Management’s Discussion & Analysis of Financial Condition and Results of Operations

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. This should be read in conjunction with the consolidated financial statements for the year ended March 31, 2006 (fiscal year 2006). This management’s discussion and analysis has been prepared based on information available at May 17, 2006, except where otherwise indicated. Additional information relating to British Columbia Ferry Services can be found on SEDAR at www.sedar.com.

Except where indicated, all financial information herein is expressed in Canadian dollars and determined on the basis of Canadian generally accepted accounting principles.

BUSINESS OVERVIEW

British Columbia Ferry Services Inc. is an independent company providing ferry services on the west coast of British Columbia. We operate one of the largest and most complex ferry systems in the world, with 34 vessels operating on 25 routes. Our service is an integral part of British Columbia’s coastal transportation system, and has been designated by the Province of British Columbia as an essential service for purposes of the provincial Labour Relations Code. This designation means our services are considered necessary for the protection of the health, safety and welfare of the residents of BC.

We are a versatile company, providing a wide range of ferry services for our customers. In fiscal year 2006, we provided over 186,000 sailings, carrying over 21 million passengers and 8 million vehicles. Although we carried 14 thousand (0.2%) fewer vehicles and 297 thousand (1.3%) fewer passengers than in fiscal year 2005 we had our second highest year ever for both vehicle and passenger traffic. Our customers travel on our ferries for business purposes and for leisure. Our traffic volumes are affected by a number of factors, including population growth, economic trends and tourism.

Significant events during or subsequent to fiscal year 2006 included the following:

- On March 22, 2006, the Queen of the North, operating on its regular route from Prince Rupert to Port Hardy, ran aground on Gil Island in Wright Sound and subsequently sank in 425 metres of water. (See “Queen of the North incident” for further detail);

- On June 30, 2005, the Queen of Oak Bay, which sails between Departure Bay and Horseshoe Bay, ran aground on its approach to Horseshoe Bay terminal. After losing power, the vessel drifted into an adjacent marina, damaging a number of boats and the marina itself. No injuries were sustained as a result of the incident. Our investigation concluded that a mechanical failure of an engine speed control device (governor) led to the loss of power to both engines. Damage to the Queen of Oak Bay was minimal. A total of 28 boats moored at the adjacent marina were damaged or destroyed and the marina docks sustained significant damage as a result of the incident. Claim settlements are substantially complete and any remaining claims will be fully paid by our liability insurer.
• On July 25, 2005, we applied fuel surcharges to all fares, based on the British Columbia Ferries Commissioner’s approval of extraordinary price cap increases of 4% for major routes connecting Vancouver Island to the mainland and 6% on most other routes. Proceeds from the fuel surcharges are credited against balances in the deferred fuel cost accounts. As a result of continuing high fuel costs, a further extraordinary price cap increase was approved and fuel surcharges averaging 1.5% for major routes and 3% for most other routes became effective February 1, 2006. In his second order the Commissioner provided for additional fuel surcharges effective June 2006 if certain conditions are met. (See “Expenses – Fuel Deferral and Related Surcharge” for further detail.)

**Queen of the North**

On March 22, 2006, shortly after midnight, the *Queen of the North*, operating on its regular route from Prince Rupert to Port Hardy, ran aground on Gil Island in Wright Sound and subsequently sank. Two passengers remain unaccounted for and are presumed to have perished. Eleven passengers and crew, with minor injuries, were transferred from the incident site by helicopter to Prince Rupert where they were treated and released from hospital. The remaining passengers and crew were transferred from the *Queen of the North*’s life boats to fishing vessels and to the Coast Guard vessel *Sir Wilfred Laurier*. The vessels transported their passengers to the Village of Hartley Bay where their needs were attended to by the community. From Hartley Bay, the passengers and crew were taken to Prince Rupert by the Coast Guard vessel.

