

OMINOUS CLOUDS

prepared for

the

Ministry of Transportation and Infrastructure

by the

Ferry Advisory Committee Chairs

November 17, 2010

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PRIMARY ISSUE: Ominous clouds on the PT3 horizon

There is acute concern regarding the impact of high fares - past, present and *future* - on our communities, on the people and businesses that make up those communities and on other British Columbians seeking affordable access to our magnificent coastal village. There is also concern about service adjustments that may be implemented without a clear understanding of possible negative consequences for users or coastal communities.

A. FARES: Increases well above inflation

Minor and Northern fares have increased, on average, about 60% since 2003 and will be up about 80% by Mar 2012. (*Att.1 - Fare History, PT1 and PT2*). In fact, fares have increased more than 100% on some routes over the past seven years. Meanwhile, the Consumer Price Index has increased 10.7% from 2003 to 2009 (*Att.2 – CPI Increase*). The fares with the highest increases are the types of fares used mostly by the residents of ferry-dependent communities. The PT3 submission suggests continuation of the trend of steep fare increases which will produce even higher fares.

B. TRAFFIC: Traffic is dropping

The PT3 submission (p. 24) refers to stable traffic levels, citing total system data. In fact minor route traffic has been in steady decline while major route traffic was increasing until recently. The North/Central Coast traffic did not recover after the sinking of the Queen of the North. It has been falling precipitously for the past two years and will drop even more this year. Traffic across the system is on a downward trend, and has been since 2007/08. (*Att.3 - Traffic History by Route Groups*).

C. PRICE ELASTICITY: Fares go up, traffic goes down

Several factors affect traffic. These include, but are not limited to, population growth, changing demographics, health issues (SARS, H1N1), value of the Canadian dollar, border barriers to tourism, weather, fare levels and global financial instability. Traffic will respond to these depending on the magnitude and rate of change of any of them. We believe strongly that the dominant factor, particularly on the non-major routes, has been the level of fare increases, including fuel surcharges, since 2004.

Three indicators support this view:

1. Since 2003, the minor routes have experienced substantially higher fare increases and fuel surcharges than those which have occurred on the major routes. It is significant that the minor route group was the first to experience traffic losses which have proven to be substantial and sustained (*Atts.1, 3*).
2. The PT3 submission (p. 16) refers to the \$19.6M Provincial grant to permit 33% fare reductions in Dec 2008 and Jan 2009. It notes the “reduction was expected to stimulate traffic” but that the severe weather conditions in Dec caused a 10% decrease in traffic for that month. No mention is made of what happened in January.

In fact, January traffic responded well in what was otherwise a dismal year which saw steep fuel surcharges and the onset of a global recession (*Att.4 – January 2009 Traffic*). January 2009 was a stellar traffic month compared both to other Januaries and to the rest of fiscal 2009. The response to the fare reduction is particularly noteworthy in light of the fact January usually sees minimal discretionary travel (family visits, tourists, young people events).

3. The over-height fare premium was removed in April 2010, resulting in a 37% fare reduction for non-commercial vehicles over 7 ft. high. The response was quick and sustained – a 10% to 15% increase in that segment of the traffic (*Att.5 – Over-height Traffic Increase 2010*). It is noteworthy that this increase occurred while the rest of the non-commercial vehicle traffic was in decline. The spike in July may well have been the result of the major routes offering the Coast Saver fare discount program in July but not August. As travel on major routes is required to access many minor routes, the Coast Saver program stimulates traffic on both major and minor routes.

Ferry Advisory Committee chairs hear from community members about changes in travel patterns resulting from fare increases:

- Islanders increasingly using their own boats instead of the ferry service;
- Previously regular visitors informing accommodation providers that ferry fares are now too expensive for them to continue coming;
- People leaving ferry dependent communities because the high cost of travel has made the local cost of living no longer tolerable;
- Residents cutting back on trips other than the most urgent ones;
- Non-resident owners making fewer and fewer visits to their properties;
- Residents choosing to fly rather than to take ferries, as it is now cost effective in an increasing number of situations.

It has been our view since early this year that traffic in FY2010 will drop as much as 2%. This is notwithstanding the BC Ferries Business Plan forecast (p. 16) of 2.3% and 2.7% growth in passenger and vehicle traffic respectively. Attachment 3 suggests FY2011 traffic declines are, in fact, likely to be between 1% and 2%, barring a miraculous recovery this winter.

In the absence of any material fare relief we expect traffic will continue to decline at a similar rate next year.

D. PT3 FORECAST: Accelerated fare increases, traffic losses

We are concerned about the level of fare increases that will emerge from the PT3 discussions if there is no adjustment to the transportation fee.

Looking at the stated revenue requirements in the BC Ferries PT3 submission, and recognizing its inherent assumptions have yet to be tested, we see a potential jump of more than 45% for the aggregated non-major routes over the coming term. If traffic remains at submission estimate levels (unlikely), the added 45% revenue need would translate into a fare increase cap of about 10% per year, assuming it would be smoothed over the term and

that the three non-major routes would be combined under a common fare cap. Most importantly, that 10% fare cap assumes the transportation fee remains at its current level.

If that happens, we expect that traffic will fall even faster and farther than at present.

An expected lower traffic re-forecast would serve to increase the fare cap. As well, there are several other factors such as volatile fuel prices or changing economic conditions that could alter the financial context as the future becomes clearer prior to September 2011, when the final fare cap is announced. This happened going into PT2, when the final fare cap turned out to be significantly higher than the preliminary one.

E. SERVICE LEVELS: Reductions and unintended consequences

The FACC fully supports judicious service realignment when and where it makes sense. However, such service realignment needs to be done very carefully with full consideration of the consequences of any adjustment.

The notion of 'efficiency' based on load factors or percent utilization of capacity can be misleading. On many routes, ferries travel very lightly loaded in order to pick up heavy loads going the opposite direction. There can be light sailings within the eight hour shift time. There can be seasonal and weekday/weekend traffic differences that must all be accommodated by the same vessel. A large vessel may be required in order to cross open water even though the loads may be light at times. The traffic profile *must* be taken into consideration when using load factors as a measure of efficiency on any given route.

Some routes, while experiencing overall traffic declines, are encountering regular overloads with waits up to two hours on their busier sailings. While discretionary traffic is decreasing, non-discretionary traffic can be increasing, stressing the capacity of the existing fleet. This is particularly apparent when smaller vessels are used to replace ferries in for refit.

