Condensed Interim Consolidated Financial Statements

BRITISH COLUMBIA FERRY SERVICES INC.

For the three months ended June 30, 2019 and 2018
(Unaudited)

BRITISH COLUMBIA FERRY SERVICES INC.

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

	June 30, 2019	March 31, 2019
Assets		
Current assets		
Cash and cash equivalents	60,333	59,888
Restricted short-term investments (note 6(b))	31,531	31,651
Other short-term investments	58,173	74,648
Trade and other receivables	32,815	23,246
Prepaid expenses	20,302	8,306
Inventories	30,605	30,870
Derivative assets (note 9)	3,844	8,145
	237,603	236,754
Non-current assets		
Loan receivable	24,515	24,515
Property, plant and equipment (note 3)	1,801,960	1,820,232
Intangible assets (note 4)	100,432	101,029
Derivative assets (note 9)	1,279	-
	1,928,186	1,945,776
Total assets	2,165,789	2,182,530
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	55,131	80,173
Interest payable on long-term debt (note 5)	16,033	18,429
Contract liabilities	32,365	28,709
Current portion of long-term debt (note 5,6)	77,831	57,183
Current portion of accrued employee future benefits	2,000	2,000
Current portion of lease liabilities (note 5)	2,301	2,184
Provisions	65,110	62,778
	250,771	251,456
Non-current liabilities		
Accrued employee future benefits	20,377	20,583
Long-term debt (notes 5,6)	1,195,868	1,222,860
Lease liabilities (note 5)	39,400	39,797
Other liabilities (note 7)	11,840	9,516
	1,267,485	1,292,756
Total liabilities	1,518,256	1,544,212
Equity		
Share capital	75,478	75,478
Contributed surplus	25,000	25,000
Retained earnings	537,175	525,006
Total equity before reserves	637,653	625,484
Reserves (note 10(a))	9,880	12,834
Total equity including reserves	647,533	638,318
Total liabilities and equity	2,165,789	2,182,530

Commitments (note 3)

BRITISH COLUMBIA FERRY SERVICES INC.

Condensed Interim Consolidated Statements of Profit or Loss and Other Comprehensive Income (unaudited)
(Expressed in thousands of Canadian dollars)

	Three months ended June 30	
	2019	**2018**
Revenue		
Vehicle and passenger fares	162,476	158,427
Net retail (note 11)	16,797	15,559
Fuel surcharges (rebates) (note 16)	839	(4,517)
Other income	3,037	2,808
Revenue from customers	183,149	172,277
Ferry service fees	55,409	49,797
Federal-Provincial Subsidy Agreement	7,835	7,626
Total revenue	246,393	229,700
Expenses (note 12)		
Operations	140,688	135,872
Maintenance	26,312	22,221
Administration	8,696	9,739
Depreciation and amortization	44,722	42,025
Total operating expenses	220,418	209,857
Operating profit	25,975	19,843
Net finance and other expenses (note 13)		
Finance expenses	14,991	14,972
Finance income	(1,173)	(1,257)
Net finance expense	13,818	13,715
(Gain) loss on disposal and revaluation of property, plant and equipment and intangible assets	(12)	88
Net finance and other expenses	13,806	13,803
NET EARNINGS	**12,169**	**6,040**
Other comprehensive (loss) income (note 10(b))		
Items that will be reclassified subsequently to net earnings	(58)	7,879
Total other comprehensive (loss) income	(58)	7,879
Total comprehensive income	12,111	13,919

BRITISH COLUMBIA FERRY SERVICES INC.

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

	Three months ended June 30	
	2019	**2018**
Cash flows from operating activities		
Net earnings	12,169	6,040
Items not affecting cash		
Net finance expense	13,818	13,715
Depreciation and amortization	44,722	42,025
Other non-cash changes to property, plant and equipment	(46)	412
Changes in:		
Accrued employee future benefits	(206)	(536)
Derivative assets and liabilities recognized in net earnings	7	62
Provisions	2,332	2,385
Accrued financing costs	635	503
Total non-cash items	61,262	58,566
Movements in operating working capital		
Trade and other receivables	(9,569)	(13,990)
Prepaid expenses	(11,996)	(11,086)
Inventories	265	121
Accounts payable and accrued liabilities	(25,042)	7,648
Contract liabilities	3,656	4,609
Change in non-cash working capital	(42,686)	(12,698)
Change attributable to capital asset acquisitions	26,940	1,178
Change in non-cash operating working capital	(15,746)	(11,520)
Cash generated from operating activities	57,685	53,086
Interest received	700	767
Interest paid	(18,582)	(18,919)
Net cash generated by operating activities	39,803	34,934

BRITISH COLUMBIA FERRY SERVICES INC.