An emergency environmental plan was implemented in conjunction with external authorities, including the Canadian Coast Guard as the lead agency, Environment Canada, the Provincial Ministry of Environment and the Federal Department of Fisheries and Oceans. Burrard Clean Operations, under contract to us, led the containment activities at the incident site using 1,800 metres of barrier boom to protect sensitive areas. We continue to monitor the situation and are currently investigating the feasibility of recovering the fuel and lubricants remaining in the vessel.

The Transportation Safety Board, as the lead investigation agency, along with Transport Canada and the RCMP, are conducting investigations into the cause of the sinking. We are also conducting our own internal investigation.

A tug and barge service, as well as air service, was used as an interim measure to ensure that supplies reached the Queen Charlotte Islands and passengers requiring passage were accommodated. The *Queen of Prince Rupert*, which was undergoing refit at the time of the sinking, returned to service on the north coast route on April 19th. For this summer we intend to augment service provided by the *Queen of Prince Rupert* with additional tug and barge service.

We maintain commercial insurance coverage for incidents of this nature. In accordance with generally accepted accounting principles, $6.6 million of the expected $67.9 million net hull and machinery insurance policy proceeds have been recorded as receivable to offset insurable losses (including our liability insurance deductible of $1.0 million) incurred to March 31, 2006. We received the $67.9 million proceeds in May 2006. These proceeds, less the aforementioned receivable, will be recognized in the first quarter of fiscal year 2007. Claims for loss of life,
personal belongings of passengers, passenger automobiles, and other types of claims are in the process of settlement. We expect that substantially all third party claims in excess of our deductible will be paid by our liability insurer.

Our hull and machinery insurance policies have subsequently been renewed with an increase in annual premium costs of approximately $1.5 million. We expect that foregone passenger revenues resulting from the loss of the vessel will be largely offset by avoided operating costs and interest income on invested insurance proceeds. It is uncertain at this time what the impact of this incident will be on ferry service fees under the Coastal Ferry Services Contract.

We have not observed any measurable impact on traffic levels elsewhere in our system that we attribute to this unfortunate event.

We are conducting an international search to lease or purchase a replacement vessel. However, it is important to note that if we do find a replacement vessel for the Queen of the North, it will take several months to certify the vessel, implement a safety management system and train our crews. We also plan to accelerate the process for the construction of up to three new northern vessels for which the Provincial government has entered into an agreement to provide financial support.

In accordance with the terms of the Coastal Ferry Services Contract, we filed a notice of force majeure with the Province of British Columbia (the "Province") and are in discussions with them as to the appropriate level of service to be provided until the acquisition of a replacement vessel.

**CORPORATE STRUCTURE**

**Coastal Ferry Services Contract**

We operate ferry services under a regulatory regime as defined by the *Coastal Ferry Act*, and under the terms set out in the Coastal Ferry Services Contract. This 60-year services contract with the Province, which commenced April 1, 2003, stipulates the number of round trips that must be provided for each regulated ferry service route in exchange for specified fees. These fees are fixed over the first performance term of the contract, which ends March 31, 2008. The Coastal Ferry Services Contract also includes fees for the provision of specific social program services delivered on behalf of the Province.

Under the terms of this contract, we also receive an annual amount from the Province based on its agreement with the Government of Canada to fulfill the obligation of providing ferry services to coastal British Columbia. The amount of this payment is adjusted annually based on the Vancouver Consumer Price Index.

**Economic Regulatory Environment**

The office of the British Columbia Ferries Commissioner (the "Commissioner") was created under the *Coastal Ferry Act*, enacted by the Province on April 1, 2003. The Commissioner regulates price caps for designated ferry route groups which, to the end of the first performance term, are specified in the *Coastal Ferry Act*. The Commissioner is also responsible for regulating the reduction of service, discontinuance of routes and certain other matters. The *Coastal Ferry Act* requires the Commissioner to undertake regulation in accordance with several principles, including placing priority on the financial sustainability of ferry operators,
encouraging ferry operators to adopt a commercial approach to ferry service delivery and moving over time to a greater reliance on a user pay system.

