Condensed Interim Consolidated Financial Statements

BRITISH COLUMBIA FERRY SERVICES INC.

Nine months ended December 31, 2017 and 2016
(Unaudited)

BRITISH COLUMBIA FERRY SERVICES INC.

Condensed Interim Consolidated Statements of Financial Position (Unaudited)
(Expressed in thousands of Canadian dollars)

	December 31, 2017	March 31, 2017
Assets		
Current assets		
Cash and cash equivalents	105,282	72,032
Restricted short-term investments (note 6(b))	32,466	32,426
Other short-term investments	143,195	115,582
Trade and other receivables	26,075	15,319
Prepaid expenses	8,042	7,454
Inventories	29,163	28,257
Derivative assets (note 9)	11,617	1,604
	355,840	272,674
Non-current assets		
Loan receivable	24,515	24,515
Land lease	29,886	30,230
Property, plant and equipment (note 3)	1,691,973	1,621,802
Intangible assets (note 4)	98,889	97,673
	1,845,263	1,774,220
Total assets	2,201,103	2,046,894
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	62,610	55,173
Interest payable on long-term debt (note 5)	16,522	18,458
Deferred revenue	33,355	20,705
Derivative liabilities (note 9)	-	1,048
Current portion of long-term debt (note 5,6)	34,573	30,939
Current portion of accrued employee future benefits	1,400	1,400
Current portion of obligations under finance lease (note 5)	1,617	1,582
Provisions	59,537	55,711
	209,614	185,016
Non-current liabilities		
Accrued employee future benefits	22,282	20,913
Long-term debt (note 5,6)	1,290,621	1,273,860
Obligations under finance lease (note 5)	39,208	40,423
Other liabilities (note 7)	7,750	5,250
	1,359,861	1,340,446
Total liabilities	1,569,475	1,525,462
Equity		
Share capital	75,478	75,478
Contributed surplus	25,000	25,000
Retained earnings	524,931	424,020
Total equity before reserves	625,409	524,498
Reserves (note 10(a))	6,219	(3,066)
Total equity including reserves	631,628	521,432
Total liabilities and equity	2,201,103	2,046,894

Commitments (note 3)

See accompanying notes to the condensed interim consolidated financial statements.

BRITISH COLUMBIA FERRY SERVICES INC.

Condensed Interim Consolidated Statements of Comprehensive Income (Unaudited)
(Expressed in thousands of Canadian dollars)

	Three months ended December 31		Nine months ended December 31	
	2017	2016	2017	2016
Revenue				
Vehicle and passenger fares	136,201	127,066	524,626	502,443
Ferry service fees	40,380	38,866	141,874	138,909
Net retail (note 11)	13,147	12,090	49,950	45,807
Federal-Provincial Subsidy Agreement	7,446	7,289	22,337	21,868
Fuel rebates (note 16)	(4,169)	(3,787)	(15,783)	(14,764)
Other income	2,243	2,139	7,741	7,512
Total revenue	195,248	183,663	730,745	701,775
Expenses (note 12)				
Operations	117,637	110,191	376,538	353,964
Maintenance	28,185	18,009	62,751	53,252
Administration	9,020	8,577	28,243	25,361
Depreciation and amortization	40,453	37,065	119,101	110,278
Total operating expenses	195,295	173,842	586,633	542,855
Operating (loss) profit	(47)	9,821	144,112	158,920
Net finance and other expenses (note 13)				
Finance income	1,501	1,262	3,929	3,446
Finance expenses	(15,284)	(15,073)	(45,872)	(44,018)
Net finance expense	(13,783)	(13,811)	(41,943)	(40,572)
(Loss) gain on disposal and revaluation of property, plant and equipment, intangible assets and inventory	(1,009)	25	(1,258)	(128)
Net finance and other expenses	(14,792)	(13,786)	(43,201)	(40,700)
NET (LOSS) EARNINGS	**(14,839)**	**(3,965)**	**100,911**	**118,220**
Other comprehensive income (note 10(b))				
Items not to be reclassified to net earnings	-	-	(1,943)	(1,240)
Items to be reclassified to net earnings	9,731	6,325	10,541	16,861
Total other comprehensive income	9,731	6,325	8,598	15,621
Total comprehensive (loss) income	(5,108)	2,360	109,509	133,841

See accompanying notes to the condensed interim consolidated financial statements.

BRITISH COLUMBIA FERRY SERVICES INC.