There is a concern that declining traffic for the past few years may be seen as a signal that there will be even less demand for ferry service in the future. This could be extended to replacing existing vessels with smaller ferries with reduced capital costs. We believe that traffic levels on the non-major routes have been suppressed in large part by the extreme fare increases. In the event fares return to a more moderate increase rate, it is entirely possible traffic will return to the normal growth pattern experienced over previous decades. The system will need adequately sized vessels in that event.

It must be remembered always that the non-major ferry routes are our life-lines. Unlike VIA Rail or Greyhound Bus Lines, BC Ferries provides the only practical transportation link for our communities. There are no options.

F. PT3 AFFORDABILITY: Limits to what people can or will pay

Affordability is a relative term:

- For visitors, families, Scout groups, cyclists, contemplating a trip to a ferry-dependent community, it's a matter of 'is it worth it, or is there another destination almost as exciting but less expensive to get to?' This affects tourism-based local businesses;
- For residents, it's a matter of foregoing trips 'to town' to access goods and services. As well as diminishing residents' quality of life, there is a ripple effect on the businesses in the larger towns at the other end of the ferry life-lines;
- For junior sports teams, it's a matter of 'can the parents afford the added cost for their youngsters to participate in league play or tournaments?';
- For people on low incomes, it's a matter of 'can I afford to continue living in my community?' when the cost of all goods and services transported by ferries escalates in step with personal fare increases. This leads to critical gaps in the core community, the volunteers, (fire, ambulance, arts, service) and the employees of local businesses.

In each case, it varies with personal financial circumstances and the interest level of the individuals. For residents in most of island and Sunshine Coast communities, the income levels are well below the provincial average, making these people more sensitive to the 'affordability' decisions than might otherwise be the case (*Att.6 – Affordability Table*).

G. PT3 COST DRIVERS: Non-discretionary cost increases

We're aware of the new cost factors recently added or about to be added to BC Ferries' expenses, many of which are legislated and unavoidable. These include increased crewing levels mandated by the federal government, HST adding to cost of services purchased, carbon tax increases, increased costs associated with increased responsibilities of the Commissioner and replacement of obsolete computer systems. Most of these costs have come into being since the current coastal ferry model was created and the original transportation service fee set.

The twenty-two vessels serving the minor routes are old, having an average age of 35 years, with sixteen of them being over 30 years old (*Att. 7 – Minor Route Fleet Age Profile*). Between now and the final fare increase cap decision next September, it is conceivable new information will emerge leading to higher maintenance, repair and refit costs, further increasing the fare cap. We are told part of the high cost of operating BC Ferries is the fact that the previous administration kept vessels well beyond their economic lives. We are now seeing that life extensions of old minor route vessels have apparently become the norm. If the former view is valid, it would seem to raise the question of whether or not the life extension program is the most economical in terms of life cycle and long term costs.

In addition, capital costs have doubled between FY2005 and FY2010, from \$20.4M to \$40.9M on the Minor routes and Rte 3 combined, even though there's only been one minor vessel and one rebuild placed in service in the period. Much of this added expense relates to allocated capital costs of major terminal expansions on the major routes. It is anticipated

this non-vessel capital budget will continue to grow. These new burdens will all be carried by the fare-paying customer in the absence of Provincial funding relief.

H. GOVERNMENT FUNDING: \$92M or \$200M? Or both?

The FACC refer to a constant Provincial annual basic transportation fee of \$92M since 2003, plus additional funding to cover Northern route capital costs. The Ministry counters with \$200M planned for this year to go towards coastal ferry services.

The two numbers refer to two different things. (*Att. 8 – Funding Table FY2010*).

The difference lies in where the money comes from and where it goes.

The Provincial transportation fee is basic support for the non-major coastal ferry service, which will never be able to achieve full user pay. It is the contribution determined by the contract as support of the system. Other contributions made by the provincial government are directed to specific groups such as seniors, students and contractors other than BC Ferries. The funding goes to, but passes through, BC Ferries to the recipients.

The FACC point is that the transportation fee is the one Provincial element which, when altered, can affect the fare increase cap.

Non-major tariff revenue and the Provincial transportation fee are on two very different trajectories. In the period between 2004 and 2010, the tariff revenue from the non-majors increased 48% from \$80M to \$118M, while the basic transportation fee remained fixed at \$92M. (*Att.9 – Tariff and Service Fee Increases*)

I. TRAFFIC AND RETURN ON EQUITY: Small traffic shift; big ROE shift

ROE is directly dependent on net earnings, which in turn are acutely dependent upon traffic. More particularly, net earnings are substantially affected by small variations from anticipated traffic levels. Those small variations are currently resulting in expected ROEs of only 2.7% for 2010/11 and 1.4% for 2011/12 against a target of 13.16%. These results are based on the traffic forecasts in the submission. If the traffic forecasts are reduced further, as they almost certainly will be, the ROE results will suffer accordingly, which will generate the need for even higher net revenue in PT3. That higher revenue can only come from two sources, the fare box or the Province.

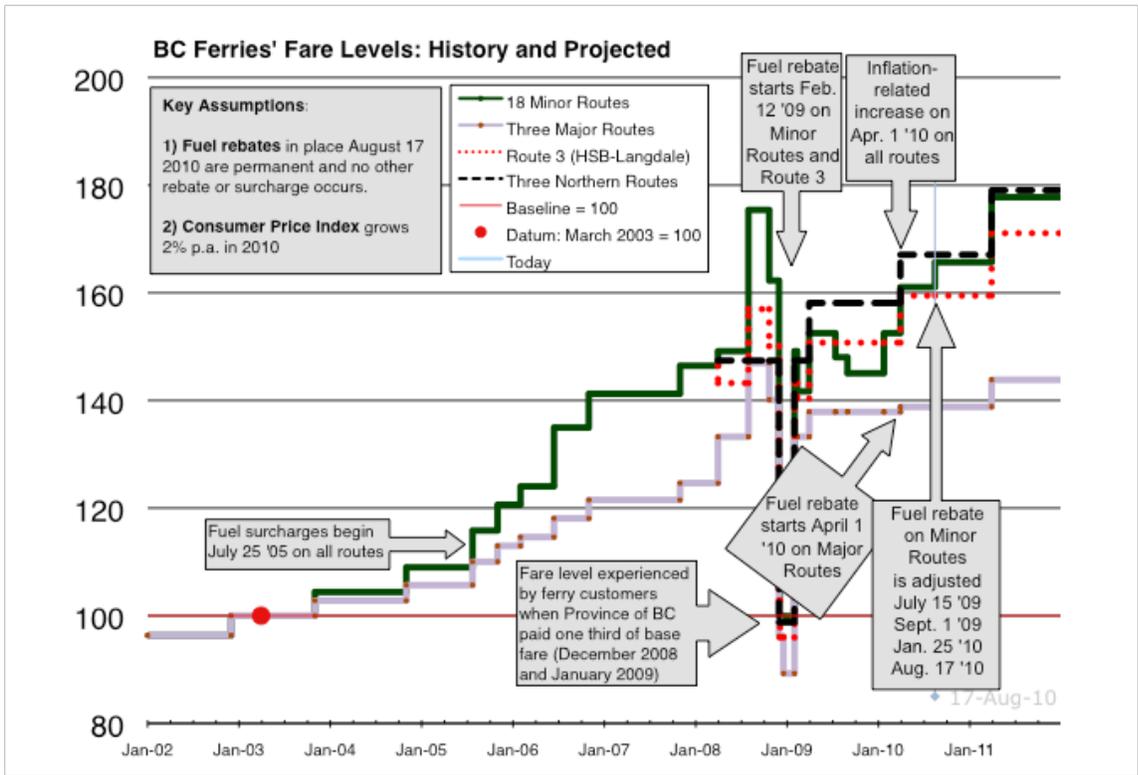
CONCLUSIONS: Economics, ferry service and support for coastal communities

