British Columbia Ferry Commission

June 19, 2006

BACKGROUND TO ORDER 06-03
QUESTIONS AND ANSWERS
on Fuel Prices and Fuel Surcharges

This background paper addresses the following questions:

1. BC Ferries earned $50 million last year: why not just require the company to absorb the extra fuel cost?

2. Has BC Ferries been required to look at revenues and potential savings in other areas of its operation to absorb all or part of increased fuel costs?

3. What is the history of ferry fares, oil prices, and fuel surcharges?

4. What is the current fuel price outlook?

5. What are deferral accounts?

6. What is the future of the deferral accounts?

7. Why do the major routes face lower percentage surcharges?

8. Why are some taxpayer supported routes being treated differently from others?

9. What prevents over-recovery of fuel costs by BC ferries?

10. Northern routes have experienced reduced service: shouldn't they receive lower not higher fares?

11. What consideration has been given to potential decreases in ferry use resulting from fare increases?

12. Shouldn't ferry fares and surcharges be set so as to minimize impacts on the costs of goods and services delivered to the islands?

13. Can the public apply for removal of the surcharges?

14. How can be people be heard and have assurance that the impacts on communities are being considered?

1. BC Ferries earned $50 million last year: why not just require the company to absorb the extra fuel cost?

The Commission does have the authority to deny fuel surcharges to BC Ferries and to require the company to absorb all fuel costs but such an action would violate important principles and compromise the long-term health of the ferry service, as follows.

- Under the Coastal Ferry Act (the Act) the Commission regulates BC Ferries' performance over four year terms, on a set timetable. For each term, BC Ferries knows in advance what ferry services must be delivered and the permitted fare levels. There are less than two years left in the current term. If the Commission were to require the company to pay extraordinarily high fuel costs without relief, the company's earnings would, in effect, be confiscated mid-term. This would reduce BC Ferries' accountability for its own performance, create uncertainty in the expected earnings and lessen its incentive to improve cost-effectiveness and productivity in future. This is not in the long term interest of the ferry system or ferry users.

- Current fuel prices were not anticipated when the fare levels were set at the start of the current term. The increases in fuel costs, actual and expected in the rest of this term through March 2008, exceed any ordinary variation that prudent management can be expected to cope with under the original fare levels. They are extraordinary, with the cost now projected at over $95 million for the whole performance term, and outside BC Ferries control. Without relief through fuel surcharges—similar to those imposed by other transportation companies—BC Ferries will be less able to fund needed fleet renewals, as both retained earnings and allowable borrowings will be lower. Again, this is not in the long term interest of ferry service.

- At the end of the current term, in a review of permitted fare levels (a price cap review), the Commission will adjust BC Ferries allowable fare levels (incorporating fuel surcharges) after considering all the costs (including fuel), for the following term. At that time ferry customers will receive the benefits of productivity gains achieved in the current term and from the Commission's target for future cost-efficiencies. Limiting uncertainties through a consistent regulatory regime, and maintaining incentives, are key to realizing those gains.

2. Has BC Ferries been required to look at revenues and potential savings in other areas of its operation to absorb all or part of increased fuel costs?

Yes: the Commission made two rulings requiring BC Ferries to absorb part of the increased fuel cost.

- First, BC Ferries is absorbing part of the increase in fuel prices, as "ordinary" and without compensation, as a normal part of doing business.

The Commission's ruling for the July 2005 fuel surcharge determined that a one-time 5% increase in the price of fuel (above general inflation, and relative to a fuel price expected at the start of the current performance term in 2003) to be an "ordinary" increase for BC Ferries to absorb. This will reduce BC Ferries retained earnings for the first performance term (through March 2008) by some $7 to $8 million below what it would otherwise have been. The rest of the increase in the price of fuel was recognized as "extraordinary" as defined in the Act. This additional fuel cost is tracked through a "deferral account" (explained below) and if not recovered through a fuel surcharge, it is eventually recoverable through fares (and/or higher service fees at the discretion of the province).