Condensed Interim Consolidated Statements of Cash Flows (Unaudited)
(Expressed in thousands of Canadian dollars)

	Nine months ended December 31	
	2017	2016
Cash flows from operating activities		
Net earnings	100,911	118,220
Items not affecting cash		
Net finance expense	41,943	40,572
Depreciation and amortization	119,101	110,278
Loss on disposal and revaluation of property, plant and equipment, intangible assets and inventory	1,258	128
Other non-cash changes to property, plant and equipment	481	(1,604)
Changes in:		
Accrued employee future benefits	(574)	361
Derivative assets and liabilities recognized in net earnings	(20)	(10)
Provisions	3,826	4,347
Long-term land lease	344	344
Accrued financing costs	136	271
Total non-cash items	166,495	154,687
Movements in operating working capital		
Trade and other receivables	(10,756)	3,529
Prepaid expenses	(588)	(400)
Inventories	(906)	(2,244)
Accounts payable and accrued liabilities	7,437	(9,379)
Deferred revenue	12,650	(1,991)
Change in non-cash working capital	7,837	(10,485)
Change attributable to capital asset acquisitions	(1)	3,040
Change in non-cash operating working capital	7,836	(7,445)
Cash generated from operating activities	275,242	265,462
Interest received	3,624	3,149
Interest paid	(51,434)	(50,469)
Net cash generated by operating activities	227,432	218,142

BRITISH COLUMBIA FERRY SERVICES INC.

Condensed Interim Consolidated Statements of Cash Flows (Unaudited)
(Expressed in thousands of Canadian dollars)

	Nine months ended December 31	
	2017	2016
Cash flows from financing activities		
Proceeds from long-term debt	45,264	44,858
Repayment of long-term debt	(24,241)	(15,750)
Repayment of finance lease obligations	(1,180)	(1,129)
Deferred financing costs incurred	(1,417)	(1,495)
Net cash generated by financing activities	18,426	26,484
Cash flows from investing activities		
Proceeds from disposal of property, plant and equipment	471	137
Purchase of property, plant and equipment and intangible assets	(185,426)	(149,705)
Changes in debt service reserve	(40)	(130)
Net purchase of short-term investments	(27,613)	(56,395)
Net cash used in investing activities	(212,608)	(206,093)
Net increase in cash and cash equivalents	33,250	38,533
Cash and cash equivalents, beginning of period	72,032	79,113
Cash and cash equivalents, end of period	105,282	117,646

BRITISH COLUMBIA FERRY SERVICES INC.

Condensed Interim Consolidated Statements of Changes in Equity (Unaudited)
(Expressed in thousands of Canadian dollars)

	Share capital	Contributed surplus	Retained earnings	Total equity before reserves	Reserves (note 10(a))	Total equity including reserves
Balance as at March 31, 2016	75,478	25,000	352,692	453,170	(24,223)	428,947
Net earnings	-	-	118,220	118,220	-	118,220
Other comprehensive income	-	-	-	-	15,621	15,621
Realized hedge losses recognized in fuel swaps	-	-	-	-	6,015	6,015
Hedge losses on interest rate forward contract reclassified to net earnings	-	-	-	-	186	186
Balance as at December 31, 2016	75,478	25,000	470,912	571,390	(2,401)	568,989
Balance as at March 31, 2017	75,478	25,000	424,020	524,498	(3,066)	521,432
Net earnings	-	-	100,911	100,911	-	100,911
Other comprehensive income	-	-	-	-	8,598	8,598
Realized hedge losses recognized in fuel swaps	-	-	-	-	501	501
Hedge losses on interest rate forward contract reclassified to net earnings	-	-	-	-	186	186
Balance as at December 31, 2017	75,478	25,000	524,931	625,409	6,219	631,628

See accompanying notes to the condensed interim consolidated financial statements.

British Columbia Ferry Services Inc. (the “Company”) was incorporated under the *Company Act (British Columbia)* by way of conversion on April 2, 2003, and now validly exists under the *Business Corporations Act (British Columbia)*. The Company’s primary business activity is the provision of coastal ferry services in British Columbia.

The Company is subject to the *Coastal Ferry Act* (the “Act”) as amended, which came into force on April 1, 2003. Its common share is held by the B.C. Ferry Authority (the “Authority”), a corporation without share capital, and it is regulated by the British Columbia Ferries Commissioner (the “Commissioner”) to ensure that rates are fair and reasonable and to monitor service levels.

The Company’s business is seasonal in nature, with the highest activity in the summer (second quarter) and the lowest activity in the winter (fourth quarter), due to the high number of leisure travellers and their preference for travel during the summer months. The Company also takes advantage of the low activity during the winter months to perform a significant portion of the required annual maintenance on vessels and terminals.