1. High fares have caused traffic declines. These have been greatest on the routes with the highest fare increases and highest fuel surcharges. Now all routes have been affected. These declines will continue in the absence of any fare relief.
2. The traffic declines mirror the economic and social impact of the high fares on British Columbia's ferry-dependent coastal communities and on individual ferry users. While the traffic drops are incremental, the cumulative impacts are touching the limits of what communities and travelers can bear.
3. All the signs are pointing to even steeper fare increases in PT3, in the absence of additional funding from the Province.
4. With seven years of experience, it is time for the Province to take stock of the results of the ferry experiment. In what ways has it delivered the hoped-for results and in what ways has it fallen short? And what to do about it?
5. The "modest and predictable annual fare increases" promised by the Ministry in 2003 have failed to materialize on the non-major routes.

RECOMMENDATIONS: Assess, adjust

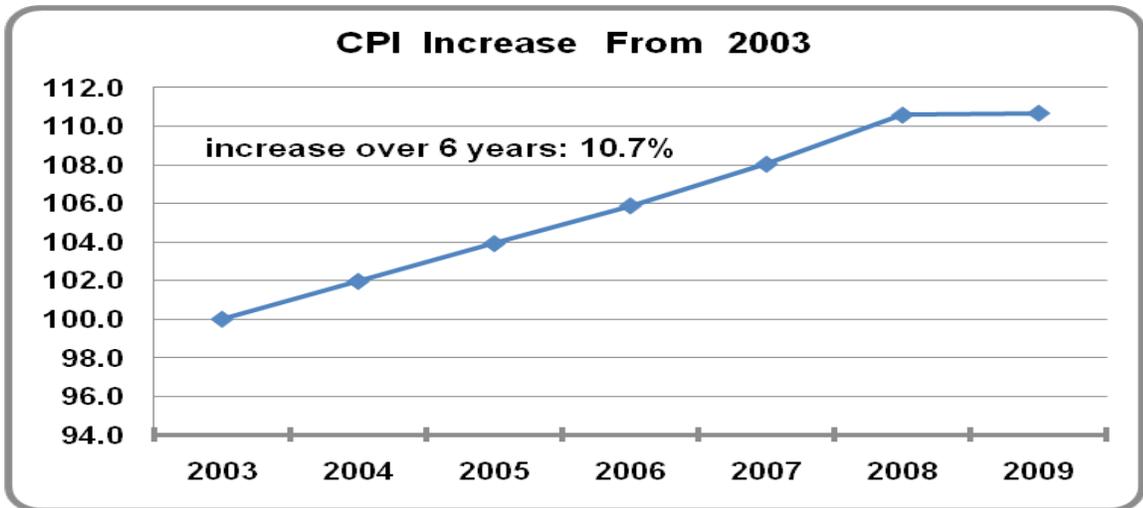
1. Ministry to conduct review of the community impact of ferry fares, past, present and future.
2. Ministry, together with BC Ferries, to carefully assess any contemplated service changes, in terms of benefits to, and impacts on, affected communities before incorporating in PT3 contract.
3. If the failure to provide "modest and predictable" annual fare increases is in fact proving harmful to British Columbians and the coastal communities, then adjust the Transportation fee to a level that *will* provide "modest and predictable" fare increases more in line with inflation.
4. If contemplated service adjustments make sense, then proceed with them, giving consideration to who the beneficiaries of any such changes should be – the Province, the customers or both.

