

BC Ferry Services Inc and
Provincial Liabilities

December 5, 2005

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Reference Documents

The documents related to the Indenture which sets up security arrangements for the bond offerings including the *Master Trust Indenture*, *Supplemental Indentures 1–4*, the *Acknowledgement Agreement* and the *Credit Agreement* are available on the Canadian securities web site (sedar.com). However it is practically impossible to find the documents as they are all listed by the same name: *other material contracts*. Therefore these documents have been down loaded, named properly and attached as electronic pdf files to this report.

Also attached is the *October 5, 2004 Long Form Prospectus (LFP)*, used here as the basic reference document as it has the most complete information on the company of any other, single document to date. I refer to other documents as required.

Other documents referred to including the *Coastal Ferry Act*, *Service Contract*, *Master Agreement* (on terminal leases) and the *03/04* and *04/05 BCFS Annual Reports* are available on the BCFS web site (bcferries.com) and the Ferry Commissioner web site (bcferrycommission.com). The final attachments are the *02/03 BC Ferry Corporation Annual Report (BCFC)* which describes the formation of the new company and is no longer available on the BCFS web site and the latest *Q2 05 BCFS Financial Report* filings from sedar.com.

Electronic Document Attachments as follows:

| | |
|------------|---|
| 1 | <i>October 5, 2004 Long Form Prospectus</i> |
| 2 | <i>Acknowledgement Agreement</i> |
| 3 | <i>Master Trust Indenture</i> , |
| 4a, 4b, 4c | <i>Supplemental Indentures 2–4</i> |
| 5 | <i>Q2 05 BCFS Financial Report</i> |
| 6 | <i>Credit Agreement</i> |
| 7 | <i>Entitlement to Federal Subsidy Brief</i> |

Author

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Overview

This report will consider the purported independent nature of BC Ferry Services Inc (BCFS). It will examine the company's dependence on both BC and Federal tax dollars, its debt load and the risk borne by the province in its operations. It will also consider the ability of the company to continue to operate service on the government subsidized routes to ferry dependent BC coastal communities, the cost of new vessels which may be borne in whole or in part by BC taxpayers and the flawed nature of the *Coastal Ferry Act* itself. All these issues are of grave concern to the union representing the employees of the company and to the users of this service as their marine highway.

Setting the Scene: The Coastal Ferry Act and Establishment of the New Company

Perhaps the most egregious action by the Provincial government as far as citizens are concerned was the way in which the “independent” company free of “government influence” was set up at the expense of tax payers. While it is difficult to understand the complicated transactions executed by the government in this matter, some things are clear.

We present here Note 1 to the Consolidated Financial Statements (BCFC Annual Report 02/03, pp 52–55) which documents this transaction:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED MARCH 31, 2003 AND 2002

British Columbia Ferry Corporation (the “Corporation”) was incorporated under the Ferry Corporation Act on June 30, 1976. The Corporation’s primary business activity is the provision of ferry services in British Columbia. The Minister of Finance holds the shares of the Corporation as representative of Her Majesty the Queen in Right of the Province of British Columbia.

1 .TRANSITION TO BRITISH COLUMBIA FERRY SERVICES INC:

Subsequent to the year-end, on April 1 and 2, 2003, the ownership of the Corporation’s shares and other significant assets was significantly altered, and the Corporation began operations under the new name, B.C. Ferry Services Inc.

The new Coastal Ferry Act (the “Act”) came into force on April 1, 2003. The Act established a new independent regulatory framework for coastal ferry services and a new service delivery model. The Act establishes the B.C. Ferry Authority, a corporation without share capital to govern British Columbia Ferry Services Inc. The Act also creates a new position, British Columbia Ferries Commissioner, to ensure that rates are fair and reasonable and to monitor service levels.

Service levels that fall outside the mandate of a commercial operation are to be negotiated between the provincial government and British Columbia Ferry Services Inc. on a route-by-route basis under the terms of the new Coastal Ferry Services Contract (the “Contract”). The Contract is for a period of sixty years, renegotiated after a first term of five years and each four-year term thereafter. The Contract defines the service levels to be maintained, the provision of certain provincial social policy initiatives, the routes to be operated and the fee to be provided for these services. The initial term provides for an annual fee not to exceed \$105.5 million.

On April 1, 2003, in anticipation of the transfer of share ownership to the newly established B.C. Ferry Authority, the Corporation’s land and structures comprising the terminals were transferred from the Corporation to the British Columbia Transportation Financing Authority. In exchange, the Corporation received recognition of a prepayment of terminal leases for a period of sixty years.

On April 2, 2003, the Corporation converted from incorporation under the Ferry Corporation Act to incorporation under the Company Act (British Columbia).

British Columbia Ferry Services Inc. then amended its Memorandum and Articles to revise the number and classes of authorized shares. The new authorized share capital consists of 1,000,000 Class A voting common shares, without par value; 1 Class B voting common share, without par value; and 80,000 Class C non-voting, 8% cumulative preferred shares, with a par value of \$1,000 per share. The Class C preferred shares are convertible to Class A shares upon the sale of the outstanding Class B share by the original shareholder. Special share rights attached to the Class C shares restrict British Columbia Ferry Services Inc.’s ability to issue shares and to declare dividends.

A debenture in the amount of \$427.7 million was issued in favor of the Province of British Columbia. The debt bears interest payable semi-annually in arrears and is due March 31, 2006. The interest rate is currently 5.33% subject to adjustment under certain conditions. The debenture is secured by a registered mortgage on vessels and on the leasehold interest under the terminal lease and by a general security agreement on property.

British Columbia Ferry Services Inc. then redeemed 100% of its outstanding shares previously held by the Minister of Finance as representative of Her Majesty the Queen in Right of the Province of British Columbia in exchange for preferred shares and cash of a combined amount equal to the Corporation’s equity value of \$503.2 million as at March 31, 2003.

Immediately thereafter, British Columbia Ferry Services Inc. issued one new Class B share in favor of B.C. Ferry Authority, in exchange for \$1,000.

The effect of the above transition on the balance sheet of the Corporation using the transactions noted above and assuming the new structure had been implemented on March 31, 2003 is summarized in the following table:

1 .TRANSITION TO BRITISH COLUMBIA FERRY SERVICES INC:
YEARS ENDED MARCH 31, 2003 AND 2002 (COLUMNAR AMOUNTS EXPRESSED IN THOUSANDS) :

| | March 31, 2003 | Subsequent transition transactions | Pro forma March 31, 2003 |
|--|----------------|--|--------------------------|
| Current assets: | | | |
| Cash and cash equivalents | \$ 14,557 | \$ 427,678 (b) (427,678) (c) 1 (d) | \$ 14,558 |
| Accounts receivable and prepaid expenses | 34,926 | – | 34,926 |
| Inventories | 19,305 | – | 19,305 |
| | 68,788 | 1 | 68,789 |
| Capital and other assets | 567,968 | (230,232)(a) 230,232 (a) | 567,968 |
| | \$ 636,756 | \$ 1 | \$ 636,757 |
| Liabilities: | | | |
| Current liabilities | \$ 112,284 | – | \$ 112,284 |
| Deferred employee obligations | 21,294 | – | 21,294 |
| Long-term debt | – | 427,701 (b) | 427,701 |
| | 133,578 | 427,701 | 561,279 |
| Shareholders' equity | | | |
| Common shares | 6,851 | (6,851) (c) 1 (d) | 1 |
| Preferred shares | – | 75,477 (c) | 75,477 |
| Contributed surplus | 536,957 | (496,327) (c) (40,630)(e) | – |
| Deficit | (40,630) | 40,630 (e) | – |
| | 503,178 | (427,700) | 75,478 |
| | \$ 636,756 | \$ 1 | \$ 636,757 |

(a) Land and structures that comprise the terminals disposed and leased back.