1. Accounting policies:

These condensed interim consolidated financial statements do not include all disclosures normally provided in annual financial statements and should be read in conjunction with the Company’s audited consolidated financial statements and the related notes for the year ended March 31, 2017, as they follow the same accounting policies, unless otherwise indicated.

(a) Basis of preparation:

British Columbia Ferry Services Inc. is a company domiciled in Canada. The address of the Company’s registered office is Suite 500, 1321 Blanshard Street, Victoria, BC Canada, V8W 0B7. These condensed interim consolidated financial statements as at and for the three and nine months ended December 31, 2017 and 2016 comprise the Company and its subsidiaries (together referred to as the “Group”).

These condensed interim consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) and its interpretations and comply with International Accounting Standard (“IAS”) 34 *Interim Financial Reporting*.

These condensed interim consolidated financial statements were approved by the Board of Directors on February 23, 2018.

These condensed interim consolidated financial statements have been prepared using the historical cost method, except for land, land under finance lease, derivatives, and cash and cash equivalents, which are measured at fair value.

These condensed interim consolidated financial statements are presented in Canadian dollars (“CAD”) which is the Group’s functional currency. All tabular financial data is presented in thousands of Canadian dollars.

2. Adoption of new and amended standards and interpretations:

(a) Changes in accounting policies:

No new or amended standards or interpretations to existing standards were applied by the Group during the nine months ended December 31, 2017.

(b) Future changes in accounting policies:

IFRS 15 *Revenue from Contracts with Customers*:

IFRS 15 *Revenue from Contracts with Customers* will replace IAS 11 *Construction Contracts* and IAS 18 *Revenue*. It provides a single, principles based five-step model to be applied to all contracts with customers. IFRS 15 also requires additional disclosures. The mandatory effective date of IFRS 15 is for annual reporting periods beginning on or after January 1, 2018. Earlier application is permitted. The Group intends to apply the standard using the modified retrospective approach. The cumulative impact of the application will be recognized in retained earnings as of April 1, 2018 and comparative periods will not be restated. The Group is currently assessing the potential effects of adopting IFRS 15 on its consolidated financial statements, including the impact of the changes in its internal control and to the disclosure requirements. The Group does not expect the application of this standard to have a significant impact on its consolidated financial statements, other than additional disclosure.

IFRS 9 *Financial Instruments (2014):*

On July 24, 2014, the IASB issued the completed version of IFRS 9 and the Group adopted IFRS 9 (2013) in fiscal 2015. IFRS 9 (2014) introduces a new expected credit loss model for calculating impairment, and incorporates the guidance on the classification and measurement of financial assets and the final general hedge accounting requirements originally published in IFRS 9 (2013). The mandatory effective date of IFRS 9 (2014) is for annual reporting periods beginning on or after January 1, 2018 and must be applied retrospectively with some exemptions. The Group has determined the need to establish an expected credit loss provision for trade receivables. The Group does not expect the application of IFRS 9 (2014) to have a significant impact on its consolidated financial statements, other than additional disclosure, as the Group has an existing provision for impairment.

2. Adoption of new and amended standards and interpretations (continued):

(b) Future changes in accounting policies (continued):

IFRS 16 *Leases*:

On January 13, 2016, the IASB issued IFRS 16 *Leases,* which will replace IAS 17 *Leases*. The standard introduces a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognize a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. The standard is effective for annual reporting periods beginning on or after January 1, 2019. Early adoption is permitted if IFRS 15 *Revenue from Contracts with Customers,* has also been applied. The Group intends to early adopt IFRS 16 for the annual reporting period beginning on April 1, 2018 and expects to apply the modified retrospective approach with no restatement of prior periods. The Group expects that IFRS 16 will result in:

- an increase in assets and liabilities with the recognition of right of use assets and additional lease liabilities;
- a decrease in lease expense and an increase in amortization and accretion expenses; and
- an increase in cash flow generated by operating activities as these lease payments will be recorded as financing outflows in the consolidated statements of cash flows.

The Group is currently analyzing the potential effects of adopting IFRS 16. The Group does not expect the application of this standard to have a significant impact on its consolidated financial statements, other than additional disclosure.