- Second, to encourage fuel efficiency, the Commission gave BC Ferries a target volume for fuel used each year, with the extra cost of any fuel used in excess of the target volume being uncompensated by fuel surcharges.

BC Ferries has undertaken fuel efficiency measures, including replacing vessel engines, and operating at slower speeds where possible. The company has reduced fuel consumption by 4.2% over the last four years.

In addition recognizing that the company 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 be assured that fuel conservation efforts continue in a methodical and planned manner.

For the last two remaining years of the current performance term, the Commission expects the company to reduce the volume of fuel burned by 1% per cent cumulatively for each year from the volume in FY 05/06. The cost of fuel used above these targets will not be added to the backlog of fuel costs (in the deferral accounts described below) but must be charged to BC Ferries' operating costs. This means ferry customers will not pay for any fuel costs that result from a failure to meet these targets because above-target fuel consumption levels will be entirely for BC Ferries' operating expenses and not recoverable through surcharges. There will be adjustments to avoid penalizing BC Ferries for operating additional sailings, or benefiting from reduced sailings (e.g. in the north).

In January 2006 the Commission asked for a comprehensive plan by June 15, 2006, describing measures taken and 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. This plan is published on the Commission website.

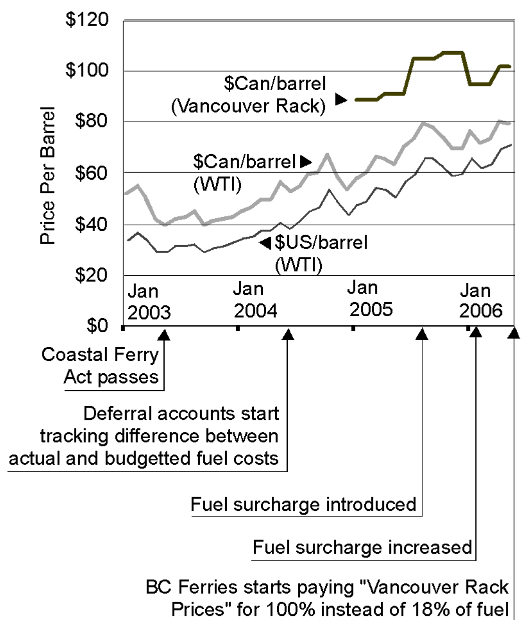
As one of the fuel conservation measures, the Commission encourages BC Ferries to continue exploring with the Province as its contracting partner, the merits of adjusting core service patterns, including capacities and schedules to enable vessels to achieve reduced fuel consumption on individual routes,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

3. What is the recent experience of oil prices, ferry fares, and fuel surcharges?

The Coastal Ferry Act of 2003 fixed initial fare levels, that is, maximum average fares, to be equal to the average of the fares payable as at April, 2003. The Act increases caps by 2.8% for the major route group and 4.4% for the other route groups every year through BC Ferries' first performance term, which is the five years ending March 2008.

When initial price caps were set, the fuel prices included in BC Ferries' budget were based on crude oil at about US$30 per barrel (then C$40), as measured by the benchmark West Texas Intermediate (WTI) crude oil price, with a stable outlook.

History of Crude Oil Prices



Unfortunately, in the first year of the performance term, fuel prices, both current and forecast, started to rise rapidly and BC Ferries applied to the Commission for fuel surcharges. The Commission ruled in July 2005 and again in January 2006 that the situation was extraordinary within the meaning of the Act's section 42, warranting price cap increases.

On March 31 2006 BC Ferries' long-term contract at "Edmonton Par" prices, which have been at a level similar to the WTI benchmark prices illustrated above, ended. It could not be renewed. Instead, the company had to pay "Vancouver Rack" prices for all its fuel, which are typically more than 20% higher than the "Edmonton Par" prices. Consequently, BC Ferries experienced another major increase in fuel costs.