(b) Debt issued for cash.

(c) Common shares redeemed for 75,477 Class C preferred shares and cash.

(d) Issuance of one Class B share.

(e) Elimination of deficit by transfer from contributed surplus.

In a nut shell what happened was legislated by the Province and was highly unusual. In order to redeem 100% of the outstanding shares of the Crown Corporation being held by the Minister of Finance, the new company needed cash. So it mortgaged the assets it had just been given by the Province back to the Province for the amount of \$428 million. Then it reorganized it shares, selling 75,477 shares to the Province. The Province also gave the new company \$1,000 to buy one common share.

If only other “independent” businesses could get such a great start-up deal. In effect, the taxpayers of the Province funded the deal to transfer ownership of their assets at little benefit to themselves, even paying off the \$40 million deficit to find themselves owners of a company which had gone from over \$500 million in shareholder equity to just \$75 million in equity. Granted the Province made money on the interest on the mortgage in the year it held it, and also receives annual dividends of some \$6 million. But this is peanuts when compared with the value of the Crown Corporation which was essentially given away.

This deal was further complicated when the assets were again mortgaged to the Banking Consortium to secure the \$500 million bond offerings which were then used to pay off the mortgage held by the Province. At the same time the company established a large line of credit. These unusual transactions can only be attributed to the fact that the company was a public transportation service, a service that had been declared an essential service by the Province, a service that was a regulated monopoly, and a service in which the Province had a unique interest and powers as follows:

1) Province holds all but one share of the company.

2) Province has contracted to pay over \$100 million in annual revenue to the company.

- 3) Province appoints 2 of the Directors of the new Ferry Authority and BCFS.
- 4) Province retains ownership of the lands, terminals and marine structures.
- 5) Province holds unusual powers and makes certain guarantees as we shall see below.

Who Owns BC Ferry Services?

The company always refers to itself as an independent company. However, this seems to be more a matter of wishful thinking and creative use of language than, in fact, a reality. There is no legal definition of an “independent” company. There is a legal definition of public company: namely, one which enjoys the use of public funds. The term independent company appears to be more an advertising term for the new structure, coined to sell this arrangement to the unsuspecting BC taxpayer. Ownership is the first case in point. The Province owns \$75 million worth of preferred shares of the company. The BCFA owns one common share.

Pages 42-43 of the LFP describe the shares structure as follows:

Share and Loan Capital

“The authorized capital of BC Ferries consists of 1,000,000 Class “A” Common shares without par value (the “Class A Shares”), one Class “B” Common share without par value (the “Class B Share”), and 80,000 Class “C” Preferred shares with a par value of \$1,000 per share (the “Preferred Shares”).

Common Shares:

Each Class A Share and Class B Share (collectively, “Common Shares”) entitles the holder thereof to receive notice of, to attend, and to one vote at, meetings of the shareholders of BC Ferries. The Common Shares are not entitled to dividends unless declared by the directors of BC Ferries out of monies lawfully available for dividends after payment of the preferential cash dividend payable to the holders of the Preferred Shares [the Province]. In the event of any liquidation, dissolution or winding up of BC Ferries, or other distributions of the assets of BC Ferries, the holders of the Common Shares will be entitled to their pro rata share of the assets of BC Ferries, subject to the preferential distribution to the holders of the Preferred Shares. The one authorized Class B Share is currently held by the BCFA. There are currently no Class A Shares issued or outstanding. The Class A Shares are issuable only upon conversion of the Preferred Shares in accordance with their terms.

Preferred Shares:

The Preferred Shares do not entitle the holders thereof to receive notice of, to attend, or to vote at, meetings of the shareholders of BC Ferries, except as otherwise provided by law. Holders of the Preferred Shares are entitled to fixed cumulative preferential cash dividends as and when declared at the rate of 8% per annum. Dividends, if declared, will be payable annually. Holders of the Preferred Shares will not be entitled to any dividends other than or in excess of the fixed cumulative dividend. There are currently 75,477 Preferred Shares issued and outstanding, all of which are owned by the Province. So long as there are any Preferred Shares issued and outstanding, BC Ferries may not, without the approval of the holders of the Preferred Shares,

- (i) amend its constituting documents,
- (ii) declare or pay any dividends on any other class of shares,
- (iii) redeem, purchase or otherwise pay off shares of any other class,
- (iv) issue any additional shares of any class or securities exchangeable or convertible into shares of any class other than Class A Shares upon conversion of Preferred Shares,
- (v) take any steps to liquidate, dissolve, or wind up, or
- (vi) sell, lease or otherwise dispose of all or substantially all of its property or assets.

The Preferred Shares may, at the option of the holders thereof, be converted into Class A Shares on a one-for-one basis if BCFA, as the registered and beneficial holder of the one issued and outstanding Class B Share, sells, transfers or otherwise disposes of the Class B Share, or any beneficial interest in the Class B Share.

The Province is an owner as it has purchased shares and does in fact receive the only dividends from the company. Although it does not have voting privileges, it has a unique position of determining the course of the company as evidenced not only by share ownership and by appointing Directors to the Board, but also by the exercise of limiting the actions of the company as described in items (i) through (iv) above.

To completely clarify the ownership position of the Province, we turn to Duhaime’s Canadian Legal Dictionary (<http://www.duhaime.org/default.aspx>) which defines the terms *company*, *share*, *common share*, *preferred share* and *dividend* as follows:

Company: A legal entity, allowed by legislation, which permits **a group of people, as shareholders, to create an organization**, which can then focus on pursuing set objectives, and empowered with legal rights which are usually only reserved for individuals, such as to sue and be sued, own property, hire employees or loan and borrow money. Also known as a “corporation.” The primary advantage of a company structure is that it provides the shareholders with a right to participate in the profits (by dividends) without any personal

liability (the company absorbs the entire liability of the business).

Share: **A portion of a company bought by a transfer of cash** in exchange for a certificate, the certificate constituting proof of share ownership. Persons owning shares in a company are called “shareholders”. There are two basic kinds of shares: common and preferred. A shareholder is not liable for the debts or other obligations of the company except to the extent of any commitment made to buy shares. The two other benefits of shares include a right to participate in profits (through dividends) and the right to share the residue of assets of the company, once liabilities have been paid off, if it is ever dissolved.