(Tabular amounts expressed in thousands of Canadian dollars)

3. Property, plant and equipment:

	Vessels	Berths, buildings and equipment under finance lease	Berths, buildings and equipment	Land under finance lease*	Land*	Construction in progress	Total
Cost:							
Balance at March 31, 2017	1,305,845	642,436	104,332	6,824	18,433	212,467	2,290,337
Additions	-	-	-	-	-	179,401	179,401
Disposals	(9,140)	(1,424)	(423)	-	-	(629)	(11,616)
Transfers from construction in progress	217,612	25,419	7,900	-	-	(250,931)	-
Balance at December 31, 2017	**1,514,317**	**666,431**	**111,809**	**6,824**	**18,433**	**140,308**	**2,458,122**
Accumulated depreciation:							
Balance at March 31, 2017	467,454	149,958	51,123	-	-	-	668,535
Depreciation for the period	79,174	21,577	7,796	-	-	-	108,547
Disposals	(9,139)	(1,392)	(402)	-	-	-	(10,933)
Balance at December 31, 2017	**537,489**	**170,143**	**58,517**	-	-	-	**766,149**
Net carrying value:							
As at March 31, 2017	**838,391**	**492,478**	**53,209**	**6,824**	**18,433**	**212,467**	**1,621,802**
As at December 31, 2017	**976,828**	**496,288**	**53,292**	**6,824**	**18,433**	**140,308**	**1,691,973**

*** Land under finance lease and land are measured at fair value.**

3. Property, plant and equipment (continued):

Other disclosures – property, plant and equipment:

During the three months ended December 31, 2017, financing costs capitalized during construction amounted to $1.4 million (December 31, 2016: $1.0 million) and during the nine months ended December 31, 2017, financing costs capitalized during construction amounted to $4.0 million (December 31, 2016: $3.1 million) with an average capitalization rate of 5.05% (December 31, 2016: 5.02%).

Contractual commitments as at December 31, 2017, for assets to be constructed totalled $143.8 million (March 31, 2017: $186.7 million). These contractual commitments include $66.1 million (March 31, 2017: $103.7 million) of the total contract value of $140 million for the mid-life upgrade and conversion to dual fuel of the two Spirit class vessels and $50.8 million (March 31, 2017: $nil) of the total contract value of $60 million for the construction of two minor class vessels. The remaining contract value has been previously invoiced and paid.

During the three and nine months ended December 31, 2017, the Group recorded asset impairment of $0.6 million (December 31, 2016: $nil). The impairment loss is reported under “Loss on disposal and revaluation of property, plant and equipment, intangible assets and inventory” in the consolidated statements of comprehensive income.

The Government of Canada, through the New Building Canada Fund, agreed to provide funding of up to $43.4 million to help offset the costs of the newly established route connecting Port Hardy and Bella Coola and the replacement of two minor vessels. During the three and nine months ended December 31, 2017, the Group recorded $7.6 million as a reduction of the cost of property, plant and equipment. No funding was recorded in fiscal 2016.

During the three months ended December 31, 2017, the Group received $0.3 million of rental income earned from buildings held for leasing purposes (December 31, 2016: $0.3 million) and during the nine months ended December 31, 2017, the Group received $0.8 million (December 31, 2016: $0.8 million) of rental income earned from buildings held for leasing purposes. These buildings have a cost and accumulated depreciation of $11.9 million and $3.0 million, respectively, as at December 31, 2017.

During the three months ended December 31, 2017, the *Queen of Nanaimo* (decommissioned during the three months ended September 30, 2017) was sold. The *Queen of Burnaby* (decommissioned during the three months ended June 30, 2017) is classified as held for sale and has no carrying value.

(Tabular amounts expressed in thousands of Canadian dollars)

4. Intangible assets:

	Acquired software, licenses & rights	Internally developed software & website	Assets under development	Total
Cost:				
Balance at March 31, 2017	103,249	13,324	24,646	141,219
Additions	-	-	11,973	11,973
Disposals	-	-	(203)	(203)
Transfers from assets under development	3,706	2,127	(5,833)	-
Balance at December 31, 2017	**106,955**	**15,451**	**30,583**	**152,989**
Accumulated amortization:				
Balance at March 31, 2017	31,895	11,651	-	43,546
Amortization for the period	10,106	448	-	10,554
Balance at December 31, 2017	**42,001**	**12,099**	-	**54,100**
Net carrying value:				
As at March 31, 2017	**71,354**	**1,673**	**24,646**	**97,673**
As at December 31, 2017	**64,954**	**3,352**	**30,583**	**98,889**

Other disclosures – intangible assets:

During the nine months ended December 31, 2017, the Group recorded asset impairment of $0.2 million (December 31, 2016: $0.2 million). The impairment loss is reported under “Loss on disposal and revaluation of property, plant and equipment, intangible assets and inventory” in the consolidated statements of comprehensive income.