In its January 2006 ruling the Commission considered the future of fuel prices to be particularly uncertain and said the actual experience and outlook (for the 28 month period from December 1, 2005 to March 31, 2008, i.e. the end of the first performance term) would be reviewed in May or June 2006. The Commission specified a formula linking the size of a possible third fuel surcharge in June, 2006 to an updated fuel price outlook. The fuel surcharge, as a percentage of the November 2006 fare base, was to be:

(a) for the major route group: **one per cent multiplied by a factor Y, and**

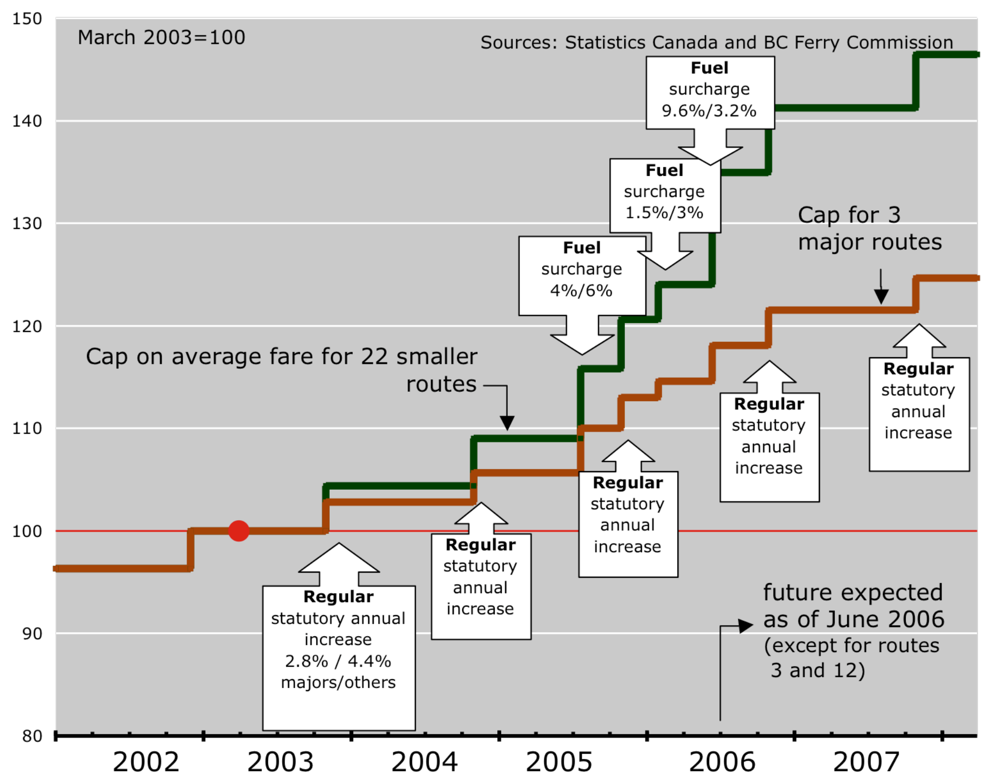
(b) for the other route groups: **three per cent multiplied by a factor Y;**

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

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.

The chart below illustrates the resulting escalation of fare caps resulting from the combination of statutory and extraordinary fuel surcharge increases, for the major routes and other route groups.

BC Ferries fare cap escalation
for 3 major routes and 22 other smaller routes



4. What is the current fuel price outlook?

In its November, 2005 application BC Ferries provided price forecasts made by Purvin and Gertz Inc. (PGI), an energy consulting firm, for three types of crude oil—West Texas Intermediate (WTI), "Edmonton Par" and "Vancouver Rack" for the next three years.

The latter two types were the prices used in BC Ferries fuel oil contracts. They were more representative of the prices that BC Ferries could have expected to pay over the next two years than the WTI price used in its first fuel surcharge application.

Until March 31 2006, BC Ferries obtained some 82% of its fuel requirements at "Edmonton Par" and 18% at "Vancouver Rack" prices. As mentioned above, BC Ferries' long-term contract at "Edmonton Par" prices then ended and could not be renewed. The company had to pay "Vancouver Rack" prices for all its fuel, typically more than 20% higher than the "Edmonton Par" prices..