Common share: The basic share in a company. **Typically, common shares have voting rights** and a pro rata right to any dividends declared. They differ from preferred shares which, by definition, carry some kind of right or privilege above the common shares (e.g. first to receive any dividends).

Preferred shares: A share in a company that has some kind of special right or privilege attached to it, such as that it is distinguished from the company’s common shares. **The most common special right is a preference over holders of common shares when dividends are declared.** Another, is for the preferred shares to be redeemable at the option of either the holder or the company. Still another might be able to disallow voting rights to preferred shareholders.

Dividend: A proportionate distribution of profits made in the form of a money payment to shareholders, by a for-profit corporation. Dividends are declared by a company’s board of directors. [all emphasis ours]

One other point should also be noted in this regard. That is the final statement regarding selling of the one class B common share quoted above (from LFP p 43). This clause is purported to be a protection for the Province and its taxpayers. However, we are deeply concerned that should the company find itself in financial trouble, or for any other reason, it could in fact sell, transfer or otherwise dispose of its one common voting share thereby activating this clause. Then the banking consortium which holds the company’s debt or any person or corporation they choose could own our ferry system and oversee the operation and the workers as a majority shareholder.

Although the Province gave the BC Ferry Authority (BCFA) Board the \$1000 to buy the single share, the Province cannot prevent the sale of that share. Activation of this clause by the company would affect the true privatization of our ferry system. This is something citizens have clearly stated they do not want and something the Province has not been willing to do in an outright way.

Provincial Role in BC Ferry Services

While the company likes to describe themselves as “independent”, there are many, many ways in which the Province has an active role in the company’s operations. Of course the first is the tax dollar subsidies which the company enjoys.

Tax Dollar Subsidies

The Province not only continues to subsidize this company with tax dollars, it does so at far greater level than it did prior to conversion from a Crown Corporation. Page 46 of LFP shows that the tax subsidy to BCFC was \$72 million in 2002/03. In 2003/04, the first year of operation as the “independent” BCFS company, the subsidy (now characterized as a “service fee”) rose to \$105.8 million dollars, an increase of 32%. One can only wonder how the Crown Corporation would have done with such a sizeable increase in tax dollars to support its operations.

It is interesting to note that the company acknowledges the true nature of these monies on LFP page 13, as follows: “During the 2003/04 fiscal year, BC Ferries carried 21.4 million passengers and 8.3 million vehicles, generating \$533.7 million in revenue, including **federal and provincial subsidies.**” [emphasis ours.]

On page 13 we see too the statement, “The Coastal Ferry Services Contract also provides that the Province will continue to make available to BC Ferries the proceeds of a federal subsidy pursuant to the Canada / British Columbia Coastal Ferry Subsidy Agreement dated April 18, 1977.” The very fact the Federal Subsidy is being handed over to the company is of concern.

I have attached a brief prepared for the Brentwood/Mill Bay Ferry Action Committee which discusses these concerns in detail. Suffice it to say here, the original subsidy of federal taxpayer dollars was intended to support a provincial coastal ferry service, surely not an “independent” company, especially one which spends its capital to

purchase vessels off-shore and then lobbies the federal government for relaxation of duties on those vessels. This agreement comes up for review in 2007. Should it be modified or rescinded due to the new company's activities, BC taxpayers could be placed at risk for increased subsidy payments to keep the company afloat.

In the BCFS Annual Report for 2004/05 (p 46), the provincial service fee is reported at \$106.97 million dollars and the Federal subsidy is \$24.34 million. So the total annual Federal and Provincial subsidies currently amount to more than \$131 million dollars. A windfall of public money indeed for a company "independent of government and operating on a commercial basis" (Service Contract, p 4, item D).

Since this company was removed by the *Coastal Ferry Act* from the scrutiny of the Auditor General, taxpayers have no idea how these tax dollars are truly being spent. This is one of the major flaws in the Act. Like the use of the word "independent", the use of the words "service fee" are linguistic sleight of hand meant to obscure the obvious nature of these tax dollar subsidies.

Financial Solvency

While we are looking at the financial situation of the company, the question of the company's current debt load must be considered as it places BC tax payers and ferry users at great risk.

The Debt to Equity Ratio (ratio of total liabilities to total shareholder equity) is a common method used to consider the financial health of a company.

We turn to page 45 of the *2004/205 BCFS Annual Report* for the *Consolidated Balance Sheets* and to page 89 of the *LFP Consolidated Balance Sheets* for the necessary figures for comparative calculations (as tabulated here in millions of dollars):

| Year | Company | Total Liabilities | Total Equity | Debt to Equity Ratio |
|---------|-------------------|-------------------|--------------|----------------------|
| 2002/03 | BCFC (Crown Corp) | \$133.578 | \$503.178 | 0.27 |
| 2003/04 | BCFS Inc | \$532.362 | \$97.425 | 5.46 |
| 2004/05 | BCFS Inc | \$632.181 | \$131.210 | 4.82 |

First we note the issue of \$500 million in bonds has watered down the shareholder equity in the company from over \$500 million in 02/03 to \$131 million in 04/05 or a reduction in value of more than a 70%. While the company simply says they must borrow money to finance the new ships, we note the bond issues have been used largely to repay the debt to the Province. More borrowings will be necessary to actually build new vessels.

We are concerned as to what the current, very high debt to equity ratios mean to the company's shareholders (ie, BC tax payers) and how this affects the financial stability of the company. Investopedia, an on-line resource for investors (www.investopedia.com), describes debt to equity ratios as follows:

- 1) A high debt/equity ratio generally means a company has been aggressive in financing its growth with debt. This can result in volatile earnings as a result of the additional interest expense.
- 2) If a lot of debt is used to finance increased operations (high debt to equity), the company could potentially generate more earnings than it would have without this outside financing. If this were to increase earnings by a greater amount than the debt cost (interest) then the shareholders benefit as more earnings are being spread around to the same amount of shareholders. However, the cost of this debt financing may outweigh the return that the company generates on the debt through investment and business activities and become too much for the company to handle, which may result in bankruptcy and leave shareholders with nothing, so it is a delicate balance. This is what the leverage effect is about and what the debt/equity ratio measures.
- 3) The debt/equity ratio will also be dependent on the industry the company operates in. For example, capital-intensive industries such as auto manufacturing tend to have a debt-to-equity ratio above 2, while personal computer companies have a debt to equity of under 0.5.