**2006 FINANCIAL OVERVIEW**
This section provides an overview of our financial performance over the past three fiscal years.

Our consolidated net earnings in fiscal year 2006 grew $10.1 million or 25.2% from the previous fiscal year. Our earnings in fiscal year 2005 grew $11.8 million or 42.3% from the fiscal year 2004.

<table>
<thead>
<tr>
<th>($millions)</th>
<th>Fiscal year ended March 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
</tr>
<tr>
<td>Total revenue</td>
<td>579.2</td>
</tr>
<tr>
<td>% Growth</td>
<td>2.6%</td>
</tr>
<tr>
<td>Expenses</td>
<td>(504.1)</td>
</tr>
<tr>
<td>Earnings from operations</td>
<td>75.1</td>
</tr>
<tr>
<td>Interest and other</td>
<td>(25.2)</td>
</tr>
<tr>
<td>Net earnings (loss)</td>
<td>49.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>833.7</td>
<td>763.4</td>
<td>629.8</td>
</tr>
<tr>
<td>Total long-term financial liabilities</td>
<td>516.5</td>
<td>516.6</td>
<td>443.3</td>
</tr>
</tbody>
</table>

**Revenue**
Our total revenues have increased steadily over the past three fiscal years, as shown in the table below. Year to year changes for the past two fiscal years are discussed separately below.

<table>
<thead>
<tr>
<th>Revenue ($millions)</th>
<th>Fiscal year ended March 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
</tr>
<tr>
<td>Tariff - vehicles</td>
<td>221.5</td>
</tr>
<tr>
<td>Tariff - passengers</td>
<td>132.1</td>
</tr>
<tr>
<td>Ferry service fees</td>
<td>108.2</td>
</tr>
<tr>
<td>Federal-Provincial subsidy</td>
<td>24.9</td>
</tr>
<tr>
<td>Retail</td>
<td>68.8</td>
</tr>
<tr>
<td>Other income</td>
<td>23.7</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>579.2</td>
</tr>
</tbody>
</table>
**Year to Year Comparison of Revenues 2006 – 2005**

Vehicle and passenger traffic both decreased marginally in fiscal year 2006 from fiscal year 2005, which was our strongest year ever for both types of traffic. A portion of the decrease is in the timing of the Easter weekend. In fiscal year 2005, we experienced two Easter weekends while fiscal year 2006 did not include any. We also witnessed a decrease in the number of tour buses which we believe is related to a decline in tourism. This is more evident on our major routes which experience the greatest volatility from changes in tourism.

The improvement in tariff revenue is a result of annual average rate increases of 2.8% on our three major routes connecting Vancouver Island to the mainland and 4.4% on the remaining routes. These tariff increases are as permitted by the *Coastal Ferry Act*.

<table>
<thead>
<tr>
<th>Vehicle Traffic Volume</th>
<th>Fiscal year ended March 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
</tr>
<tr>
<td>Major routes</td>
<td>3,790,368</td>
</tr>
<tr>
<td>Other routes</td>
<td>4,752,901</td>
</tr>
<tr>
<td>Total</td>
<td>8,543,269</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Passenger Traffic Volume</th>
<th>Fiscal year ended March 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
</tr>
<tr>
<td>Major routes</td>
<td>11,055,858</td>
</tr>
<tr>
<td>Other routes</td>
<td>10,673,745</td>
</tr>
<tr>
<td>Total</td>
<td>21,729,603</td>
</tr>
</tbody>
</table>

Ferry service fees are higher in fiscal year 2006 than in fiscal year 2005 due to an increase of $1.3 million (9.4%) in social program fees. These programs include discount fares for BC seniors, students traveling to and from school and persons traveling under the medical Travel Assistance Program. Ferry service fees, other than social program fees, are linked to the number of scheduled sailings which, except for emergency events, are essentially the same each year. Social program fees are based on usage.

