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Special Report by Patrick Brown

Ferries' permitted profit of 14% includes 'shadow' taxes

BC Ferry Commissioner Martin Crilly has announced that the provincially owned private corporation, BC Ferry Services Inc, will be permitted to earn a 14% return on equity during Performance Term 2 (PT2), from April 1, 2008 to March 31, 2012. This rate of return includes an allowance for corporate income taxes, which the corporation does not have to pay.

The Commissioner is instructed by the *Coastal Ferries Act* to set the 'pre-tax return on equity' allowed for BC Ferry Services Inc. He must consider the yield on 30-year federal government bonds, and to multiply that by a 'risk premium' typical of similar regulated businesses elsewhere.

The Commissioner has reported that the calculation, which was carried out by the accounting firm Pricewaterhouse Coopers, presented certain difficulties: no figures were available on the yield on 30-year bonds over the period 2008/12, and the 'risk premium' for comparable businesses 'showed high variances;' their similarity to BC Ferries was 'open to question.' Nevertheless, the accountants' best efforts estimated the appropriate after-tax return at 9.4%.

But BC Ferries Services Inc is a tax-exempt corporation under Section 149 (1.3) of the *Income Tax Act*, by virtue of its 100% ownership by the provincial government. (Canadian tax law generally accepts the principle that governments should not tax each other.)

Some might assume that, if a corporation is not required to pay taxes, its pre-tax return would equal its after-tax return. However, the Commission decided that it should be entitled to a pre-tax return set as if it were required to pay corporate

Fare-Setting

The setting of a return rate is the first step in a process that will conclude with fares set for Performance Term 2 next fall. The *Coastal Ferries Act* requires that the Commissioner must publish his preliminary decision on fare caps by March 31, 2007, probably assuming the present level of provincial government contributions in the form of 'service fees' for the various routes, and current service levels. Following this, the provincial government and BC Ferries have three months to renegotiate these service fees (by June 30, 2007) and then the Commission has a further three months to calculate and determine the resultant fare caps, which will then be published as the Commission's final decision at the end of September, 2007.

No Public Input

The Ferry Commissioner's terms of reference are limited by the *Coastal Ferries Act* to determining fare caps based on the financial needs of the ferry operators (currently only BC Ferry Services Inc). *He has emphasized that he is not required or authorized to consider the impact of increasing ferry fares on ferry users or their communities.* Consequently, there is no provision for public input in the fare-setting process. This procedure ensures that fare-setting is a purely political decision.

Current Fares Rise Is As Much as 50%

Fares for the current Performance Term, which started with the 'privatization' of BC Ferries on April 1, 2003, have risen 2.8% annually on the 'major' (Mainland to Victoria and Nanaimo) routes, and 4.4% annually on all other routes. These fares were based on provincial contributions which were determined at the start. Since that time, rapidly increasing fuel costs have led BC Ferries to apply for a number of 'extraordinary' increases, which have been granted by the Commissioner. The result is that by March 31, 2008, fare levels will have risen over five years by 25% on the major routes and nearly 50% on other routes (see *Island Tides*, June 29, 2006).

The Role of Subsidies

Most Islanders regard BC Ferries as properly part of the highway system, where gasoline taxes cover 70% of the costs, and general provincial revenue the rest. The ferry-financing formula prior to 'privatization' recognized ferries as part of the highway system by allocating a fixed percentage of provincial gasoline taxes as a ferry system subsidy.

The current provincial government has refused to make any contribution to fuel cost increases by way of increases in 'service fees', with the result that the ferry fares (and other revenue) now cover 84% of ferry costs, as calculated by an Islands Trust study (see *Island Tides*, November 16, 2006). The Islands Trust contrasted this with Translink, where fares cover only 47% of costs, and BC Transit, where fares cover only 37% of costs.

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income tax, so it 'grossed-up' the permitted return to allow for this, and arrived at a 'pre-tax' 14%. (Comparable figures have not been made available for current years.) The permitted return is thus inflated to include 'shadow' taxes.

Justification or Spin?

According to the Commission's own figures, each additional percentage point of permitted return is equivalent to added revenues of $1.75 million per year, or an increase in fares of 0.5%. Thus the decision to 'gross-up' the permitted return to allow for corporate taxes (which the company does not pay) costs ferry customers an additional 2.3% in fares.

The Commission justifies this position as follows: 'Behind the decision to gross-up the after-tax figure is the presumption that legislators (in establishing the governance framework) and the government (in its application of tax policy) intended that the benefit of BC Ferries' non-taxable status should go first to the company and not directly to ferry customers.'

Why Not?

The reason is clearly that the Commission's mandate is to ensure the financial health of the company, and not to consider the public interest. According to the Commission, 'BC Ferries was given the opportunity to comment on the methodology and findings throughout, via face-to-face meetings with BC Ferries management and in written submissions to the Commission.' Other opinions may have been sought, but are not mentioned.

The Commission explains that its 'interpretation' (of what is meant by 'pre-tax' if no taxes are to be paid) 'makes it considerably easier for BC Ferries to achieve target levels of earnings and build equity, to meet its undertakings for maximum leverage and debts and thereby to finance its capital investments.

The company, after all, cannot raise more equity on the markets, because it is 100% owned by the provincial government. It must be entirely financed by borrowings, which are estimated to reach $1.3 billion by 2009.

Over the past five years, 'service fees' from the provincial government have remained unchanged, with the exception of an additional contribution to the cost of replacing the sunken *Queen of the North*. The company has expressed the carefully phrased opinion that the required tariff revenue amounts for Performance Term 2 'will not be earned under the price caps that will be in effect at the end of performance term one.'

Determining the trade-off between additional service fees and increased ferry fares will thus be squarely in the hands of the provincial government after March 31. ✐

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