Addressing point 1 in the above discussion, the company's interest expense on long-term debt (as reported in the *04/05 Annual Report*, p 46 *Consolidated Statements of Earnings and Retained Earnings* and *Q2 05/06 BCFS Financial Report*, p 2) in millions of dollars is as follows:

| Year | Company | Interest Expense |
|--------------|-------------------|---|
| 2002/03 | BCFC (Crown Corp) | \$0 |
| 2003/04 | BCFS Inc | \$24.48 |
| 2004/05 | BCFS Inc | \$22.67 |
| Q1& Q2 05/06 | BCFS Inc | \$12,292 (There is another interest payment due on November 28/05.) |

Addressing points 2 and 3 in the above discussion, the debt to equity ratios are **extremely high** even for a capital intensive business. That the company is highly debt-leveraged can not be contested. This is particularly worrying as the Province would have little recourse but to purchase back the service were BCFS to go bankrupt. As we shall see this contingency is well accounted for in the various contracts and legal documents the company and the Province have entered into and would occur at great cost to BC taxpayers.

The Capital Markets Platform section of the LFP (beginning on page 55) contains a section titled Additional Indebtedness Test (pp 56-57) which only exacerbates the concern regarding debt leveraging and the Provincial governments role in the company. The excerpt below regards the banking consortium which holds the \$500 million debt and their requirements as to debt levels. CFO Robert Clark, actually quoted these high debt loads in a public meeting as though the bank consortium which has made over \$12 million in interest and \$4 million in fees on this debt were to be the citizen's guide to prudent debt load! Please note item (e) in particular [emphasis ours]:

There is no limit on the aggregate amount of Borrowings which may be secured under the Indenture. However, other than Permitted Borrowings, BC Ferries will not be permitted to issue any Additional Indebtedness (whether or not secured under the Indenture) unless the Trustee has been provided with a certificate of a senior officer of BC Ferries certifying the following matters, as evidence of BC Ferries' compliance with the test for incurring such Additional Indebtedness (the "Additional Indebtedness Test"):

- (a) that no Default or Event of Default exists or would exist immediately after the issuance of such Additional Indebtedness;
- (b) that the Debt Service Coverage Ratio is at least 1.5:1 and, taking into account the Additional Indebtedness and the use of the proceeds therefrom (with respect to such proceeds, taking into account only EBITDAR derived from the use of such proceeds which BC Ferries reasonably expects to be sustainable), would be at least 1.5:1;
- (c) that the amounts held in the Debt Service Reserve Fund and any Sinking Fund (after reflecting deposits to be made on the date of issuance of such Additional Indebtedness) are at least equal to the amount required to be maintained in the Debt Service Reserve Fund or such Sinking Fund;
- (d) that such Additional Indebtedness ranks no higher than pari passu with any previously issued Bonds; and
- (e) that the Leverage Ratio, taking into account the Additional Indebtedness and the use of proceeds therefrom, would not exceed:
 - (i) if the common shares of BC Ferries are wholly owned by the BCFA, **the Province or any Crown Corporation:**
 - (A) before April 1, 2006, 90%;
 - (B) on or after April 1, 2006, 85%; or
 - (ii) if the common shares of BC Ferries are **not wholly owned by the BCFA, the Province or any Crown Corporation, 75%.**

Here we see that the banks will allow the company to carry a 90% debt load (85% after April 2006) as long as the current structure stands or upon change the Province remains involved in the company. If the Province is not involved, the debt load could not exceed 75%. This places the Province in the position of a guarantor of the independent company's debt load to some degree. These are extremely high debt loads. Although we are not sure what the actual debt service coverage ratio (DSCR) is at the present time, CFO Rob Clark has reported in public meetings the company can borrow more money than it already has from the consortium. This would of course further load the company with debt and water down even more the Province's share value.

One final point regarding the debt load and possible bankruptcy concerns the CEO of BCFS, David Hahn, himself, as follows:

1) Mr. Hahn is touted as an expert in “business restructuring (a polite term for bankruptcy) on the company’s web site (http://www.bcferries.com/about/executive_team.html):

David Hahn has over 20 years of executive experience, much of it with the Ogden Corporation in New York. Over the past seven years he has held the position of Chief Operating Officer at Ogden Aviation, managing U.S. and international operations, including 25,000 employees and airport operations in 30 countries. Prior to joining Ogden Corporation, Mr. Hahn was the Director of Marketing for Hertz Corporation. **He specializes in business restructuring**, strategic planning, revitalized marketing, revenue growth, acquisitions and customer service. Mr. Hahn assumed the position of President and CEO of BC Ferries on May 5, 2003.

2) On LPF page 37, his name in the list of executives and directors bears the following note:

[Note](2) Mr. Hahn was an officer of Covanta Energy Corp. (formerly Ogden Corporation) prior to 1998, and was Executive Vice President and Chief Operating Officer of Ogden Aviation Services Inc., a wholly-owned subsidiary of Covanta, from 1998 to 2003. On April 1, 2002, Covanta and its subsidiaries, including Ogden Aviation, filed petitions under Chapter 11 of the United States Bankruptcy Code. As a result of the Chapter 11 proceedings, the New York Stock Exchange suspended trading in Covanta’s stock in May 2002. Proceedings under Chapter 11 were concluded with the acquisition of Covanta and its subsidiaries in March 2004. Covanta stock is no longer listed on the New York Stock Exchange.

3) A discussion regarding the Covanta bankruptcy published by a bankruptcy creditor’s service (<http://bankrupt.com/covanta.txt>) discusses the highly debt-leveraged company and their inability to pay \$150 million in convertible debentures at maturity, \$45 million in federal and state taxes and interest on an additional \$100 million in debentures. A situation which gives us pause.

Considering the current debt load of BCFS, the rising cost of fuel, the jittery markets and the rising interest rates, from a BC taxpayer and ferry employee or ferry user point of view, Mr. Hahn’s credentials give more disquiet than comfort.

More Taxpayer Risk:

Cross Subsidization, Price Elasticity, Fares and Service Fees

The company has only three sources of funds. These include 1) monies received from customers in fares and retail and reservation transactions, 2) federal and provincial subsidies and 3) borrowings. These sources are intertwined in the sense that a shortfall in one area must be made up for by retrieval from another for the company to remain financially viable.

It should be pointed out at this juncture, the three major routes from the mainland to Vancouver Island do not receive a provincial subsidy since they make a profit. Never mind that much of the traffic is from the minor route ferries, the Coastal Ferry Act specifically states that cross subsidies from major to minor routes be kept to a minimum in the current term and phased out altogether in the second term beginning in April 2008. Significantly, the current increased service fees and increased fares are covering all costs on all routes for the independent company as the Nov 21/05 *What’s New* posting on the Ferry Commission web site informs us:

“...one of the principles of the Coastal Ferry Act is that cross subsidization from major routes to other routes should be eliminated by March 31 2008 and minimized before then: consistent with this, in 2004/5 the major route group did not cross subsidize the other 22 routes; the latter had a break-even year (even if deferred fuel costs are included as current operating expenses).”

Also it should be noted, the three major routes do have core service levels to be maintained under the *Service Contract* (p 30) and thus are termed *designated* routes. The *Service Contract* lists \$512 million in capital projects for these major routes over the next five years. How these will be paid for remains a mystery. It is our understanding that the cost of the new vessels, docks, terminals and ship upgrades will be added to fares on the routes to which they apply. However, there is nothing to preclude a service fee (tax subsidy) being added for these routes in 2008 if necessary to maintain the commercial viability of the routes in the face of these capital projects which include the three new Class C German vessels.