Capitalized financing costs during construction for intangible assets for the three months ended December 31, 2017 totalled $0.2 million (December 31, 2016: $0.3 million) and for the nine months ended December 31, 2017 capitalized financing costs totalled $0.8 million (December 31, 2016: $1.9 million).

During the nine months ended December 31, 2017, intangible assets totalling $6.2 million (December 31, 2016: $17.2 million) were acquired and $5.8 million (December 31, 2016: $4.3 million) were internally developed.

(Tabular amounts expressed in thousands of Canadian dollars)

5. Liabilities arising from financing activities:

	Long-term debt	**Obligations under finance lease**	**Interest payable on long-term debt**
Balance at March 31, 2017			
Current	30,939	1,582	18,458
Non-current	1,273,860	40,423	-
	1,304,799	42,005	18,458
Additions	45,264	-	47,972
Payments	(24,241)	(1,180)	(49,908)
Additions to debt issue costs	(1,417)	-	-
Amortization of debt issue costs	789	-	-
Balance at December 31, 2017	1,325,194	40,825	16,522
Current	34,573	1,617	16,522
Non-current	1,290,621	39,208	-
Balance at December 31, 2017	1,325,194	40,825	16,522

(Tabular amounts expressed in thousands of Canadian dollars)

6. Loans:

	As at	
Long-term debt:	December 31, 2017	March 31, 2017
6.25% Senior Secured Bonds, Series 04-4, due October 2034 (effective interest rate of 6.41%)	250,000	250,000
5.02% Senior Secured Bonds, Series 07-1, due March 2037 (effective interest rate of 5.06%)	250,000	250,000
5.58% Senior Secured Bonds, Series 08-1, due January 2038 (effective interest rate of 5.62%)	200,000	200,000
4.70% Senior Secured Bonds, Series 13-1, due October 2043 (effective interest rate of 4.75%)	200,000	200,000
4.29% Senior Secured Bonds, Series 14-1, due April 2044 (effective interest rate of 4.45%)	200,000	200,000
12 Year Loan, maturing March 2020		
Tranche A (effective interest rate of 5.17%)	16,875	22,500
Tranche B (floating interest rate of 1.76% at December 31, 2017)	22,500	22,500
12 Year Loan, maturing June 2020		
Tranche A (effective interest rate of 5.18%)	18,750	24,375
Tranche B (floating interest rate of 1.82% at December 31, 2017)	22,500	22,500
2.95% Loan, maturing January 2021 (effective interest rate of 3.08%)	31,500	36,000
2.09 % Loan, maturing October 2028 (effective interest rate of 2.70%)	41,110	43,923
2.09 % Loan, maturing January 2029 (effective interest rate of 2.68%)	42,425	45,264
2.09 % Loan, maturing January 2029 (effective interest rate of 2.70%)	42,425	-
	1,338,085	1,317,062
Less: Unamortized deferred financing costs and bond discounts	(12,891)	(12,263)
Total	**1,325,194**	**1,304,799**
Current portion	34,573	30,939
Non-current portion	1,290,621	1,273,860
Total	**1,325,194**	**1,304,799**

6. Loans (continued):

(a) Credit facility:

The Group has a credit facility with a syndicate of Canadian banks, secured by pledged bonds. This revolving facility, in the amount of $155.0 million, was renewed on March 10, 2017 to extend the maturity date to April 20, 2022. There were no draws on this credit facility as at December 31, 2017 and as at March 31, 2017. There was no interest expensed during the three and nine months ended December 31, 2017 and December 31, 2016. Letters of credit outstanding against this facility as at December 31, 2017 totalled $0.1 million (March 31, 2017: $0.1 million).

(b) Debt service reserves:

Long-term debt agreements require the Group to maintain debt service reserves equal to a minimum of six months of interest payments, to be increased under certain conditions. As at December 31, 2017, debt service reserves of $32.5 million (March 31, 2017: $32.4 million) were held in short-term investments and have been classified as restricted short-term investments on the statements of financial position.

(c) Debt service coverage:

Debt service coverage (earnings before interest, taxes, depreciation, amortization, and rent) is required to be at least 1.25 times the debt service cost under the credit facility agreement. As at December 31, 2017, the debt service coverage ratio was 2.83.

In addition, there are other covenants contained in the Master Trust Indenture (“MTI”) (May 2004) available at www.SEDAR.com. The Group was in compliance with all of its covenants at December 31, 2017 and at March 31, 2017.

(d) 2.09% Loan, maturing January 2029:

The Group has a loan agreement with KfW, a German export credit bank. This loan agreement is secured under the MTI and allows for three loans of up to $45.3 million each.