Attachment 1 – Fare History, PT1 and PT2



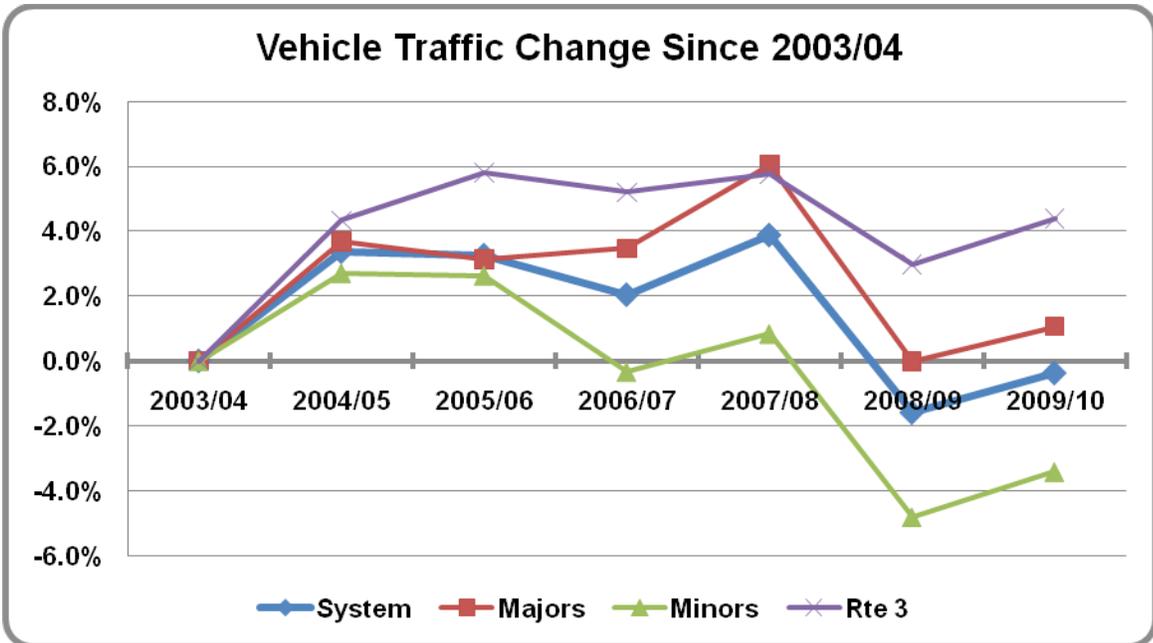
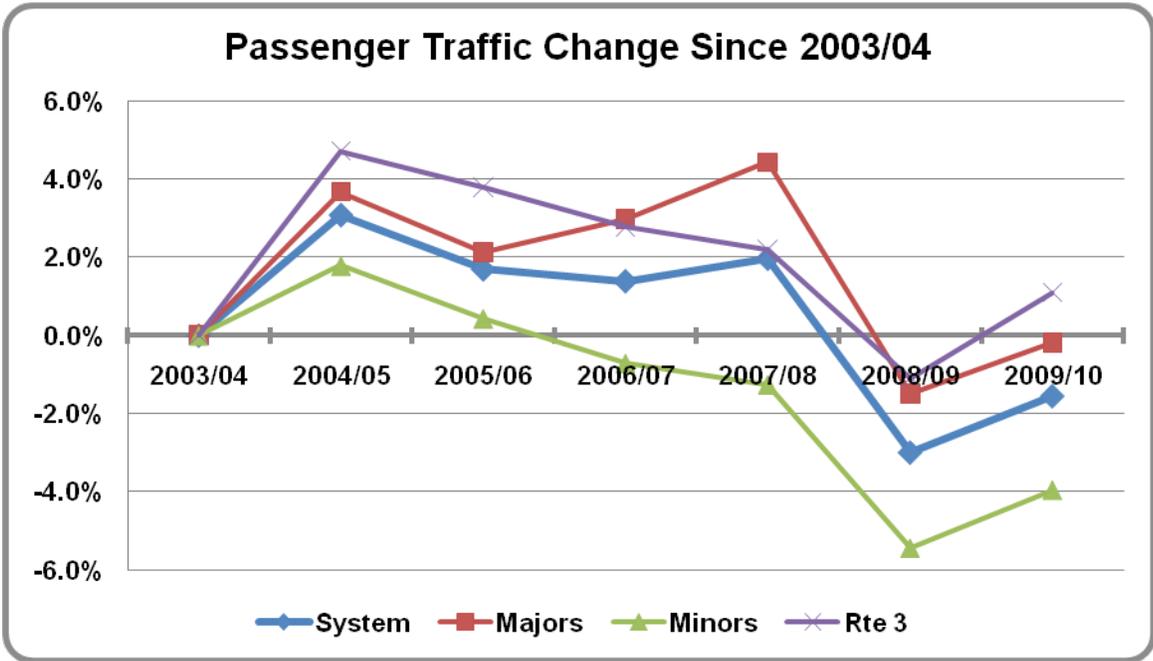
Source: BC Ferry Commissioner

Attachment 2 – CPI Increase

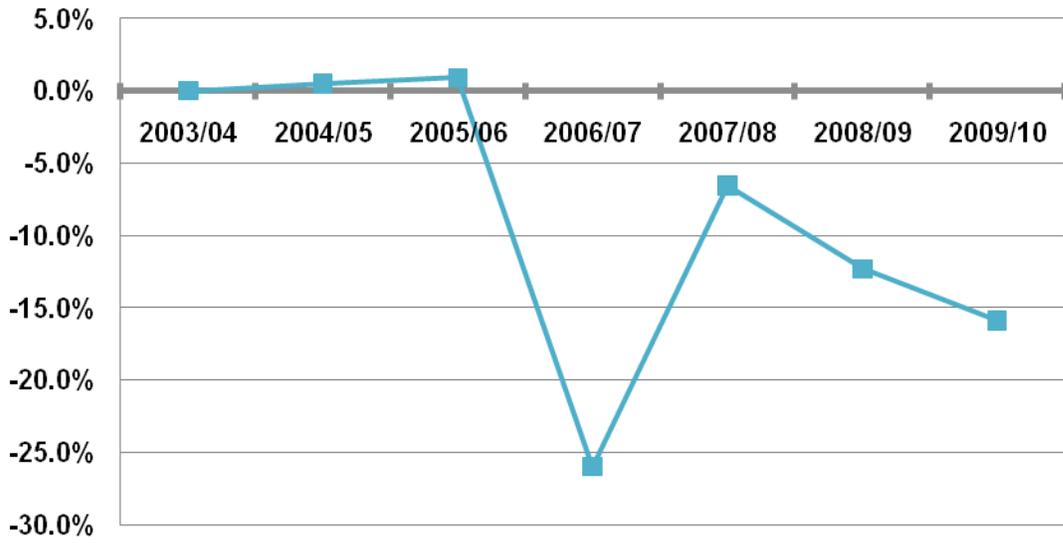


Source: Stats Canada

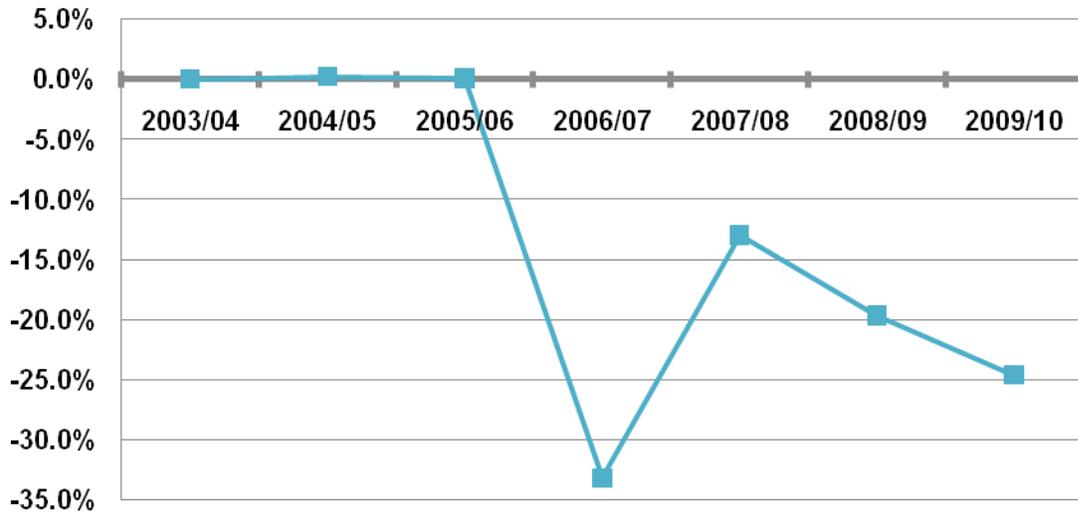
Attachment 3 - Traffic History by Route Groups