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

	Three months ended June 30	
	2019	**2018**
Cash flows from financing activities		
Repayment of long-term debt	(6,571)	(6,571)
Repayment of lease liabilities	(552)	(529)
Net cash used in financing activities	(7,123)	(7,100)
Cash flows from investing activities		
Proceeds from disposal of property, plant and equipment	95	14
Purchase of property, plant and equipment and intangible assets	(48,925)	(72,446)
Changes in debt service reserve	120	120
Net proceeds from short-term investments	16,475	25,846
Net cash used in investing activities	(32,235)	(46,466)
Net increase (decrease) in cash and cash equivalents	445	(18,632)
Cash and cash equivalents, beginning of period	59,888	69,913
Cash and cash equivalents, end of period	60,333	51,281

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 April 1, 2018	75,478	25,000	478,855	579,333	8,974	588,307
Net earnings	-	-	6,040	6,040	-	6,040
Other comprehensive income	-	-	-	-	7,879	7,879
Realized hedge gains recognized in fuel swaps	-	-	-	-	(3,322)	(3,322)
Hedge losses on interest rate forward contract reclassified to net earnings	-	-	-	-	62	62
Balance as at June 30, 2018	**75,478**	**25,000**	**484,895**	**585,373**	**13,593**	**598,966**
Balance as at April 1, 2019	75,478	25,000	525,006	625,484	12,834	638,318
Net earnings	-	-	12,169	12,169	-	12,169
Other comprehensive loss	-	-	-	-	(58)	(58)
Realized hedge gains recognized in fuel swaps	-	-	-	-	(2,957)	(2,957)
Hedge losses on interest rate forward contract reclassified to net earnings	-	-	-	-	61	61
Balance as at June 30, 2019	**75,478**	**25,000**	**537,175**	**637,653**	**9,880**	**647,533**

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:

(a) Reporting entity:

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 months ended June 30, 2019 and 2018 comprise the Company and its subsidiaries (together referred to as the "Group").

(b) Basis of preparation:

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 do not include all disclosures normally provided in annual financial statements and should be read in conjunction with the Company's last annual consolidated financial statements as at and for the year ended March 31, 2019 ("last annual financial statements"), as they follow the same accounting policies. For changes in accounting policies effective April 1, 2019, refer to note 2.

These condensed interim consolidated financial statements have been prepared using the historical cost method, except for owned land, head office land under lease and certain financial assets and liabilities including derivatives.

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.

These condensed interim consolidated financial statements were approved by the Board of Directors on August 14, 2019.

1. Accounting policies (continued):

(c) Employee benefits:

The Group has a number of defined benefit pension and post-retirement plans. The plans are generally funded by payments from employees and by the Group, taking into account the recommendations of independent qualified actuaries.

The Group's multi-employer defined benefit pension and long-term disability plans are accounted for using defined contribution plan accounting. These plans are administered by external parties and the Group does not have sufficient information to apply defined benefit plan accounting. The cost of these benefits is expensed as contributions are made to the plans.

The actuarial determination of the accrued benefit obligations for retirement benefits uses the projected unit credit method prorated on service (which incorporates management's best estimate of future salary levels, other cost escalation, retirement ages of employees and other actuarial factors). Under the projected unit credit method, the cost of these benefits is expensed over the service lives of employees in accordance with the advice of qualified actuaries who carry out a full valuation of the plans on a regularly scheduled basis. The pension obligation is measured at the present value of estimated future cash outflows using interest rates based on the yield of long-term high quality corporate bonds with maturities matching the pension obligation.

Assets are valued at fair value for the purpose of calculating the expected return on plan assets.

Actuarial gains (losses) arise from the difference between the actual and expected long-term rate of return on plan assets and the effects of changes in actuarial assumptions used to determine the accrued benefit obligation. Actuarial gains (losses) are recognized immediately in other comprehensive income ("OCI") and are not reclassified to net earnings or loss in subsequent periods.