The PGI forecast made in April 2006 shows an increase of less than 10% annually for "Edmonton Par" prices in $US over the next two years; but given the "Vancouver Rack" price, and adjusting for the lower exchange value of the U.S. dollar, the average price (weighted by consumption, quarterly) in C$/litre for the 28 months between December 1, 2005 and March 31, 2008 shows an increase of approximately 13% over the average forecast price used in the Commission's January, 2006 ruling; the additional cost for fuel in the two years to March 31, 2008 shows an increase of over $25 million.

Applying the value of 13 for the factor X in the above formula results in an increase of 3.2% for the major routes and 9.6% for the other route groups.

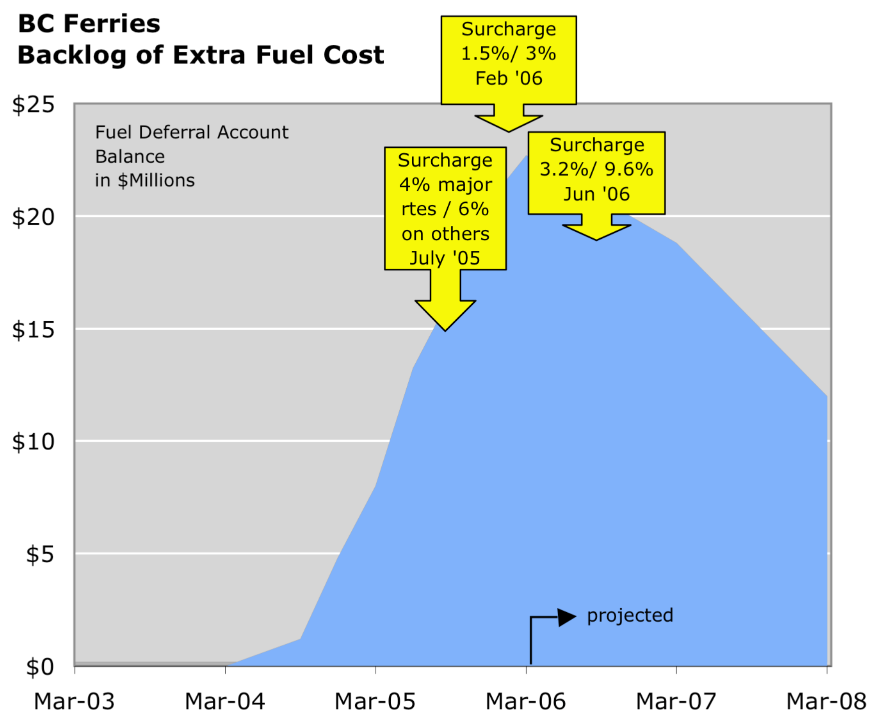
The fuel oil price forecast is based on the projections of a highly reputable firm but the Commission notes that, in general, accurate forecasts of changes in fuel oil prices have been difficult to attain. Much uncertainty remains, including the effect of recent higher prices on future demand, Canada/US exchange rate movements and the volatility shown in the Vancouver Rack price over the last few months.

5. What are fuel cost deferral accounts?

A deferral account tracks the extraordinary fuel cost for which BC Ferries has not been compensated through fuel surcharges.

Starting in fiscal 2005, the Commission allowed BC Ferries to collect its above-budget fuel costs, net of the revenue from fuel surcharges which are applied against the balance, plus an interest charge, in a *fuel cost deferral account*. Each route group has its own account. The portion of fuel costs put into the accounts are not recognized as immediate expenses, and are earmarked for future recovery. The policy is to levy such fuel surcharges as are required to reduce the balances to approximately zero by the end of fiscal 2008, i.e. the end of the first performance term. Any balances remaining will be eligible to be recovered through higher 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. The company was assured that any remaining deferred costs would be recovered through price cap adjustments (fares) in a later time period.