Retail revenue, which includes food and other retail merchandise sales, grew $1.0 million in fiscal year 2006 compared to fiscal year 2005. Revenue from food sales grew $0.3 million or 0.7%, the majority of the increase reflecting a higher spend per customer partially offset by a decrease in passenger traffic. An increase of approximately $0.4 million resulted from the addition of a new paid seating lounge on the *Spirit of British Columbia*. We also experienced a $0.3 million increase in lease revenues from the new Tsawwassen Quay, a 16,000 square foot retail outlet which opened in June 2005. (See “Investing in Our Capital Assets” for more details about the Quay.)

Other income increased a total of $4.2 million in fiscal year 2006 compared to fiscal year 2005. Reservation fees were $1.4 million higher, mainly as a result of a $1.2 million increase on our major routes. Revenue from sales of assured loading tickets (“ALTs”) increased $0.4 million. An additional $2.0 million was recognized in fiscal year 2006, reflecting the reassessment of the deferred revenue liability relating to
historical sales of paper ALTs. Sales of paper ALTs ceased in May 2005 upon the introduction of the "Coast Card". (See "Investing in our Capital Assets".) We also experienced an increase in parking and advertising revenues.

**Year to Year Comparison of Revenues 2005 – 2004**
The improvement in our tariff revenue in fiscal year 2005 compared to fiscal year 2004 was the result of higher traffic volumes, together with annual average rate increases of 2.8% on our three major routes connecting Vancouver Island to the mainland and 4.4% on the remaining routes. We experienced our strongest traffic levels ever in fiscal year 2005.

<table>
<thead>
<tr>
<th>Vehicle Traffic Volume</th>
<th>Fiscal year ended March 31</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2004</td>
</tr>
<tr>
<td>Major routes</td>
<td>3,808,843</td>
<td>3,688,123</td>
</tr>
<tr>
<td>Other routes</td>
<td>4,748,539</td>
<td>4,604,106</td>
</tr>
<tr>
<td>Total</td>
<td>8,557,382</td>
<td>8,292,229</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Passenger Traffic Volume</th>
<th>Fiscal year ended March 31</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
<td>2004</td>
</tr>
<tr>
<td>Major routes</td>
<td>11,222,356</td>
<td>10,824,727</td>
</tr>
<tr>
<td>Other routes</td>
<td>10,804,187</td>
<td>10,542,703</td>
</tr>
<tr>
<td>Total</td>
<td>22,026,543</td>
<td>21,367,430</td>
</tr>
</tbody>
</table>

Ferry service fees were higher in fiscal year 2005 compared to fiscal year 2004 due to an increase of $1.1 million (8.9%) in social program fees.

The Federal-Provincial subsidy is adjusted each year in accordance with changes in the Vancouver Consumer Price Index.

Retail revenue increased $4.6 million in fiscal year 2005 compared to fiscal year 2004. Revenue from food sales grew 2.6%, the majority of the increase reflecting a January 7, 2004 price increase of 3%. Other retail spending increased 13.4%. This increase was mainly attributable to positive customer response to our gift shop expansions on the Queen of Coquitlam, Queen of Cowichan, and the Spirit of Vancouver Island.

The increase in other income in fiscal year 2005 compared to fiscal year 2004 reflects increased usage of our reservation system. Reservation fees were $2.3 million higher, with $1.9 million more revenue from reservations on our major routes and the balance from the Horseshoe Bay-Langdale route. This increase is partially offset by reductions in foreign exchange and advertising revenues.
Expenses for the past three fiscal years are summarized in the table below.