Past service costs arising from plan amendments are recognized immediately to the extent that the benefits are already vested. Where the benefits are not vested, the costs are deferred and amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. The obligation recognized for all benefit plans includes any past service costs still to be amortized.

When a plan amendment gives rise to both a curtailment and a settlement of obligations, the curtailment is accounted for prior to the settlement. After a plan amendment, curtailment or settlement occurs, the Group uses updated actuarial assumptions to determine its current service cost and interest costs for the period. If a defined benefit plan was settled, the Group would disregard any asset ceiling when determining the plan assets as part of the calculation of gain or loss on settlement.

2. Adoption of new and amended standards:

Changes in accounting policies:

Amendments to IAS 19 *Employee Benefits*:

On February 7, 2018, the IASB published Amendments to IAS 19 *Employee Benefits*. The amendments to IAS 19 require entities to use the updated actuarial assumptions to determine current service cost and net interest for the remainder of the annual reporting period after a plan amendment, curtailment or settlement. The amendments also clarify how the requirements for accounting for a plan amendment, curtailment or settlement affect the asset ceiling requirements. The Group adopted IAS 19 effective April 1, 2019, and the requirements of these amendments will be applied to all plan amendments, curtailments or settlements occurring after this date. There was no adjustment to the condensed interim consolidated financial statements as a result of this adoption.

(Tabular amounts expressed in thousands of Canadian dollars)

3. Property, plant and equipment:

	Vessels	Berths, buildings and equipment	Right-of-use assets - berths, building & equipment	Right-of-use assets - land	Land	Construction in progress	Total
Cost:							
Balance as at March 31, 2019	1,627,311	655,543	173,548	40,868	24,714	196,359	2,718,343
Additions	(301) [1]	-	16	256	-	22,456	22,427
Disposals	(20,807)	(2,597)	-	-	-	-	(23,404)
Reclassification to: assets held for sale	(5,625)	-	-	-	-	-	(5,625)
Transfers from construction in progress	149,673	4,190	-	-	-	(153,863)	-
Balance as at June 30, 2019	**1,750,251**	**657,136**	**173,564**	**41,124**	**24,714**	**64,952**	**2,711,741**
Accumulated depreciation:							
Balance at as March 31, 2019	624,593	205,671	67,241	606	-	-	898,111
Depreciation for the period	30,163	8,462	1,720	271	-	-	40,616
Disposals	(20,727)	(2,594)	-	-	-	-	(23,321)
Reclassification to: assets held for sale	(5,625)	-	-	-	-	-	(5,625)
Balance as at June 30, 2019	**628,404**	**211,539**	**68,961**	**877**	**-**	**-**	**909,781**
Net carrying value:							
As at March 31, 2019	**1,002,718**	**449,872**	**106,307**	**40,262**	**24,714**	**196,359**	**1,820,232**
As at June 30, 2019	**1,121,847**	**445,597**	**104,603**	**40,247**	**24,714**	**64,952**	**1,801,960**

[1] Reclassifications from Other liabilities (note 7)

3. Property, plant and equipment (continued):

During the three months ended June 30, 2019, financing costs capitalized during construction amounted to $1.1 million (June 30, 2018: $1.7 million) with an average capitalization rate of 4.99% (June 30, 2018: 5.03%).

Contractual commitments as at June 30, 2019, for assets to be constructed totalled $46.6 million (March 31, 2019: $47.5 million). The majority of these contractual commitments relate to the construction of two Island class vessels.

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 months ended June 30, 2019, the Group recorded $0.1 million as a reduction of the cost of property, plant and equipment as a result of funding provided. Funding of $29.5 million was recorded as a reduction of the cost of the property, plant and equipment in fiscal years 2019 and 2018.

FortisBC Energy Inc. has committed to provide the Group with funding as part of the Natural Gas for Transportation (“NGT”) incentive funding. The contributions are dependent upon the purchase of liquefied natural gas (“LNG”). During the three months ended June 30, 2019, $0.3 million was recognized as a reduction of the cost of property, plant and equipment.

During the three months ended June 30, 2019, the Group received $0.3 million (June 30, 2018: $0.3 million) of rental income earned from buildings held for leasing purposes. These buildings have a cost and accumulated depreciation of $11.9 million and $3.7 million, respectively, as at June 30, 2019.