Proceeds of $45.3 million from the third and final loan were received during the three months ended June 30, 2017, to coincide with the contract payment schedule for the *Salish Raven* and applied toward the purchase of the vessel. This amortizing loan will be repaid over a 12-year term and bears an interest rate of 2.09% per annum. Quarterly principal payments plus interest are due in January, April, July and October each year of the term of the loan.

7. Other Liabilities:

During the nine months ended December 31, 2017, the Group received $1.8 million of the total contribution of $10.0 million from FortisBC Energy Inc. as part of the Natural Gas for Transportation incentive funding to be applied towards the mid-life upgrade, including conversion to natural gas (“NG”), of the two Spirit class vessels. A further $0.7 million was recorded during the nine months ended December 31, 2017 (March 31, 2017: $5.3 million) for the Salish class vessels. As per the contract, the contributions are dependent upon the purchase of NG and will be used to offset the incremental capital costs of the vessels.

(Tabular amounts expressed in thousands of Canadian dollars)

8. Financial instruments:

The carrying values of the Group's financial instruments approximate fair value as at December 31, 2017 and March 31, 2017 for all financial instruments except for long-term debt.

	As at December 31, 2017		As at March 31, 2017	
	Carrying Value	Approx Fair Value	Carrying Value	Approx Fair Value
Long-term debt, including current portion [1]	1,325,194	1,642,182	1,304,799	1,597,761

[1] Classified in Level 2 as the significant measurement inputs used in the valuation models are indirectly observable in active markets.

Carrying value is measured at amortized cost using the effective interest rate method. Fair value is calculated by discounting the future cash flows of each debt issue at the estimated yield to maturity for the same or similar issues at the date of the statements of financial position, or by using available quoted market prices.

The following items shown in the consolidated statements of financial position as at December 31, 2017 and March 31, 2017 are carried at fair value on a recurring basis using Level 1 or 2 inputs. There were no financial assets and liabilities at December 31, 2017 or at March 31, 2017, valued using Level 3 inputs.

	As at December 31, 2017		As at March 31, 2017	
	Level 1	Level 2	Level 1	Level 2
Asset (liability):				
Cash [1]	104,813	-	66,093	-
Cash equivalents [1]	469	-	44	-
Derivatives [2]	-	11,617	-	556
	105,282	**11,617**	**66,137**	**556**

[1] Classified in Level 1 as the measurement inputs are derived from observable, unadjusted quoted prices in active markets for identical assets.
[2] Classified in Level 2 as the significant measurement inputs used in the valuation models are indirectly observable in active markets (derived from prices).

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgment. Where market prices are not available, fair values are estimated using discounted cash flow analysis.

No amounts have been reclassified into or out of fair value classifications in the three and nine months ended December 31, 2017 or December 31, 2016. Financial assets have been pledged as security for liabilities under the MTI.

During the three and nine months ended December 31, 2017 and December 31, 2016, gains or losses related to Level 2 derivatives have been recorded in other comprehensive income ("OCI"). There were no Level 3 instruments outstanding during the period.

8. Financial instruments (continued):

The Group may use derivative instruments to hedge its exposure to fluctuations in fuel prices, interest rates and foreign currency exchange rates. The fair value of commodity derivatives reflects only the value of the commodity derivatives and not the offsetting change in value of the underlying future purchase of fuel. These fair values reflect the estimated amounts that the Group would receive or pay should the derivative contracts be terminated at the period end dates.

9. Financial risk management:

Fuel price risk:

The Group is exposed to risks associated with changes in the market price of marine diesel fuel and NG fuel. In order to reduce price volatility and add a fixed component to the inherent floating nature of fuel prices, the Group may manage its exposure by entering into hedging instruments with certain financial intermediaries. Fuel price hedging instruments are used to reduce fuel price risk and to minimize fuel surcharges, not for generating trading profits. Gains and losses resulting from fuel forward contracts are recognized as a component of fuel costs. Pursuant to the Group's Financial Risk Management Policy, the term of the contracts is not to extend beyond the end of the fourth performance term ending March 31, 2020. This policy also limits hedging, to a maximum of 95% of anticipated monthly fuel consumption for the immediately following 12 month period; 90% of anticipated monthly fuel consumption for the 12 month period thereafter; 85% of anticipated monthly fuel consumption for the period thereafter to the end of the fourth performance term.

The Group is also allowed by regulatory order to use deferred fuel cost accounts to mitigate the impact of changes in fuel price on its earnings (note 16).