Price elasticity of fares on the minor routes is an ongoing concern. Regardless of the fact the Coastal Ferry Act calls for a move to “greater reliance on a user pay system”, it is apparent from the company’s own studies that use

will drop off as fares continue to increase. On pages 15 & 16 of the LFP, the company states:

“Demand on Northern and Other Routes is relatively more inelastic (less sensitive to price changes) than demand on Major Routes because those customers make a much higher proportion of non-discretionary trips and there are fewer alternatives for travel to and from the communities served by those routes.”

A table follows in the LFP which shows for a real fare increase of +10%, BCFS can expect only a +6.3% revenue impact on major routes and a +8.7% impact on the Northern and Other [minor] routes.

The company has just applied for a second fuel surcharge which will bring that fee to a total of 12% on the minor routes and 6.5% on the major routes this year. Obviously the surcharges are based not on what is fair and reasonable for ferry users in ferry-dependent communities, but rather on what the market will bear.

On the major routes where trips are more discretionary, the surcharges are half those of the routes where travellers are more captive customers. In 2008 when the next performance term's fares and service fees are negotiated the surcharges affect on profitability of routes will be a factor in determining both service fees and fares.

This places taxpayers at risk of increased subsidies occurring from company decisions. Furthermore in 2008, all of the monies in the 1st fuel deferral account will be added into fares. (We do not yet know what the Commissioner will determine as to customer repayment of the 2nd surcharge.) As of September 30th (*Q2 05/06 BCFS Financial Report*, p 2), these deferred fuel costs were at \$16.5 million. It is obvious the company will not be able to continue to increase fares at the rate they have been doing to fund the company and still maintain traffic volume. Really, their only other sources of revenue besides fares are our tax dollars and borrowing from the banks.

That the company is aware of the law of diminishing returns on fares, is apparent in another way as well. Namely in their request to the Province in the Northern Strategy Report that the cost of new vessels for the Northern Routes be reflected in increased service fees. The customers in these ferry dependent northern communities can not bear the full burden of new vessel cost in increased fares as the Act clearly intends. Especially when one considers the 4.4% annual increase on all minor routes added to the 12% fuel surcharge fare increase. this amounts to a total of 16.4% increase this year alone. In a similar manner, at the recent August 05 Public Consultation in Powell River, members of the public Strategy Review Committee were told by CFO Robert Clarke to “lobby the government” for increased service fees to keep the fares down when new ships are added to the Powell River Routes.

Significantly, the BCFS Report requesting the increase in service fees on the Northern routes has been sitting on the desk of Minister of Transportation, Kevin Falcon, since August of 2004. That the government is reluctant to announce an increase in services fees can be deduced from the 15-month hold they have put on making this decision while they “negotiate” with BCFS. This reeks of political interference, something we were told would NOT happen under the new company structure.

It is becoming more and more apparent that the two reasons given to taxpayers for establishing the new company structure — namely to reduce government interference and to “save” \$2 billion in tax payer dollars when building the new ships was wishful thinking at best. And this wishful thinking continues in the company's own statements. On page 53 of the LFP, the company states in their Capital Plan:

“Over the next decade, approximately \$1.8 billion in capital expenditures is planned to replace ageing vessels and upgrade terminals. Approximately 70% of such expenditures will be associated with new vessel acquisitions, vessel upgrades and component replacement, with the balance allocated to terminals and other projects. ...BC Ferries estimates that cash provided by operating activities will be sufficient to fund approximately half of the capital expenditures over the next decade.”

This statement was written in October of 2004. At that time, the half of the capital expenditures to be funded from cash from operations would amount \$900 million over 10 years or \$90 million per year. Of the \$180 million spent as capital investment over the last two years, only \$18.5 million or 10% has gone towards new ship construction (for preliminary payments on the Super C-class German vessels). Hopefully, BCFS will soon stop the cosmetic upgrades to terminals and ships and put their limited investment dollars into new ship construction. Then tax payers will not be so likely to bear the burden of the cost of new vessels, and fleet replacement could begin in earnest.

We have some miscellaneous questions generated by the BCFS books which we hope the Auditor General will also address.

1) On page 58 of the 04/05 BCFS Annual Report, Notes to Consolidated Financial Statements, Note 13(c), we find this statement under *Risks*:

(c) Foreign exchange risk: The Company may enter into foreign exchange forward contracts to manage its exposure on future purchase commitments. As at March 31, 2005, the Company has entered into foreign exchange forward contracts valued at Cdn \$449.9 million, for the committed cost, including customs and duty, of three new Super C-class vessels that are payable in euros (March 31, 2004 - nil).

What is the real value of the contracts on the Super-C's? What are the fees the company is paying on these foreign exchange contracts? The company had previously stated amounts were guaranteed and assured us they chose the off-shore shipbuilder due to a lower price than Canadian shipbuilders could offer. Were the federal duties and the risk contracts costs calculated into the bid evaluations? None of this information is available to the public. A public who could well bear some of the costs of these ships as we have discussed above.

2) We see the company has received some more federal tax dollars, this time for Interest Rate Support (Q2 05 BCFS Financial Report, Note 6, p 7):

“During the period, the Company received interest rate support from the Government of Canada. The government has agreed to provide \$4.0 million in the form of interest rate support to the Company. Of this, \$0.5 million has been recorded as a reduction of capitalized interest and \$1.0 million as reduction of interest expense. The remaining \$2.5 million will be recognized over the next fifteen months as a reduction of interest expense. The Company has no requirement to repay these funds, other than as a result of an event of default on bond interest payments.”

We would be interested in learning the exact nature of this tax subsidy. Whether it has been granted to other companies, when it was granted, by whom and the rationale?

3) And just below this as Note 7 a statement of an error in the cash flow for June 30/05 :

“Reclassification of cash flow statement for the three months ended June 30, 2005: The June 30, 2005 cash flow statement has been amended to correct a misclassification of nonoperating working capital totalling \$15.9 million. The effect of this reclassification is to decrease previously reported cash used by changes in operating working capital by \$15.9 million and to increase previously reported cash used in the purchase of capital assets by \$15.9 million during the three months ended June 30, 2005.”

Obviously, it is time for the Auditor General to assist the citizens of this Province in understanding what is going on at this company by a thorough examination of the company's books.

Additional Provincial Liabilities

There are numerous other provincial obligations/liabilities contained in company documents. All of these mean the Province is carrying risk for the “independent” company, BCFS. Should the company be unable to meet its commitments, the Province would have little option but to take over the operations of the ferries again. I will outline these obligations/liabilities briefly before we examine the Indenture documents including the Acknowledgement Agreement in detail. [All emphasis in following quotes is ours.]

1) Vessel Purchase Options (LFP p 14)

[a]“ If a vessel becomes surplus to BC Ferries' requirements as a result of a route discontinuance authorized by the Commissioner, BC Ferries has an option to require the Province to purchase that surplus vessel for net book value, provided that BC Ferries has used all reasonable commercial efforts to redeploy the surplus vessel.