The *Howe Sound Queen* (decommissioned during the three months ended June 30, 2019) and the *Queen of Burnaby* (decommissioned during the year ended March 31, 2018) are classified as held for sale and have no carrying value.

(Tabular amounts expressed in thousands of Canadian dollars)

4. Intangible assets:

	Acquired software, licenses and rights	Internally developed software and website	Assets under development	Total
Cost:				
Balance as at March 31, 2019	130,335	18,887	22,297	171,519
Additions	-	-	3,509	3,509
Transfers from assets under development	1,675	1	(1,676)	-
Balance as at June 30, 2019	**132,010**	**18,888**	**24,130**	**175,028**
Accumulated amortization:				
Balance as at March 31, 2019	58,879	11,611	-	70,490
Amortization	3,786	320	-	4,106
Balance as at June 30, 2019	**62,665**	**11,931**	**-**	**74,596**
Net carrying value:				
As at March 31, 2019	**71,456**	**7,276**	**22,297**	**101,029**
As at June 30, 2019	**69,345**	**6,957**	**24,130**	**100,432**

Capitalized financing costs during construction for intangible assets with an average capitalization rate of 4.99% for the three months ended June 30, 2019 totalled $0.2 million (June 30, 2018: $0.2 million).

During the three months ended June 30, 2019, intangible assets totalling $2.2 million (June 30, 2018: $2.2 million) were acquired and $1.3 million (June 30, 2018: $2.0 million) were internally developed.

(Tabular amounts expressed in thousands of Canadian dollars)

5. Liabilities arising from financing activities:

Continuity of liabilities arising from financing activities:

	Long-term debt	Lease liabilities	Interest payable on long-term debt
Balance as at March 31, 2019	1,280,043	41,981	18,429
Additions	-	272	15,454
Payments	(6,571)	(552)	(17,850)
Amortization of debt issue costs	227	-	-
Balance as at June 30, 2019	**1,273,699**	**41,701**	**16,033**
Current	77,831	2,301	16,033
Non-current	1,195,868	39,400	-
Balance as at June 30, 2019	**1,273,699**	**41,701**	**16,033**

During the three months ended June 30, 2019, the Group recognized $0.5 million (June 30, 2018: $0.5 million) of interest expense related to lease liabilities.

(Tabular amounts expressed in thousands of Canadian dollars)

6. Loans:

	As at	
Long-term debt:	June 30, 2019	March 31, 2019
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%)	5,625	7,500
Tranche B (floating interest rate of 2.29% at June 30, 2019)	22,500	22,500
12 Year Loan, maturing June 2020		
Tranche A (effective interest rate of 5.18%)	7,500	9,375
Tranche B (floating interest rate of 2.28% at June 30, 2019)	22,500	22,500
2.95% Loan, maturing January 2021 (effective interest rate of 3.08%)	18,000	18,000
2.09% Loan, maturing October 2028 (effective interest rate of 2.70%)	35,503	36,437
2.09% Loan, maturing January 2029 (effective interest rate of 2.68%)	36,767	37,710
2.09% Loan, maturing January 2029 (effective interest rate of 2.70%)	36,767	37,710
	1,285,162	1,291,732
Less: Unamortized deferred financing costs and bond discounts	(11,463)	(11,689)
Total	**1,273,699**	**1,280,043**
Current	77,831	57,183
Non-current	1,195,868	1,222,860
Total	**1,273,699**	**1,280,043**

(Tabular amounts expressed in thousands of Canadian dollars)

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 6, 2019 to extend the maturity date to April 20, 2024. There were no draws on this credit facility as at June 30, 2019 and as at March 31, 2019. There was no interest expensed during the three months ended June 30, 2019 and June 30, 2018. Letters of credit outstanding against this facility as at June 30, 2019 totalled $0.2 million (March 31, 2019: $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 June 30, 2019, debt service reserves of $31.5 million (March 31, 2019: $31.6 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 June 30, 2019, the debt service coverage ratio was 2.94.

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 June 30, 2019 and at March 31, 2019.

7. Other liabilities:

FortisBC Energy Inc. has committed to provide the Group with funding as part of the NGT incentive funding. The funding is dependant upon the purchase of LNG and the incremental costs of building/converting vessels to be capable of using LNG for propulsion.