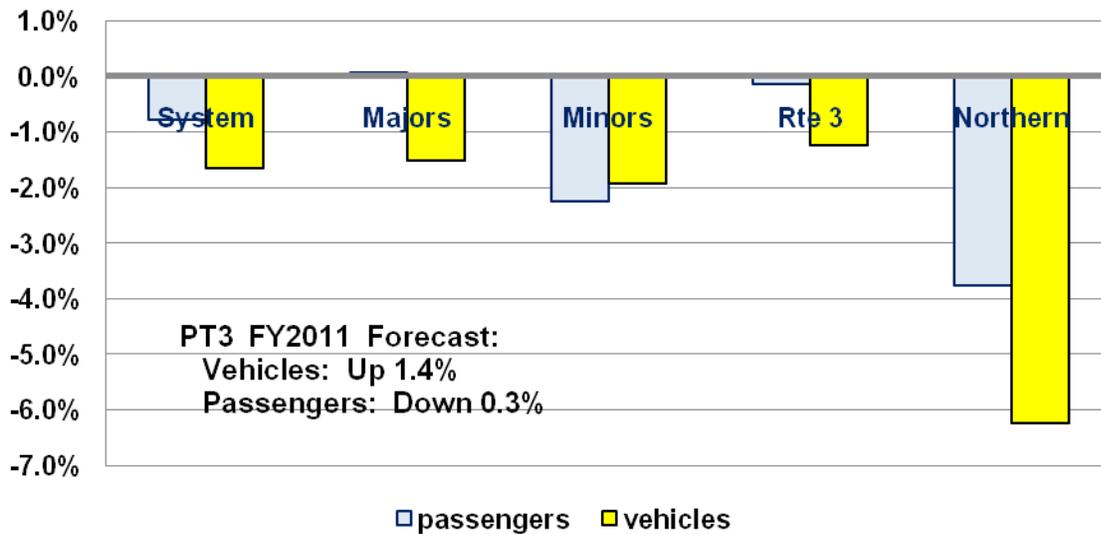
Northern/Central Coast Vehicle Traffic Change Since 2003/04



Northern/Central Coast Passenger Traffic Change Since 2003/04



Year to Sep Traffic Changes, FY2011 vs FY2010



VEHICLE TRAFFIC

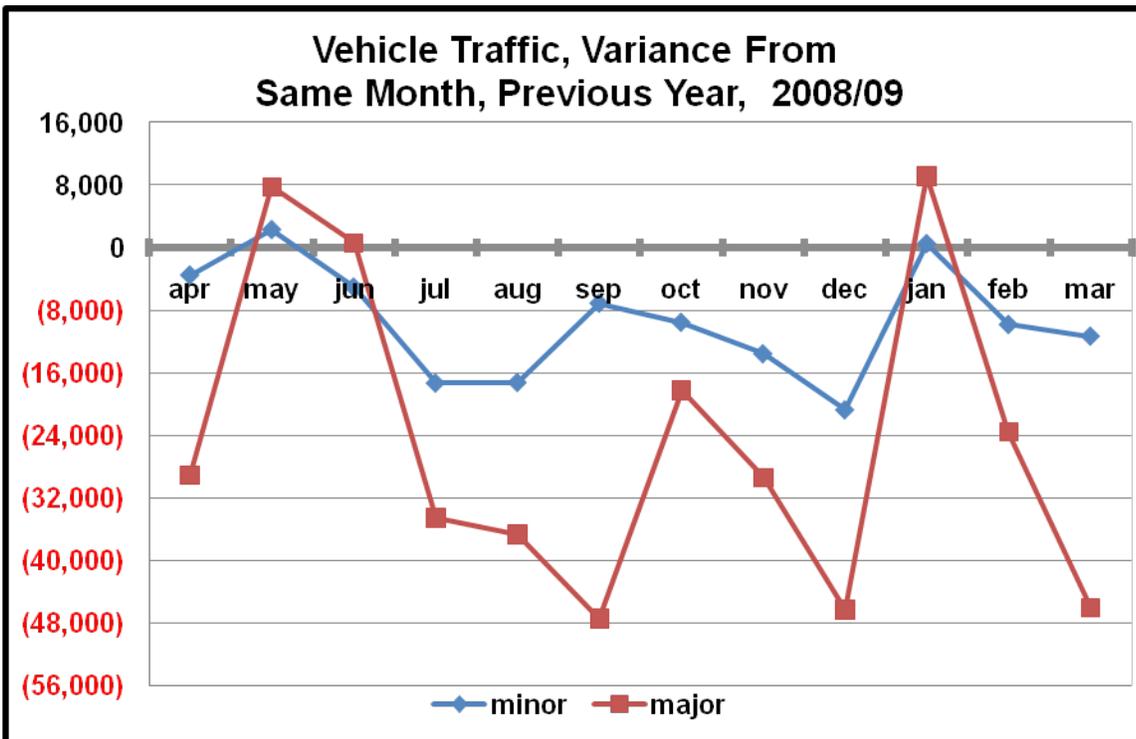
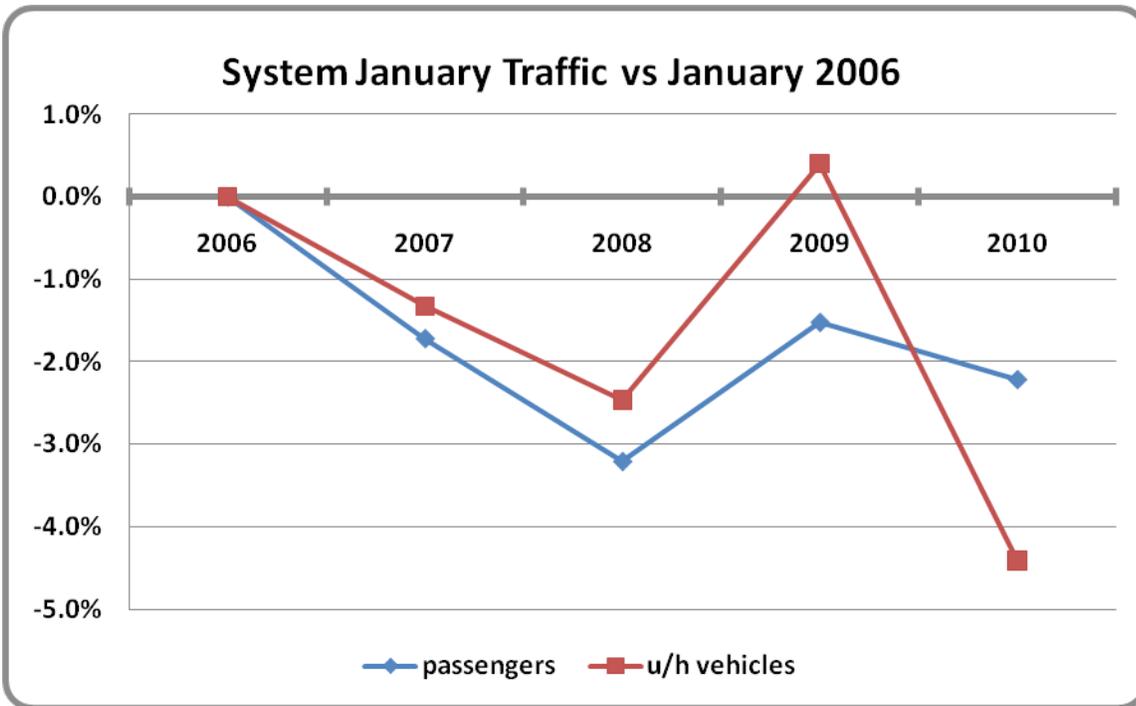
	System	Majors	Minors	Rte 3	Northern
2003/04	9,349,918	4,405,553	3,705,874	1,193,123	45,368
2004/05	9,664,719	4,567,893	3,806,406	1,244,819	45,601
2005/06	9,654,896	4,542,978	3,803,630	1,262,511	45,777
2006/07	9,540,830	4,558,529	3,693,577	1,255,151	33,573
2007/08	9,712,878	4,671,778	3,736,982	1,261,733	42,385
2008/09	9,200,996	4,404,749	3,527,763	1,228,704	39,780
2009/10	9,315,346	4,452,221	3,579,367	1,245,599	38,159
YTD09/10	4,838,459	2,253,837	1,916,143	645,127	23,352
YTD10/11	4,758,081	2,219,837	1,879,237	637,112	21,895