6. *What is the future of the deferral accounts?*

Without any fuel surcharges at all in this performance term, the deferral accounts would accumulate to over $95 million in the three years up to March 31, 2008 (excluding any interest charges). For comparison, BC Ferries' annual fare revenues for FY 2006 (without fuel surcharges) were $354 million.

Because the funds raised from fuel surcharges reduce the deferral account balances, the balances will never reach $95 million. But to date fuel surcharges have lagged the growth of fuel costs in the deferral accounts caused by higher fuel prices.. The deferral accounts' total balance grew from $8 million at March 31, 2005 to $23 million one year later.

The new fuel price outlook is expected to increase the amounts transferred to the deferral accounts by some $27 million more than the forecast used in January, 2006. The revenue from the authorized increases in fuel surcharges will raise approximately $32 million, if put into effect July 1, 2006, reducing the net balances in the deferral accounts to approximately $12 million at March 31, 2008.

7. Why do the major routes see lower percentage surcharges?

As previously illustrated fares have risen because of (a) statutory annual increases and (b) fuel surcharges. Increases are lower for the major route group.

For other route groups, fares cover only a part of the cost of operating the route. For these the average route is roughly 1/3rd user-pay (though they range widely from under 20% user pay to over 70%). So if the cost of operating the route increases 10%, *and if all that extra cost has to be borne by ferry customers*, fares would have to go up by 30%.

- If the route had been 100% user-pay, the fare increase would be the same as the cost increase (i.e. 10%). This is the case for the major routes. This relationship between the full costs and customer revenue is the main reason for the majors having lower percentage increases.

- Note the dollar fare increase can be the same for the two types of route, but the percentage fare increase is higher because it is calculated on a smaller base.

- Another factor is that the price of fuel delivered to the ship is higher for the smaller routes (8% higher than for the major routes on average in FY 2005).

8. Why are some taxpayer supported routes being treated differently from others?

The impact of fuel price on the cost of operating the route varies by route, depending on the fuel usage, linked to route distance. The northern routes, being much longer, have higher fuel usage. The provincial taxpayer funding via service fees was initially set to meet the expected shortfall by route between BC Ferries costs and the revenue generated by the route, but the differential effect of higher fuel prices on each route is now revealed in the different deferral account balances, with different trends, for each route group.

In previous rulings the Commission calculated fuel surcharges separately for the major route group and for all other routes together, for the purpose of matching the increased fuel costs. It is now expected that some individual route groups such as route 3 (Langdale to Horseshoe Bay) and route 12 (Brentwood Bay to Mill Bay) will show significant over-recoveries by the end of this performance term in March 2008. Others, notably the northern route group, are expected to show large deficits (costs in excess of fuel surcharge revenues) at that date. The unknown fuel usage of a possible replacement for the Queen of the North adds to the uncertainty over the deferral account balance.

In these circumstances the Commission has decided, for purposes of reducing or eliminating the fuel surcharges, to treat each route group separately.

9. What prevents over-recovery of fuel costs by BC Ferries?

Fuel surcharges and BC Ferries' extra fuel costs are tracked through a deferral account, the balance of which represents the backlog of extra fuel costs for which BC Ferries is to be compensated.

The fuel surcharge is authorized until March 2008, and is calculated to reduce the accumulated backlog of extra fuel costs to approximately $12 million by that date, based on fuel price projections.

If fuel prices are lower than expected and the deferral account is paid off earlier than expected, the fuel surcharges, or a portion of them, will be removed before March 2008.

10. Northern routes have experienced reduced service: shouldn't they see lower not higher fares?

The northern routes are fuel-intensive and receive substantial service fees; this means the ratio of fuel costs to fare revenues is high (relative to other routes). Therefore, when fuel costs rise, a high percentage fuel surcharge (compared to other route groups) is needed to cover them.

Since BC Ferries has not yet been able to replace its vessel the Queen of the North which sank on March 22, 2006, the two routes in the northern route group (Port Hardy-Prince Rupert and Prince Rupert-Skidegate) have seen reduced service, and reduced traffic carried. This also means less fuel burned.

