy which would remove any incentive for efficiency on the part of BC Ferries would seem to be counter to the purpose of price cap regulation.

At the same time, price cap regulation is intended to preserve incentives for efficiencies by allowing BC Ferries to retain all productivity gains during the period between price cap reviews. This would suggest that the price-cap-regulated BC Ferries should not be required to share any productivity gains it has achieved prior to the price cap review.

A way to resolve this seeming paradox is to allow only a partial pass through of the fuel price increase. This approach would preserve incentives to become more efficient in the use and choice of fuel. It results in a sharing of forecast risk regarding fuel prices by both the ferry customers and BC Ferries.

The issue then arises as to exactly how much of the fuel price increase should be passed through. One approach to this is to recognize that some fuel price increases would be considered to be ordinary (rather than extraordinary) and only the amount of increase in fuel prices above the ordinary/extraordinary threshold should be allowed. This requires the Commission's judgment as to what degree of risk sharing is appropriate. The Commission has to balance incentives for fuel efficiency, with the requirements of the BC Coastal Ferry Act that priority is to be placed on the financial sustainability of ferry operators.

Preliminary Decisions

Before making this preliminary decision the Commission considered comments from the public in some 70 letters and phone calls received since June 10th 2005. It will continue to receive and consider comments until July 18th 2005 before finalizing the decision.

In the Commission's view **it is reasonable for BC Ferries to absorb a portion of the increased costs into its operations statement as an "ordinary" increase**. These are difficult times for transportation companies but the company cannot expect to pass along to its customers its entire increase in fuel costs. The Commission has decided that this portion should equal a 5% variance above the originally expected level of fuel prices as defined by the set price in Commission Order 04-02 of 28th September 2004 which authorized the establishment of deferral accounts.

The Commission's view is that it is reasonable to recover the forecast balances of the Deferral Accounts over the remainder of the current performance term, which ends March 31, 2008. On this basis the required increases are calculated at 4% for the major routes (route group 1) and at 6% for the other route groups.

The Commission's calculations of the amounts raised through the above measures are:

- increase of 5% in budgeted fuel costs charged to operations effective July 24, 2005 is forecast to amount to $1.8 million for fiscal 2006, $2.6 million for fiscal 2007 and $2.6 million for fiscal 2008. These amounts total $7.0 million and will reduce the forecast amount required from fuel surcharges to less than $50 million by March 31, 2008.

- a fuel surcharge of 4% on the major routes is estimated to raise $31 million to the end of the first performance term,
- a fuel surcharge of 6% on all other routes (route groups 2 to 6) is estimated to raise $17 million to the end of the first performance term.

On this basis the Deferral Account balances are forecast to rise slightly by March 31 2006 before declining to zero by March 31 2008.

The Commission notes that **price caps will see their regular increase November 1 2005** under the Coastal Ferry Act and expects that BC Ferries will make immediate use of this statutory increase by raising its fares.

Risks

The Commission fully recognizes that its preliminary decision assumes that fuel prices through March 31, 2008 are close to the forecast relied upon by BC Ferries. If fuel prices are significantly higher than this major bank forecast it will likely be necessary to examine the case for a further fuel surcharge.

The **forecasts of revenue depend on customer acceptance of the surcharges** as necessary in a period of high fuel prices. Reductions in passengers carried could have a significant impact on the revenue forecast and BC Ferries profitability.

One of the statutory principles that the Commission must follow in its regulation of ferry operators is to place…"priority….on the financial sustainability of the ferry operators" (Sec. 38 (1)(a) of the Act). The Commission recognizes that **its decision to require BC Ferries to absorb a portion of the higher fuel costs will have some effect on BC Ferries profitability** but notes that the proposed **transfer to operating costs of a portion of the increased fuel costs amounts to less than 1% of BC Ferries annual costs** and should not have an appreciable effect on its financial position. Although the company has recorded good results in its first two years of operation with a consequent strengthening of its balance sheet, it has major requirements for capital expenditure in future years which will require all of its cash flow as well as substantial borrowings. This decision should have a minimal effect on the company's finances.

Fuel Cost Hedging Strategy

BC Ferries has informed the Commissioner that it intends to undertake a fuel cost hedging strategy and advises that its proposed fuel hedging program will, by averaging in on a monthly basis, have a range of between 30% and 90% of its fuel requirements with a target of 70%. Gains or losses from hedging will continue to be charged to the Deferral Accounts. BC Ferries has requested the Commissioner to review the hedging program and acknowledge that the strategy is appropriate. The Commission has no expertise or policy requirements with respect to hedging but acknowledges that hedging is appropriate and accepts that gains or losses from hedging should be charged to the Deferral Accounts.