PASSENGER TRAFFIC

	System	Majors	Minors	Rte 3	Northern
2003/04	21,367,430	10,824,727	7,870,279	2,555,463	116,961
2004/05	22,026,543	11,222,356	8,010,988	2,675,997	117,202
2005/06	21,729,603	11,055,858	7,904,228	2,652,455	117,062
2006/07	21,664,953	11,146,311	7,814,225	2,626,258	78,159
2007/08	21,788,461	11,304,042	7,771,266	2,611,402	101,751
2008/09	20,727,493	10,664,158	7,441,718	2,527,653	93,964
2009/10	21,035,644	10,804,836	7,559,130	2,583,488	88,190
YTD09/10	12,637,635	6,598,779	4,436,669	1,533,216	68,971
YTD10/11	12,537,804	6,603,809	4,336,466	1,531,159	66,370

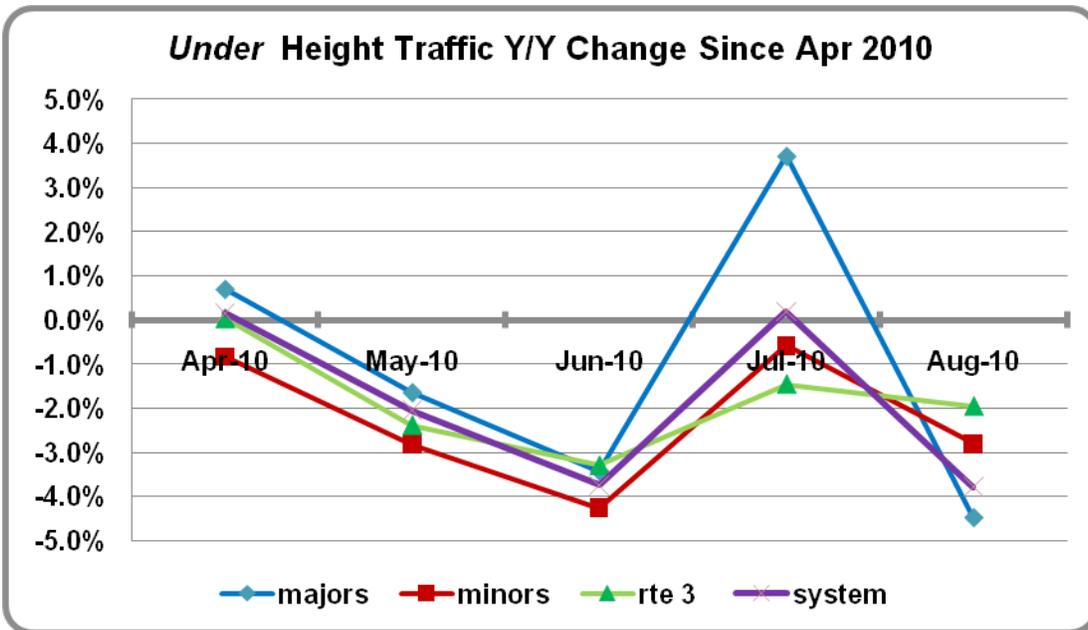
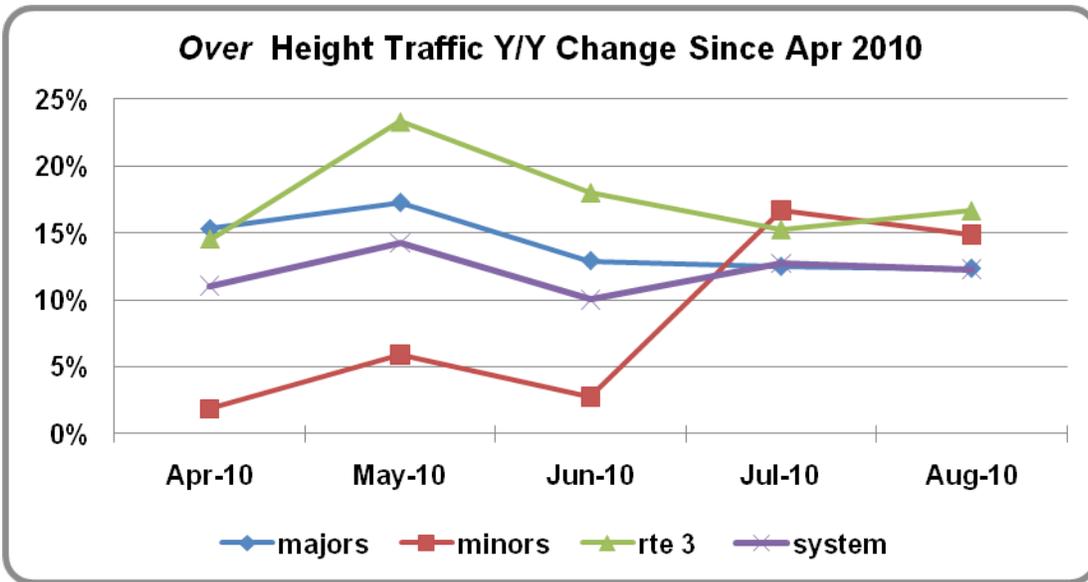
Source: BC Ferries Annual Reports to the Commissioner
 BC Ferries Website Traffic Statistics