<table>
<thead>
<tr>
<th>Expenses ($millions)</th>
<th>Fiscal year ended March 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
</tr>
<tr>
<td>Operations</td>
<td>291.7</td>
</tr>
<tr>
<td>Maintenance</td>
<td>81.1</td>
</tr>
<tr>
<td>Administration</td>
<td>51.2</td>
</tr>
<tr>
<td>Total operations, maintenance &amp; administration</td>
<td>424.0</td>
</tr>
<tr>
<td>% Increase (decrease)</td>
<td>(0.3%)</td>
</tr>
<tr>
<td>Cost of retail goods sold</td>
<td>27.0</td>
</tr>
<tr>
<td>Amortization</td>
<td>53.1</td>
</tr>
<tr>
<td></td>
<td>504.1</td>
</tr>
<tr>
<td>% Increase</td>
<td>0.9%</td>
</tr>
<tr>
<td>Loss (gain) on foreign exchange</td>
<td>(0.2)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>25.1</td>
</tr>
<tr>
<td>Loss on disposal of capital assets</td>
<td>0.3</td>
</tr>
<tr>
<td></td>
<td>25.2</td>
</tr>
</tbody>
</table>

**Fuel Deferral and Related Surcharge**

In September 2004, the British Columbia Ferries Commissioner issued an order authorizing us to maintain deferred fuel cost accounts to mitigate the effect on our earnings of unpredictable and uncontrollable price volatility in world fuel oil markets. The Commissioner established set prices for fuel oil for each of the years until March 31, 2008, at which time the Commissioner will decide on the continuation of the deferred fuel cost accounts. Differences in fuel costs arising from our actual price paid per litre being higher or lower than the unit set price are charged to the deferral accounts.

On June 13, 2005, we filed an application with the British Columbia Ferries Commissioner under section 42 of the Coastal Ferry Act for extraordinary price cap increases. We had experienced significantly higher prices for fuel oil than expected. At the time of the application, our annual cost of fuel was projected to be 45% higher than it was two years earlier, exceeding $72 million this fiscal year. As a result of the higher forecast costs, the deferred fuel cost account balances would be greater than originally expected. The application requested extraordinary price cap increases to allow for fuel surcharges in order to reduce or eliminate these balances.

The Commissioner’s ruling approved extraordinary price cap increases of 4% for major routes connecting Vancouver Island to the mainland and 6% on most other routes. The price cap increases allowed for fuel surcharges which took effect on July 25, 2005, to be applied to all fares. Proceeds from the fuel surcharges are credited against balances in the deferred fuel cost accounts.

As part of the Order, the Commissioner also increased the set prices established in a previous ruling by 5% effective July 24, 2005. In fiscal year 2006, this increase in
set prices resulted in $1.6 million of additional expense. This change resulted in a 5% increase in fuel costs charged to expense for the balance of fiscal year 2006 and for the two succeeding years in addition to the increase established in the original order. This will reduce the projected amount added to the deferral account balances by an equal amount. The Order can be viewed on the Commissioner’s website at www.bcferrycommission.com.

As a result of continuing high fuel costs and a new annual fuel cost projection of $76 million for fiscal year 2006, we applied to the British Columbia Ferries Commissioner on November 28, 2005, for additional price cap increases to allow for further fuel surcharges.

On January 20, 2006, the Commissioner issued a further decision which was segregated into two parts:

1. The Commissioner granted additional price cap increases which allowed for the implementation of an incremental fuel surcharge on all fare types, averaging 1.5% for major routes connecting Vancouver Island and the Mainland and 3% for most other routes, effective February 1, 2006;

2. Another increase may be granted effective June 2006, if certain conditions are met. The Commissioner has developed a formula to determine the amount, if any, of the increase. Due to the continued high cost of fuel and despite $11.2 million in fuel surcharges collected in fiscal year 2006, the balance in the fuel deferral accounts has increased from $8.0 million at March 31, 2005 to $22.7 million at March 31, 2006. We anticipate that the Commissioner will grant a further increase.