[b]“The Province has an option to purchase a vessel (free and clear of all liens) for net book value if the vessel is no longer needed and BC Ferries wishes to dispose of it.

[c]“Subject to the terms of the Acknowledgement Agreement, the Province also has the option to purchase each of the vessels owned or leased by BC Ferries and used to provide services under the Coastal Ferry Services Contract upon the occurrence of an event of default under the Coastal Ferry Services Contract by BC Ferries.”

The option [a] above which requires the Province to purchase vessels makes BC taxpayers liable and places them at risk if the company cannot fulfil its obligations under the *Service Contract*. The third option [c] above is not really an option since if the company were to default on its obligations, the Province would have no option but to purchase the vessels in order to keep the essential service of ferry transportation available to ferry dependent communities and fulfil their obligations under the Federal Agreement.

2) Master Agreement and Terminal Leases (LFP p 14)

“If BC Ferries fails to meet its obligations under a Terminal Lease, or upon an event of default under the Coastal Ferry Services Contract by BC Ferries, the **BCTFA may at its option re-enter and take possession of the ferry terminal properties** (including leasehold improvements) and at its option terminate the lease, subject to the terms of the Acknowledgement Agreement. In addition, BC Ferries has a right to terminate a Terminal Lease in certain circumstances where BC Ferries has been authorized by the Commissioner to discontinue a route.”

This option similarly is not really an option for the Province if it is to maintain the essential transportation service.

3) Service Contract Term and Renewal (LFP p 30)

“The Coastal Ferry Services Contract has a 60 year term, but may be renewed for an additional 20 year term if mutually agreed. If the Coastal Ferry Services Contract is not renewed the **Province has the option to purchase all the outstanding shares of BC Ferries at fair market value** (determined as if the Coastal Ferry Services Contract had been renewed for 20 years), **or may solicit proposals from others interested in providing ferry services on one or more designated routes.**

“ If the Province elects not to contract with BC Ferries for the provision of ferry services on a designated route after the expiry of the initial 60 year term of the Coastal Ferry Services Contract, BC Ferries has the right to require the Province to purchase surplus vessels that were used on that route for net book value, subject to certain conditions.”

These two options make it seriously unlikely that Province would not renew the 60 (actually 80) year Service Contract. They severely limit the ability of the Province to protect its citizens from inadequate service and unreasonable rates thereby placing citizens (especially those in ferry dependent communities) and ferry employees at risk.

The independent regulator is no substitute for the ability of the Province to protect its citizens since the regulator does not regulate in the public interest as evidenced by Section 38 of the Act which states as follows the Principles of Regulation:

- (a) priority is to be placed on the financial sustainability of the ferry operators;
- (b) ferry operators are to be encouraged to adopt a commercial approach to ferry service delivery;
- (c) ferry operators are to be encouraged to seek additional or alternative service providers on designated ferry routes through fair and open competitive processes;
- (d) ferry operators are to be encouraged to minimize expenses without adversely affecting their safe compliance with core ferry services;
- (e) cross subsidization from major routes to other designated ferry routes is
 - (i) to be eliminated within the first performance term of the first Coastal Ferry Services Contract to be entered into under this Act, and
 - (ii) before its elimination, to be minimized;
- (f) the designated ferry routes are to move towards a greater reliance on a user pay system so as to reduce, over time, the service fee contributions by the government.

4) Adjustment of Service Levels and Fees (LFP p 31)

“If BC Ferries deploys a new capital asset in the form of one or more vessels on a designated ferry route and the size of the new vessel or vessels enhances capacity on that designated route, the core service level in relation to that designated route may be amended at any time by mutual agreement of the parties and if such an amendment is made, the parties must amend all portions or provisions of the Coastal Ferry Services Contract affected by such amendment, including, as applicable, service fees.”

This statement goes to the fact that the company has control to some extent of the level of our tax dollar service fee subsidy during the process of capital asset deployment. It is the company after all which recommends the size of the vessels and controls the statistical data on which these recommendations are made. It would be difficult for the Province to contend that their recommendations are invalid, inaccurate or unnecessary. Once

again taxpayers are placed at risk by the decisions made by the company.

5) **Province Retains liability for First Nations Matters** (LFP p 34)

“The Province retains its liability, to the extent any exists, for the acts and omissions of the Province that occurred prior to BC Ferries’ possession of the terminal lands, and the Province agrees to reimburse BC Ferries for any damages it suffers as a result of a determination by a Canadian court that there has been an unjustifiable infringement of aboriginal rights or title by the Province in connection with the terminal lands. In addition, the Province will reimburse BC Ferries for damages suffered by BC Ferries if there is a final court decision or a treaty settlement that recognizes or confers upon a First Nation a proprietary or other interest in the ferry terminal properties and that right or interest interferes with BC Ferries’ quiet enjoyment of the ferry terminal properties as set out in the Terminal Leases. “

Suffice it to say this could comprise a significant liability for BC tax payers.

6) **Force Majeure Event to Terminals** (p 34, LFP, *Right to Terminate* heading)

“Where a terminal property is destroyed or so damaged as to be unfit for occupancy as a result of an event of force majeure, and the cost of restoration is not covered by insurance or by compensation from the Province, BC Ferries may elect to terminate the applicable Terminal Lease.”

The termination of a lease if there were an earthquake, flood, terror attack, etc. creates risk for taxpayers.

7) **Credit Facility**

Over and above the \$500 million bond debt, the company also has a line of credit (a bank loan). As such, the line of credit has a floating interest rate. A rather frightening prospect in today’s escalating interest rate economy. The *Second Supplemental Indenture* document deals with this Credit Facility. Basically it allows a further bond issue of \$710 million at time-of-initiation-current interest rates (up to 25%) should the company default on its line of credit. On page 73 of the LFP we read:

“On May 26, 2004 BC Ferries entered into the Credit Facility. Tranche A and Tranche B are available for working capital purposes, including to fund the Series Reserve Account for Tranche C, to fund the upgrade and acquisition of vessels and terminal upgrades and other general corporate uses. Tranche C was used to repay, in part, obligations to the Province and to fund the Series Reserve Accounts under the Indenture and the Supplemental Indentures...”

The Credit Facility agreement does not contain material restrictions on BC Ferries in addition to those contained in the Indenture, except that, under the Credit Facility agreement, BC Ferries must maintain a minimum Debt Service Coverage Ratio of 1.50:1. **It is an event of default if BC Ferries ceases to be at least 51% owned by the BCFA or the Province ...”**

Once again ownership by the Province cited as a condition, in this case for the very existence of the Credit Facility.