Attachment 4 – January 2009 Traffic



Source: BC Ferries Point of Sale Data

Attachment 5 – Over-height Traffic Increase 2010



Source: data provided by BC Ferries

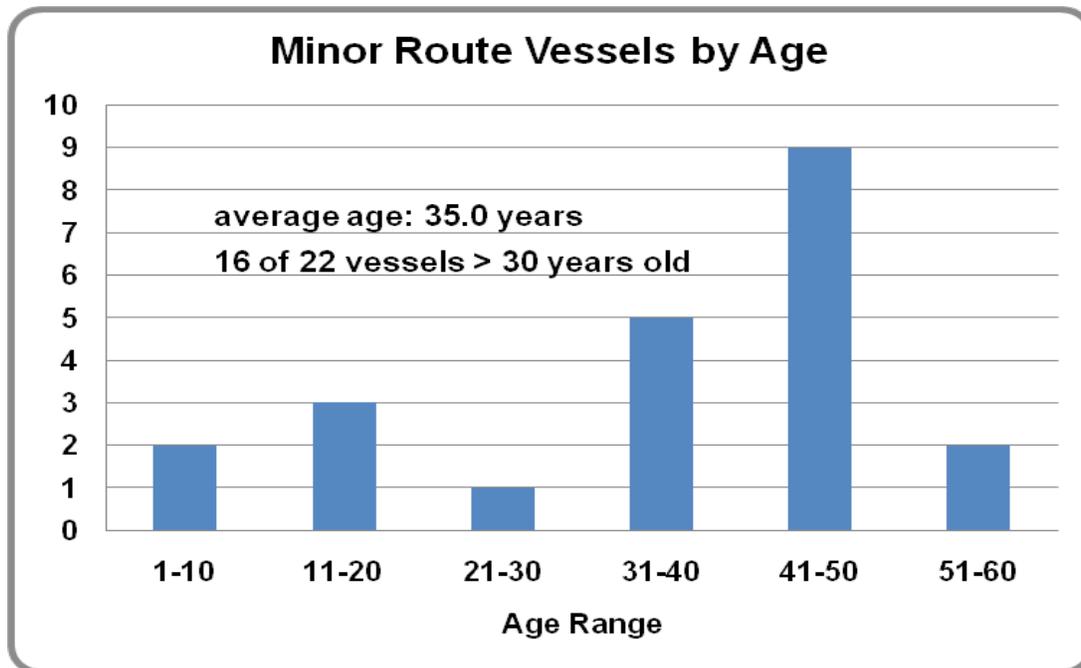
Attachment 6 – Affordability Table

Affordability - incomes - tariffs - fare increases <i>(examples)</i>	Average Individual Earnings (2005 census) BC: \$25,722	Average Household Income (2005 census) BC: \$52,709	Current tariff for family of four** to Vancouver I. (*or lower mainland)	Regular fares (Generally used by visitors) % Increase 2003-2010	Prepaid Fares (Generally used by residents) % Increase 2003-2010
Cortes Island	\$7,533	\$23,459	\$94.75	54.8%	86.4%
Hornby Island	\$15,298	\$35,921	\$87.50	58.6%	105.7%
S. Gulf Islands	\$15,691	\$41,587	\$62.90	47.8%	92.3%
Powell River	\$20,599	\$43,559	*\$158.35	46.7%	67.0%