How and when the contracted level of service will be restored is not clear at the time Order 06-03 is issued. Neither is it clear how the service will be paid for. How these matters unfold depends partly upon future discussions between the Province and BC Ferries on the interpretation of their service contract, notably on whether an "Event of Force Majeure" exists, relieving the parties of the contractual obligations, and whether they choose to renegotiate elements of their contract. Further, there are other rulings, not related to fuel surcharges, which the Commission has been asked, or expects to be asked, to make concerning northern service.

This Order 06-03 is limited to fuel price matters and does not attempt to address wider issues on the quantity and quality of service and the fare levels (before fuel surcharges) in the north.

When the Queen of the North sank, the fuel deferral account for the northern route group stood at $3 million, i.e. BC Ferries' backlog of already-incurred but not yet compensated accumulated extraordinary fuel cost on the two northern routes. Because of the cost and revenue characteristics of the routes, even without the sinking, the fuel surcharge allowed in this Order 06-03 (9.6%) would not have reduced the backlog.

Unfortunately, due to reduced service, an unexpectedly low traffic base is available to recover the backlog. If the smaller traffic base was required to recover the backlog, the percentage fuel surcharge would be need to be much higher than the 9.6% resulting from the formula specified on January 20, 2006, before the sinking. The Commission has decided it is unreasonable to require this.

Given the uncertainties of the northern service and, therefore, in fuel cost and recovery, it has been decided to hold the fuel surcharge at the level resulting from the formula, which is expected to result in a significant deferral of fuel cost into the second performance term starting April 1,2008. This deferred cost will be recoverable through fares or service fees in that term, or both.

11. What consideration has been given to potential decreases in ferry use resulting from fare increases?

The fuel surcharge rates take no account of the possibility that fewer people will travel because of higher fares, reducing BC Ferries' revenues.

12. Shouldn't ferry fares and surcharges be set so as to minimize impacts on the costs of goods and services delivered to the islands?

Under price cap regulation BC Ferries has the freedom to structure the tariffs for different classes of traffic so that the weighted average fare is within the price cap. The Commission has not given direction to BC Ferries on this matter.

BC Ferries has used its freedom to make adjustments in its tariff, of one fare relative to another so that average stays within the cap which the Commission enforces. Because of this, and the seasonal variations overlaying fares and revenues, there are individual items—like the prepaid tickets used by most island residents—which BC Ferries has increased faster than the average fare. Where this is the case, there are other fares in the tariff which BC Ferries has increased more slowly, to keep the average within the cap, such as for single-purchase travel for passengers, cars and trucks used for goods and services.

13. Can the public apply for removal of the surcharges?

There is no appeal mechanism in the Coastal Ferry Act. If the provincial government decides to increase public funding to the ferry system, then the Commission would lower the price cap, causing a fare reduction, as provided for in the Act.

14. How can be people be heard and have assurance that the impacts on communities are being considered?

The decision making framework for the regulated ferry system can be condensed as follows:

The **PROVINCIAL GOVERNMENT** decides….	The **FERRY COMMISSION** decides….
(A) • **what communities** will get government-supported ferry service (by designating routes), and • **how much service** (by defining core service on them);	(B) • the **(preliminary) level of ferry fare caps** that BC Ferries reasonably requires to operate the services defined by the government
(C) • **how much public money** to inject in order to "buy down" the Commission's preliminary fares to a level it considers in the public interest, i.e. the degree of user-pay.	(D) • the **(final) fare cap level** to reflect the government's commitment of public money. *The Commission also*: • **monitors** BC Ferries to ensure they do not overcharge or compromise service quality • **provides incentives** for BC Ferries to be efficient in delivering service.

The Commission cannot speak for the government's decisions, i.e. (A) and (C) above and any associated public processes. For its own decisions (B) and (D), the Commission's task is essentially a technical one. It is open to public comments, ideas and questions and aims to explain its decisions clearly.

BC Ferry Commission
June 19, 2006