During the nine months ended December 31, 2017, the Group entered into ultra-low sulfur diesel (“ULSD”) fuel swap contracts with a notional value of $29.2 million CAD. To reduce its exposure to changes in the ULSD and foreign exchange risk components associated with forecast diesel fuel purchases, the Group hedges using CAD denominated ULSD swaps. The notional value of all fuel swap contracts outstanding as at December 31, 2017 was $62.8 million CAD (March 31, 2017: $66.7 million). Hedge accounting was applied to these contracts. No NG swap contracts were entered into during the nine months ended December 31, 2017.

An economic relationship exists between the hedged item and the hedging instruments as the fair values of both the hedged item and the hedging instrument move in opposite directions in response to the same risk. The inclusion of credit risk in the fair value of the hedging instrument which is not replicated in the hedged item is a potential source of ineffectiveness, however, the Group does not consider this risk to be material.

During the nine months ended December 31, 2017, the total change in the value of fuel swap contracts was $11.0 million (December 31, 2016: $22.9 million). The fair value change of $10.5 million was recognized in OCI. The realized hedging loss of $0.5 million was reclassified from equity (accumulated other comprehensive income) and included in the Group’s fuel expense during the nine months ended December 31, 2017. There was no hedge ineffectiveness during the nine months ended December 31, 2017.

9. Financial risk management (continued):

	Fiscal 2018	Fiscal 2019	Fiscal 2020	Total
Cash flow hedges:				
Fuel price risk:				
Fuel contracts (litres in thousands)	15,750	68,800	30,180	114,730
Contract price range ($/litre)	$0.4931 - $0.5690	$0.5247 - $0.5680	$0.5308 - $0.5599	

(a) As at December 31, 2017, the Group's derivative assets of $11.6 million included foreign exchange forward contracts and fuel swap contracts.

Fuel swap contracts as at December 31, 2017:

					Fair value changes used for calculating hedge ineffectiveness	
	Notional value of the hedging instrument	Carrying value of the hedging instrument	Item location	Cash flow hedge reserve	Hedging instruments	Hedged items
Cash flow hedges:						
Fuel price risk	62,843	11,603	Derivative assets	11,603	11,603	11,639

(b) Cash flow hedge reserve:

	Three months ended December 31		Nine months ended December 31	
	2017	2016	2017	2016
Hedging gains (losses) recognized in cash flow hedge reserve:				
Fuel swap contracts (note 10(a))	9,731	6,325	10,541	16,861
Hedging losses reclassified from cash flow hedge reserve:				
Interest rate forward contract – amortization of hedge loss	62	62	186	186
Fuel swap contracts – (gain) loss recognized in net earnings (note 10(a))	(1,236)	880	501	6,015
Net change in cash flow hedge reserve	8,557	7,267	11,228	23,062

(Tabular amounts expressed in thousands of Canadian dollars)

10. Other comprehensive income:

(a) Continuity of reserves:

	Land revaluation reserves	Employee future benefit revaluation reserves	Fuel swaps reserves	Interest rate forward contracts reserves	Total
Balance at March 31, 2017	**7,109**	**(4,026)**	**561**	**(6,710)**	**(3,066)**
Actuarial loss on defined benefit plans (note 14)	-	(1,943)	-	-	(1,943)
Derivatives designated as cash flow hedges (note 9(b))					
Net change in fair value	-	-	10,541	-	10,541
Realized losses (note 9(b))	-	-	501	-	501
Amortization of losses (note 9(b))	-	-	-	186	186
Balance at December 31, 2017	**7,109**	**(5,969)**	**11,603**	**(6,524)**	**6,219**

(b) Other comprehensive income:

	Three months ended December 31		Nine months ended December 31	
	2017	2016	2017	2016
Items not to be reclassified to net earnings:				
Actuarial losses on defined benefit plans	-	-	(1,943)	(1,240)
Items to be reclassified to net earnings:				
Hedge gains on fuel swaps (note 9(b))	9,731	6,325	10,541	16,861
Total other comprehensive income	**9,731**	**6,325**	**8,598**	**15,621**

11. Net retail:

	Three months ended December 31		Nine months ended December 31	
	2017	2016	2017	2016
Retail revenue	21,649	20,047	81,123	75,041
Cost of goods sold	(8,502)	(7,957)	(31,173)	(29,234)
Net retail	**13,147**	**12,090**	**49,950**	**45,807**

(Tabular amounts expressed in thousands of Canadian dollars)