8) **Obligations under Capital Leases** (LFP p 99)

“During the year ended March 31, 2003, the lessors of each of the Company’s capital leases, namely the charters of the Queen of Surrey and the Queen of Oak Bay, agreed to the assignment of the existing bare-boat charter agreements to the BCTFA. **The Province, as the guarantor of the original leases, agreed to continue its guarantee following the assignment.**

BCTFA then immediately sub-chartered each of the vessels to the Company in exchange for a one-time payment representing the present value of all remaining payments under the first term of each of the original agreements. At the same time, the Company purchased options for amounts equal to the present values of each of the vessels’ buyout charge. These options, if exercised, require BCTFA to exercise the buyout clauses available at the end of the first term of each of the original agreements and to transfer the titles to the Company. The exercise price is \$1 for each option. The Company has declared its intention to exercise each of its options. It is anticipated that the title of the Queen of Surrey will pass, without additional payments, on January 1, 2006. It is anticipated that the title of the Queen of Oak Bay will pass, without additional payments, on January 1, 2007. “

Another honey of a deal, where the Province acts as guarantor for the independent company and transfers our tax dollar investment in the leases prior to March 2003 to the company for \$1.

9) **Events of Default and Remedies** (LFP pp 32-33)

“The Coastal Ferry Services Contract provides that the following events will constitute an event of default under the agreement:

- BC Ferries fails to comply with any material provision of the agreement and such failure is not cured within 30 business days after notice, or longer if the failure would reasonably require more than 30 days to rectify;
- any representation or warranty made by BC Ferries or any information furnished or submitted to the Province by BC Ferries is materially untrue or incorrect;
- BC Ferries fails to give notice to the Province of a default under the agreement;
- an order is made, resolution passed or petition filed for the liquidation or winding up of BC Ferries;
- BC Ferries becomes insolvent or commits an act of bankruptcy or a bankruptcy petition or proposal is filed or a receiver of BC Ferries is appointed;
- BC Ferries fails to pay any sum owed by it which materially adversely affects its ability to perform its obligations under the Coastal Ferry Services Contract;
- BC Ferries ceases to carry on business as a going concern;
- any action is taken to enforce any security interests which materially affects BC Ferries' ability to carry on business as a going concern;
- BC Ferries fails to make any payment due under one or more of the Terminal Leases; or
- BC Ferries fails to comply with any order issued by the Commissioner.

Upon an event of default by BC Ferries under the Coastal Ferry Services Contract, or at any time thereafter, the Province may, at its option, subject to the terms of the Acknowledgement Agreement and any trust deed to secure borrowings, elect to do any one or more of the following:

- suspend or adjust any installment of the service fees;
- require BC Ferries to remedy the default within a period of time specified by the Province and if not remedied within that time period perform the obligations itself at BC Ferries' expense;
- waive the default;
- exercise its option to purchase the vessels;
- request that the Commissioner issue an order requiring BC Ferries to remedy the default;
- bring legal action; or
- pursue any other remedy available to it at law or in equity.

In addition, the BCTFA can terminate the Terminal Leases upon the occurrence of an event of default under the Coastal Ferry Services Contract, as described under "Terminal Leases" below."

If the Province in fact were forced to issue a default against BCFS, all would not be as written above in the Service Contract however.

First, we must understand that when the Bonds were issued all of the assets of BC Ferries were mortgaged to the Banking Consortium. This included not only the vessels and the prepaid terminal leases, but also the *Service Contract*. That is correct. Our present and future tax dollar subsidy was mortgaged to the banks!

Aside from the questionable legality of this action, the powers of the independent regulator—supposedly our one guarantee for public protection from a monopolized essential service—were subsumed to the powers of the Banks and their Trustee to some degree.

The banks and their Trustee actually would be running the ferry service in case of default. See item 5.6 *Power of Attorney*, page 69 of the *Master Trust Indenture*. And they would be remedying the default. Furthermore, the banks have not 30 days as the *Service Contract* states, to act to remedy a default, but rather 60 days.

It is the *Acknowledgement Agreement* signed by the Province which allows for these changes. Page 8 of the *Master Trust Indenture* defines the *Acknowledgement Agreement* as follows:

"Acknowledgement Agreement" means an agreement, substantially in the form annexed as Schedule F, between the Province, BCTFA, BC Ferries and the Trustee, for and on behalf of the Bondholders, providing for, among other things, an acknowledgement of the rights of the Trustee, for and on behalf of the Bondholders, under this Indenture, as such agreement may be amended from time to time.

Not only do these documents double the time allowed for remedy to default, they also bar the Province from taking "severe remedies" listed in the *Service Contract*. As residents and business owners in ferry dependent communities and employees of the company will readily acknowledge, 60 days without a ferry service operating to contracted requirements would be untenable.

Furthermore, The Province would be forced to action should the Trustee seek remedy to a default of its contracts with BCFS, as outlined on page 64 of the LFP:

"Upon the occurrence of an uncured Event of Default, the Trustee may, and if directed by a Bondholders' Request shall:

- (a) declare all Bonds outstanding under the Indenture to be immediately due and payable; and
- (b) enforce the Security or any part thereof.

The Province, if it wished to keep the essential ferry service operational, would have to purchase the ships, take over the terminals and exercise its option to buy out the debt as stated on page 56 of the LFP:

“Right of Province to Purchase

The Indenture provides for the right of the Province, at any time at its option and upon providing written notice, to purchase all, but not less than all, of the outstanding Bonds at a price equal to the Redemption Price for each Series of Bonds as set out in the Supplemental Indenture authorizing such Series of Bonds.”

If the Province did not exercise its right to purchase the debt and the fleet to resume operations of the ferry service, the Banks would choose who would be running our ferry service. An evaluation of the cost of such a buy-out would be useful information for both the provincial government and the citizens of the province. We have heard estimates ranging from one to two billion in buy-out costs. It may well be the cost of all financial instruments and the assets would be prohibitive and our entire service would be privatized.

Acknowledgement Agreement

The Acknowledgement Agreement signed by the Province is the most frightening document for citizens. It calls into question the priorities of the government in allowing our tax dollar subsidies to be mortgaged and in signing away remedies to default of the *Service Contract*.

Whether or not the Province has abrogated its fiduciary duty to the citizens of this Province by being signatory to this document, must be seriously questioned. Can the Province legally acknowledge the signing over to the banks “all sources of revenue” when those sources include future tax payer dollars for 80 years?