During the three months ended June 30, 2019, the Group recorded $2.6 million of the total contribution of up to $10.0 million to be applied towards the mid-life upgrade, including conversion to LNG, of the two Spirit class vessels. As at June 30, 2019, the Group has received a total of $10.4 million in contributions related to the Spirit Class and Salish Class vessels. As of March 31, 2018, the Group had received all of the eligible contributions related to the Salish Class vessels.

During the three months ended June 30, 2019, the Group recognized $0.3 million (March 31, 2019: $0.9 million) as an offset to the capital costs of the vessels.

	Salish Class	Spirit Class	Total
Balance as at March 31, 2019	5,489	4,027	9,516
Additions	-	2,625	2,625
Reclassifications to property, plant and equipment (note 3)	(109)	(192)	(301)
Balance as at June 30, 2019	**5,380**	**6,460**	**11,840**

(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 June 30, 2019 and March 31, 2019 or all financial instruments except for long-term debt.

	As at June 30, 2019		As at March 31, 2019	
	Carrying Value	**Approximately Fair Value**	**Carrying Value**	**Approximately Fair Value**
Long-term debt, including current portion [1]	1,273,699	1,663,816	1,280,043	1,623,838

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

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 June 30, 2019 and March 31, 2019 are carried at fair value on a recurring basis using Level 1 or 2 inputs. There were no financial assets and liabilities at June 30, 2019, or at March 31, 2019, valued using Level 3 inputs.

	As at June 30, 2019		As at March 31, 2019	
	Level 1	**Level 2**	**Level 1**	**Level 2**
Asset (liability):				
Cash [1]	60,336	-	49,486	-
Cash equivalents [1]	(3)	-	472	-
Derivatives [2]	-	5,123	-	8,145
	60,333	**5,123**	**49,958**	**8,145**

[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 months ended June 30, 2019 or June 30, 2018.

8. Financial instruments (continued):

During the three months ended June 30, 2019 and June 30, 2018, gains or losses related to Level 2 derivatives have been recognized in OCI.

There were no Level 3 instruments outstanding during the period.

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:

Credit risk:

The Group is using the lifetime expected credit loss ("ECL") simplified approach as the method to determine the provision for impairment. The Group reviews for changes in circumstances at each reporting date.

Based on the historical default experience, the Group has established a lifetime ECL allowance of 1% of the trade receivables. Amounts due from the Government of Canada and the Province are considered low credit risk and are excluded. As at March 31, 2019, the provision for impairment was $0.1 million. During the three months ended June 30, 2019, the Group recorded an additional provision of $0.1 million for a total of $0.2 million.

Based on historical default experience and financial position of the counterparties and estimating the probability of default, the lifetime ECL equals zero for the Group's restricted and other short-term investments.

The Group has a loan receivable with a term of 15 years, secured by a second mortgage. The collateral is expected to exceed the amount of the loan and be available while the loan is outstanding.

9. Financial risk management (continued):

Fuel price risk:

The Group is exposed to risks associated with changes in the market price of marine diesel fuel and LNG 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. The Group's Financial Risk Management Policy 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 36 month period; and to 70% of anticipated monthly fuel consumption for the period between 36 months and the end of the fifth performance term. Performance term five will commence April 1, 2020 and end on March 31, 2024.

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).

The Group hedges using CAD denominated ultra-low sulfur diesel (“ULSD”) to reduce its exposure to changes in ULSD and foreign exchange risk components associated with forecast diesel fuel purchases. During the three months ended June 30, 2019, the Group entered into ULSD fuel swap contracts with a notional value of $44.7 million CAD. The notional value of all fuel swap contracts outstanding as at June 30, 2019 was $82.1 million CAD (March 31, 2019: $50.6 million). Hedge accounting was applied to these contracts. No LNG swap contracts were entered into during the three months ended June 30, 2019 and no LNG swap contracts were outstanding as at June 30, 2019.

During the three months ended June 30, 2019, open fuel swap contracts had unrealized hedging losses of $58,000 recognized in OCI (June 30, 2018: unrealized gains of $7,879,000). In addition, for closed fuel swap contracts net realized hedging gains of $2,957,000 were reclassified from reserves and included in the Group’s fuel expense during the three months ended June 30, 2019 (June 30, 2018: net realized hedging gains of $3,322,000). There was no hedge ineffectiveness during the three months ended June 30, 2019 or in the comparative period in 2018.