12. Operating expenses:

	Three months ended December 31		Nine months ended December 31	
	2017	2016	2017	2016
Salaries, wages & benefits	89,346	83,220	279,067	260,561
Fuel	24,100	23,353	80,339	79,316
Materials, supplies and contracted services	26,127	15,811	60,516	49,235
Other operating expenses	15,269	14,393	47,610	43,465
Depreciation and amortization	40,453	37,065	119,101	110,278
Total operating expenses	**195,295**	**173,842**	**586,633**	**542,855**

13. Net finance expense:

	Three months ended December 31		Nine months ended December 31	
	2017	2016	2017	2016
Finance expenses:				
Long-term debt	16,044	15,714	47,983	46,942
Short-term debt	45	63	329	211
Finance leases	448	465	1,355	1,408
Amortization of deferred financing costs and bond discounts	337	176	975	496
Interest capitalized in the cost of qualifying assets	(1,590)	(1,345)	(4,770)	(5,039)
Total finance expenses	15,284	15,073	45,872	44,018
Finance income	(1,501)	(1,262)	(3,929)	(3,446)
Net finance expense	**13,783**	**13,811**	**41,943**	**40,572**

14. Accrued employee future benefits:

During the three months ended December 31, 2017, the Group recognized total defined benefit costs of $0.5 million (December 31, 2016: $0.6 million) and during the nine months ended December 31, 2017, the Group recognized total defined benefit costs of $1.5 million (December 31, 2016: $1.7 million).

During the three months ended September 30, 2017, the Group recognized a net loss of $1.9 million in other comprehensive income reflecting the actuarial valuation for the retirement and death defined benefit plans as at March 31, 2017.

15. Related party transactions:

In accordance with the Act, the Group is responsible for paying any expenses that are incurred by the Authority, without charge. During the nine months ended December 31, 2017, the Group paid $115,604 (December 31, 2016: $80,688) of such expenses.

The Province owns the Group's 75,477 non-voting preferred shares, but has no voting interest in either the Group or the Authority.

(Tabular amounts expressed in thousands of Canadian dollars)

16. Economic effect of rate regulation:

The Group is regulated by the Commissioner to ensure, among other things, that tariffs are fair and reasonable. Under the terms of the Act, the tariffs the Group charges its customers are subject to price caps. The Commissioner may, in extraordinary situations, allow increases in price caps over the set levels.

In January 2014 the IASB issued IFRS 14, *Regulatory Deferral Accounts*. IFRS 14 is an interim standard that addresses the accounting for regulatory deferral accounts; however, it does not allow the recognition of regulatory assets and regulatory liabilities that result from the regulated price cap setting process for entities that had already transitioned to IFRS. The Group transitioned to IFRS effective April 1, 2011. As a result, the Group is not permitted to recognize its regulatory assets and regulatory liabilities in its consolidated statements of financial position.

Regulatory assets generally represent incurred costs that have been deferred for purposes of rate regulation because they are probable of future recovery in tariffs or fuel surcharges. Regulatory liabilities represent obligations to customers which will be settled through future tariff reductions or fuel rebates. Management continually assesses whether the Group’s regulatory assets are probable of future recovery by considering such factors as applicable regulatory changes. Management believes that the regulatory assets at December 31, 2017, are probable of future recovery in tariff or fuel surcharges.

If the Group was permitted under IFRS to recognize the effects of rate regulation, the following regulatory assets would be shown on the consolidated statements of financial position:

	As at	
Regulatory accounts	December 31, 2017	March 31, 2017
Deferred fuel costs:		
Balance, beginning of year	4,450	(6,132)
Fuel costs under set price	(7,532)	(7,625)
Rebates	15,783	18,068
Fuel price risk recoveries payable to the Province	291	139
Balance, end of period	12,992	4,450
Total long-term regulatory assets	**12,992**	**4,450**

The Act contains provisions which ensure that if tariffs charged by the Group exceed established price caps, the excess amounts collected will be returned to customers through future tariffs. At December 31, 2017, tariffs charged to customers were below established price caps.

(Tabular amounts expressed in thousands of Canadian dollars)

16. Economic effect of rate regulation (continued):

If the Group was permitted under IFRS to recognize the effects of rate regulation and to record regulatory assets and regulatory liabilities, net earnings for the three months ended December 31, 2017 would have been $2.9 million higher (December 31, 2016: $2.2 million higher) and during the nine months ended December 31, 2017, net earnings would have been $8.5 million higher (December 31, 2016: $9.2 million higher) as detailed below:

	Three months ended December 31		Nine months ended December 31	
Effect of rate regulation on net earnings	2017	2016	2017	2016
Regulatory accounts:				
Deferred fuel costs	2,911	2,159	8,542	9,237
Total increase in net earnings	**2,911**	**2,159**	**8,542**	**9,237**