Here is a list from page 75 of the LFP which details most of what the Province acknowledged with its signature:

The Province, the BCTFA, BC Ferries and the Trustee have entered into an Acknowledgement Agreement pursuant to which the Province and the BCTFA have acknowledged and agreed, amongst other things, that:

- (a) BC Ferries intended, as security for the observance and performance by BC Ferries of its obligations under the Indenture and any Supplemental Indenture, to assign all of its right, title and interest in the Coastal Ferry Services Contract and the Master Agreement to the Trustee for the benefit of the holders of the Bonds (which assignment was effected in conjunction with the issue of the Series 04-1 Bonds);
- (b) BC Ferries intended, as security for the observance and performance by BC Ferries of its obligations under the Indenture and any Supplemental Indenture, to mortgage by way of sublease to the Trustee for the benefit of the holders of the Bonds, all right, title and interest in each of the Terminal Leases (which mortgage was effected in conjunction with the issue of the Series 04-1 Bonds);
- (c) the Trustee will have the right upon an Event of Default under the Indenture to take possession of the Collateral and to appoint a receiver to operate the business of BC Ferries in accordance with the terms of the Coastal Ferry Services Contract;
- (d) the Trustee or receiver will have the right to cure defaults under the Coastal Ferry Services Contract and the Terminal Leases within the time periods provided in the Acknowledgement Agreement;
- (e) subject to certain exceptions, the Province and BCTFA will not exercise their remedies (including any remedies under the Terminal Leases) upon the occurrence of an Event of Default under the Coastal Ferry Services Contract or Terminal Leases so long as the receiver appointed by the Trustee is using reasonable commercial efforts to conduct the business of BC Ferries in accordance with the terms of the Coastal Ferry Services Contract and the Terminal Leases;
- (f) if there is a service default (defined as the failure to provide services on a route in accordance with the core service level for that route under the Coastal Ferry Services Contract, except as permitted by that contract) in respect of a particular route and the Trustee or a receiver has not commenced rectification of such default within the time period required or is no longer diligently proceeding with rectification of such default, then after notice, unless such default is cured, the Province may terminate such route and any Terminal Lease used exclusively for such route and shall concurrently exercise its option to purchase vessels used on such route;
- (g) if there are service defaults in respect of Minor Routes which represent 50% of the directly attributable revenue of all Minor Routes and the Trustee or a receiver has not commenced rectification of such defaults within the time period required or is no longer diligently proceeding with rectification of such defaults, then after notice, unless such defaults are cured, the Province may terminate all Minor Routes and any Terminal Leases used exclusively for Minor Routes and shall concurrently exercise its option to purchase vessels used on Minor Routes;
- (h) if there are service defaults on routes which represent 50% of the directly attributable revenue from all routes and the Trustee or

- a receiver has not commenced rectification of such defaults within the time period required or is no longer diligently proceeding with rectification of such defaults, then after notice, unless such defaults are cured, the Province may terminate all routes under the Coastal Ferry Services Contract and all Terminal Leases and shall concurrently exercise its option to purchase all vessels;
- (i) the termination of a particular route or Terminal Lease by the Province or BCTFA will eliminate any requirement in the Coastal Ferry Services Contract to provide services on such route or routes to or from the Ferry Terminal Property which is the subject of the terminated Terminal Lease; and
 - (j) if, following the occurrence of an event of default under the Coastal Ferry Services Contract or under a Terminal Lease, there is a disruption in the provision of services under the Coastal Ferry Services Contract that is not a temporary service disruption (as defined in the Coastal Ferry Services Contract), or there is a disruption as a result of an event of force majeure and the Province is in a materially better position than BC Ferries to restore the disrupted services during the continuance of the event of force majeure, the Province may assume management of the operations of BC Ferries in accordance with the terms of the Acknowledgement Agreement until the appointment of a receiver by the Trustee.”

We respectfully request the Auditor General examine this agreement and the related indenture documents in detail in order to ascertain the risks to BC taxpayers and the legality of the actions the government has taken.

Additional Risks

The following concerns are not referenced in the LFP and are therefore appended to this report here.

1) Deas Pacific Marine

Deas Pacific Marine, the only subsidiary to date of the company, is rarely referred to and with good reason. It loses almost \$10 million per year and is responsible for all the refit work for BC Ferries. It does not operate like a shipyard and has reverted back to its original status as a maintenance and refit facility. Under its current management it is losing enough money in three years to construct a new intermediate class vessel.

How the company is managing this subsidiary requires careful scrutiny. Any management decisions being made which create liability for the company also creates liability for BC tax payers as we have seen through the course of this report.

2) Tax Exempt Status

BC Ferries enjoys the privilege of not paying taxes and is still in court attempting to get reimbursement of excise tax money for the last decade or more. This is a well known Federal case that has been going on for some time. As an “independent” company, will this case still have the same weight? Or will this prove to be yet another financial lose which this “independent” company and BC taxpayers can hardly afford?

Further, as some shipowners have pointed out to the Ferry Commissioner in the ASP process documents, this makes the ASP process something of a joke in that a shipowner who is not tax exempt can hardly compete with one who is. If the ASP process is not competitive then its alleged purpose of placing BCFS in the competitive market to test its management of the company is also a joke and affords no protection to BC tax payers at all.

BC Ferries has also been aggressively lobbying Ottawa and Minister David Emerson (who at one time sat on the Board of BCFC) for duty remission on the new Super C’s valued at \$80 million dollars. No other shipowner in the country would be given air-time to gain that kind of remission from duty. Why is this even being considered by the Federal government if they do not see the BCFS Service as in some way an essential, provincial transportation service. How can BCFS expect to have their have their independent cake and eat it too?

3) Insurance Liabilities

The Marine Industry in general is increasingly becoming dependent upon liability insurance and BC Ferries premiums must be sky-rocketing. For example, the newly enacted Migratory Bird Convention Act (Amended) carries escalating fines of \$1 million per day and up to three years in jail for depositing oil or other substances harmful to migratory birds in the water. The onus is on the shipowner or the ships’ officer to prove they either acted with due diligence or that they didn’t do it. This is reverse onus and destroys the presumption of innocence formerly guaranteed under the Charter of Rights and Freedom.

BC Ferries will not be able to sidestep this federal law. Union President, Jackie Miller, has spoken directly to

Environment Canada Directors and they are making no special deals. Huge fines and possibly jail time will be in the future for BC Ferries, its management and its crews because of its aging, leaking fleet. Another liability for this company with a huge debt load which could ill afford such fines and stay in business.

BC Ferries will be enjoying financial assistance, no doubt, to enhance maritime security for the fleet as per a Board of Directors requirement. This is not so much to ensure the safety of the fleet but to again to appease the insurance companies.

Further to that, BC Ferries has experienced its worst year ever in terms of vessel breakdowns and maintenance issues, not to mention the Queen of Oak Bay grounding which cost the company \$3 million just for starters. In the event of a major marine disaster involving loss of life, BC Ferries will sink like a stone.

The Marine Liability Act, the Migratory Bird Convention Act and new provisions of the Criminal Code of Canada coupled with a fleet that is the second oldest in the world and whose maintenance is improperly planned or left off entirely, in favour of cosmetic terminal and ship renovations renders BC Ferries an outstanding risk.

Summary

We respectfully submit this report to the Auditor General and trust it will prove of use to his office in the ir examinations of and deliberations on BC Ferries Services, Inc.

We believe the *Coastal Ferry Act* is seriously flawed and needs to be repealed or amended to protect the interests of the tax payers of this province, provincial agreements with the federal government, the users and employees of the ferry service and residents of ferry-dependant communities.

We applaud the examination of the company and expect the preliminary investigation will lead eventually to a full audit of the company's books and recommendations from the office of the Auditor General for protection of BC taxpayer interests in this matter.