In addition, the Commissioner has set an efficiency target requiring us to reduce fuel consumption by 1% in fiscal year 2007 and by an additional 1% in fiscal year 2008 and has included a requirement that we develop and file a plan to address fuel savings. This Order can also be viewed on the Commissioner’s website.

We are continuing to implement a wide variety of fuel saving measures ranging from operating our vessels more efficiently to installing new, more fuel-efficient engines on some of our vessels. For the year ended March 31, 2006, compared to the previous year, our fuel consumption was reduced by 3.4% (with a reduction in sailings provided of 0.4%). This reduction is primarily as a result of improvements in on-time performance, an engine upgrade on the Queen of New Westminster and a fuel monitor system installed on the Queen of Alberni. In both fiscal years 2006 and 2005, the large Spirit vessels, which carry vehicles and passengers between Vancouver Island and the Mainland, were out of service for maintenance for approximately the same time period. When the Spirit vessels are out of service, they are replaced by smaller vessels and we experience a savings in fuel consumption.

**Year to Year Comparison of Expenses 2006 – 2005**
The total decrease in operations expenses in fiscal year 2006 compared to fiscal year 2005 was $2.3 million. This reflects a $7.7 million net decrease in property tax expense. In January, 2006 the Property Assessment Appeal Board accepted an agreement we reached with the BC Assessment Authority to settle our 2004 and 2005 terminal property assessment appeals. Prior to becoming an independent company, we paid approximately $1.4 million per year in grants-in-lieu of property taxes. In 2004, we paid $8.9 million in property tax and $9.9 million in 2005. The settlement reduces our terminal property assessments by approximately 40% for
2004 and 47% for 2005 which resulted in a refund of $8.2 million. This reduction in property tax expense was partially offset by an increase in wages and benefits of $3.6 million, a $0.7 million increase in the total fuel costs due to a 7% increase in the set price as approved by the British Columbia Ferries Commissioner, partially offset by efficiency savings, $1.3 million increase in marine insurance and $1.6 million increase in major ad campaigns and travel agent fees. Costs not covered by third party insurance for the grounding of the Queen of Oak Bay totalled $1.5 million, with $1.2 million reflected in operations and $0.3 million reflected in maintenance expenses.

Maintenance expenses, which include expenditures for vessel refit and maintenance as well as terminal maintenance activities, were $5.7 million lower in fiscal year 2006 compared to fiscal year 2005. This was mainly due to the higher maintenance costs incurred in fiscal year 2005 for one-time costs required to meet Transport Canada requirements.

Administration expenses increased $6.7 million in fiscal year 2006 compared to the previous fiscal year. Increases include:
- $3.7 million for corporate information technology support. We have had many new initiatives and upgrades to our computer systems, including safety and security programs, a new catering and retail system and systems to improve customer service, which require increased support;
- $2.1 million resulting from our internal control certification project. We have initiated this project to document and test the effectiveness of internal controls on which management is relying to support certifications required by the Canadian Securities Administrators; and
- $2.1 million costs for severance and restructuring.

These increases were partially offset by administrative efficiencies.

The $0.5 million increase in cost of retail goods sold in fiscal year 2006 compared to fiscal year 2005 reflects the higher level of retail sales and the higher cost of premium products.

Amortization increased a total of $5.4 million in fiscal year 2006 compared to the previous fiscal year. This increase was a result of additional assets coming into service including:
- $1.7 million reflecting the Queen of Oak Bay $35.1 million upgrade;
- $1.7 million reflecting new information technology including our Coast Card, our new point of sale system, crew scheduling system and enterprise resource planning projects.