** family of four includes two adults, two children aged 5 to 11 and a vehicle.

Source: 2005 Canada Census
BCFerries Website

Attachment 7 – Minor Route Fleet Age Profile



Source: BCFerries Website

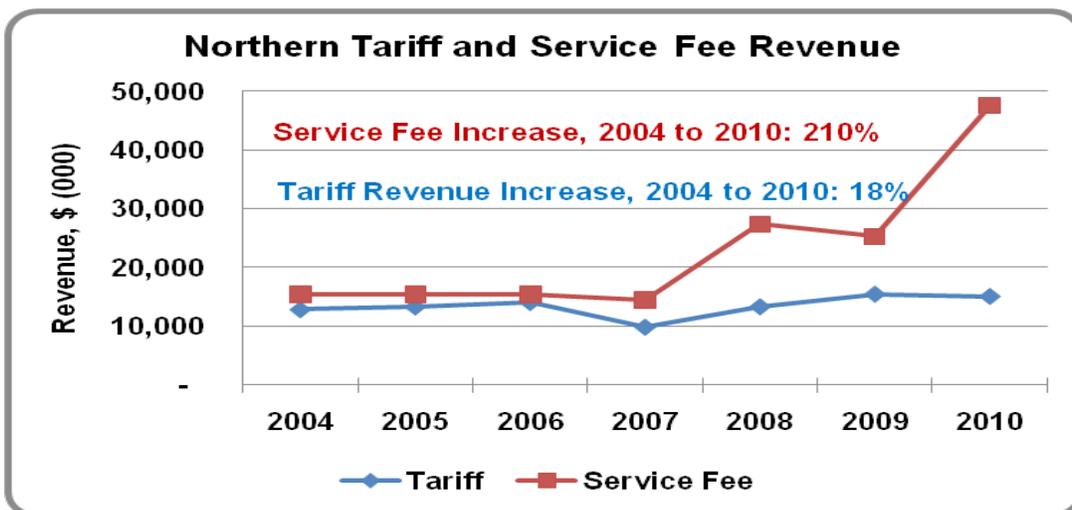
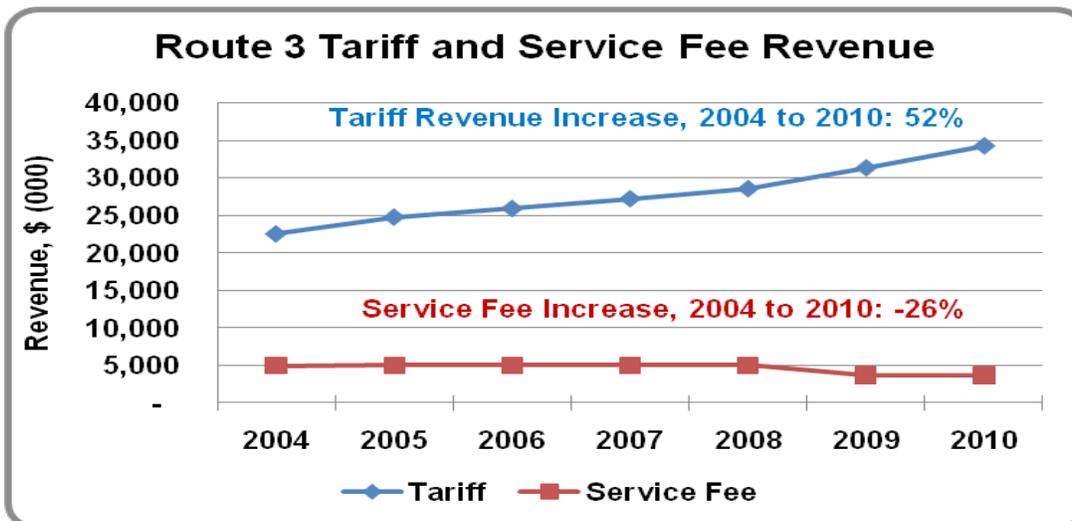
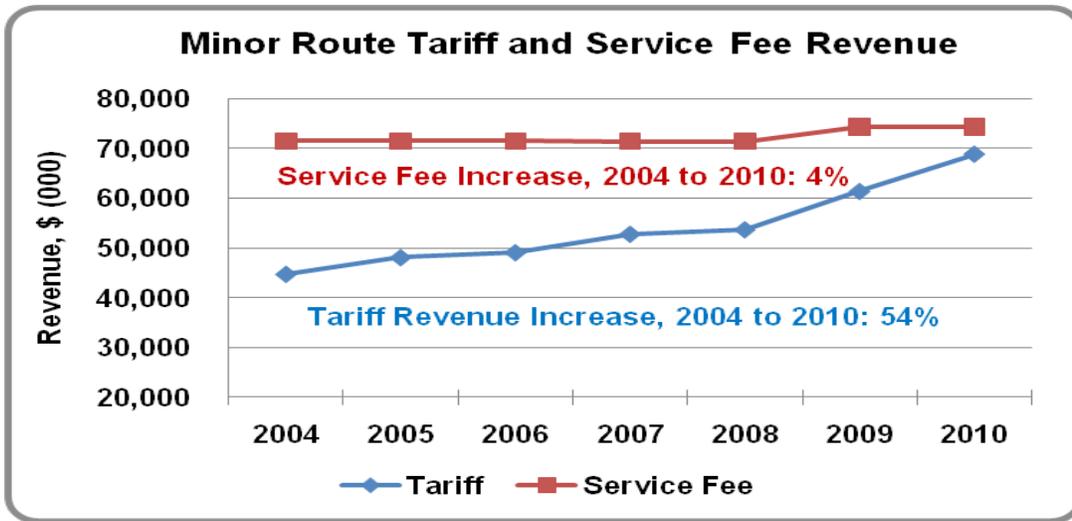
Attachment 8 - Funding table to FY2010

PROVINCIAL AND FEDERAL FERRY-RELATED CONTRIBUTIONS				
	FY 2004	FY 2008	FY 2009	FY 2010
	start PT1	end PT1	start PT2	
	(\$M)	(\$M)	(\$M)	(\$M)
Provincial government transportation fees				
Basic transportation fee (Rte 3 and Minors)	76.47	76.45	78.01	78.01
Basic transportation fee (Northern)	15.35	15.37	13.81	13.81
Total basic transportation fee	91.82	91.82	91.82	91.82
Northern adjustment transportation fee		11.98	11.48	33.78
Total provincial transportation fees	91.82	103.80	103.29	125.60
Other provincial government payments				
33 % fare reduction program (applied to all routes)			19.60	
Service restoration agreement (majors and Rte 3)			1.20	
Contribution to fuel deferral accounts (from Federal duty remission on Northern Adventure)		1.28	1.68	1.62
Contribution to Northern fuel deferral account (surcharge/rebate adjustment)			2.43	-1.27
Total 'Other' payments		1.28	24.91	0.35
Total provincial govt contributions to BCF operations	91.82	105.08	128.21	125.95
Federal-provincial subsidy agreement (* see below)				
Allocated to Rte 3 and Minors	19.90	21.47	19.79	20.26
Allocated to Northern	4.07	4.39	6.51	6.66
Total federal-provincial subsidy agreement	23.97	25.86	26.29	26.92
Total provincial, federal contributions to BCF operations	115.79	130.94	154.50	152.87
'Pass-through' funding to third parties through BCF				
Social Program Reimbursement (seniors, students, medical)				
. . . . Fares for travelers on major routes	6.67	8.79	9.91	10.77
. . . . Fares for travelers on non-major routes	5.64	8.46	9.35	11.29
Total social program reimbursements	12.32	17.25	19.25	22.06
Contracted route fees (pass-through funding to third-party carriers on unregulated routes)	1.75	1.70	1.94	1.85
Nicola refit costs reimbursements (\$0.5M in 2008, \$1.1M in 2009 for BCF vessel leased to Lax Kw'alaams)		0.50	1.10	
Total pass-through funding to third parties	14.06	19.45	22.29	23.91
Total provincial and federal ferry-related contributions	129.85	150.39	176.79	176.78
Dividend paid by BC Ferries to provincial government	-6.04	-6.04	-6.04	-6.04

* Money from federal government to provincial general revenue.
Provincial government allocates it to ferries.

Sources: BC Ferries, BC Ferry Commission

Attachment 9 - Tariff and Service Fee Increases



Source: BC Ferries annual reports to the Commissioner