9. Financial risk management (continued):

Fuel price risk (continued):

	Fiscal 2020	Fiscal 2021	Fiscal 2022	Total
Cash flow hedges:				
Fuel price risk:				
Fuel contracts (litres in thousands)	60,932	39,260	31,160	131,352
Contract price range ($/litre)	$0.5475 - $0.6570	$0.6280 - $0.6499	$0.6270 - $0.6310	

(a) Fuel swap contracts as at June 30, 2019:

					Fair value changes used for calculating hedge ineffectiveness	
	Notional value of the hedging instrument	Carrying value of the hedging instrument	Item location – derivative assets	Cash flow hedge reserve	Hedging instruments	Hedged items
Cash flow hedges:						
Fuel price risk	44,425	3,844	Current	3,844	3,844	3,848
Fuel price risk	37,706	1,279	Non-current	1,279	1,279	1,288

(b) Cash flow hedge reserve (note 10(a)):

	Three months ended June 30	
	2019	2018
Items recognized in cash flow hedge reserve:		
Unrealized (losses) gains in fuel swap contracts	(58)	7,879
Items reclassified from cash flow hedge reserve:		
Interest rate forward contract – amortization of hedge loss	61	62
Fuel swap contracts – gain recognized in net earnings	(2,957)	(3,322)
Net change in cash flow hedge reserve	**(2,954)**	**4,619**

(Tabular amounts expressed in thousands of Canadian dollars)

10. Reserves and other comprehensive (loss) income:

(a) Continuity of reserves:

	Land revaluation reserves	Employee future benefit revaluation reserves	Fuel swaps reserves	Interest rate forward contract reserves	Total
Balance as at March 31, 2019	16,879	(5,969)	8,138	(6,214)	12,834
Derivatives designated as cash flow hedges (note 9(b)):					
Net change in fair value	-	-	(58)	-	(58)
Realized gains	-	-	(2,957)	-	(2,957)
Amortization of loss	-	-	-	61	61
Balance as at June 30, 2019	**16,879**	**(5,969)**	**5,123**	**(6,153)**	**9,880**

(b) Other comprehensive (loss) income:

	Three months ended June 30	
	2019	**2018**
Items to be reclassified to net earnings:		
Hedge (losses) gains on fuel swaps (note 9(b))	(58)	7,879
Total other comprehensive (loss) income	(58)	**7,879**

(Tabular amounts expressed in thousands of Canadian dollars)

11. Net retail:

	Three months ended June 30	
	2019	**2018**
Retail revenue	27,025	25,112
Cost of goods sold	(10,228)	(9,553)
Net retail	**16,797**	**15,559**

12. Operating expenses:

	Three months ended June 30	
	2019	**2018**
Salaries, wages & benefits	107,334	99,480
Fuel	26,973	28,939
Materials, supplies and contracted services	25,344	23,191
Other operating expenses	16,045	16,222
Depreciation and amortization	44,722	42,025
Total operating expenses	**220,418**	**209,857**

13. Net finance expense:

	Three months ended June 30	
	2019	**2018**
Finance expenses:		
Long-term debt	15,456	15,745
Short-term debt	63	351
Lease liabilities	507	477
Amortization of deferred financing costs and bond discounts	288	308
Interest capitalized in the cost of qualifying assets	(1,323)	(1,909)
Total finance expenses	14,991	14,972
Finance income	(1,173)	(1,257)
Net finance expense	**13,818**	**13,715**

14. Accrued employee future benefits:

During the three months ended June 30, 2019, the Group recognized total defined benefit costs of $0.5 million (June 30, 2018: $0.6 million).

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 three months ended June 30, 2019, the Group paid $61,107 (June 30, 2018: $22,769) 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.

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 June 30, 2019, are probable of future recovery in tariff or fuel surcharges.

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 June 30, 2019 and March 31, 2019, 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, the regulatory assets for the three months ended June 30, 2019 would have been $2.7 million (March 31, 2019: $4.5 million).

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 June 30, 2019 would have been $1.8 million lower (June 30, 2018: $5.0 million higher) as detailed below:

	Three months ended June 30	
Effect of rate regulation on net earnings	**2019**	**2018**
Regulatory accounts:		
Deferred fuel costs:		
Fuel costs (under) over set price	(937)	489
(Surcharges) rebates	(839)	4,517
Total (decrease) increase in net earnings	(1,776)	5,006