Interest expenses increased $0.6 million in fiscal year 2006 compared to fiscal year 2005 reflecting the overall increase in our average level of debt and the effect of interest rates payable on the debt instruments issued and in place as described in the "Liquidity and Capital Resources" section below. Increases in debt costs were partially offset by interest rate support recorded under the Structured Financing Facility Program offered by the Government of Canada for the Queen of Oak Bay and Queen of Nanaimo mid-life upgrades. A total of $5.6 million in support has been granted of which we have reflected $2.0 million as a decrease in bond interest costs for fiscal year 2006 and $0.6 million to offset interest costs previously capitalized on the upgrades. The remaining $3.0 million will be applied against future bond interest costs.
Year to Year Comparison of Expenses 2005 – 2004
The total increase in operations expenses in fiscal year 2005 compared to fiscal year 2004 was $8.0 million. The most significant increase of $5.8 million was due to the first complete calendar year of the change from paying grants-in-lieu to property taxes based on assessed value. Another $1.6 million was due to increased wage and training costs.

Maintenance expenses, which include expenditures for vessel refit and maintenance as well as terminal maintenance activities, were $0.7 million higher in fiscal year 2005 compared to the previous fiscal year. We experienced higher maintenance costs in fiscal year 2005 for one-time costs required to meet Transport Canada requirements, while in fiscal year 2004 we incurred one-time costs to repair the Queen of Surrey after a fire onboard.

Administration expenses increased $5.6 million in fiscal year 2005 compared to fiscal year 2004. The most significant increase was the cost of corporate information technology support of $4.3 million. We have had many new initiatives and upgrades to our computer systems which require increased support.

The increased cost of retail goods sold in fiscal year 2005 compared to the previous fiscal year reflects the higher level of retail sales. The expansion of our vessel gift shops with increased lines of merchandise has been very successful.

Amortization increased a total of $0.3 million in fiscal year 2005 compared to fiscal year 2004. This change was a combination of revisions to the estimates of vessel salvage value and increases from additional assets coming into service, partially offset by the Queen of Chilliwack being fully amortized at the end of March 2004.

Interest expenses increased a total of $1.8 million in fiscal year 2005 compared to the previous fiscal year reflecting the overall increase in our average level of debt and the effect of interest rates payable on the debt instruments issued and in place as described in the "Liquidity and Capital Resources" section below.

Liquidity and Capital Resources
We fund our operations and capital acquisitions with cash flow generated from operations, as well as bank financing and debt issues. We expect operating cash flows to fund approximately one half of the capital expenditures over the next decade, with the balance funded by borrowings.

Long-Term Debt
In May 2004 we entered into a master trust indenture. This indenture established common security and a set of common covenants by us for the benefit of our lenders. Our financing plan encompasses an ongoing program capable of accommodating a variety of corporate debt instruments and borrowings ranking pari passu. We do not currently view common share equity as a potential source of capital and have no present intention of offering common shares to the public or other investors.

Under this indenture we completed two $250 million public offerings. A 5.74% Senior Secured Bonds, Series 04-1, due May 27, 2014 and a 6.25% Senior Secured Bonds, Series 04-4, due October 13, 2034. The net proceeds were used primarily to repay a portion of our indebtedness to the Province, to fund reserves required in
connection with these bonds and for general corporate purposes. Interest on these bonds is payable semi-annually.

We also entered into a credit agreement with a syndicate of Canadian banks which is secured under the indenture. Under this agreement, at March 31, 2006 we had two credit facilities, a 364-day revolving operating facility with a one year term-out, in an amount of $77.5 million and a three-year revolving extendible facility in an amount of $77.5 million. The revolving term facilities were available for working capital purposes, to fund the upgrade and acquisition of vessels and terminal upgrades and other general corporate purposes. The credit facilities have subsequently been renegotiated and combined into a single revolving five year term facility in the amount of $155 million.

In October 2005 we finalized two loan agreements with KfW, a German export credit bank. These agreements are secured under the Master Trust Indenture. The agreements allow us to borrow up to $90 million per loan, with the net proceeds to be used to finance the purchase of two of the three Super C-class vessels currently being built. These funds will not be advanced until the date upon which we accept delivery of the applicable vessel from the ship builder. The principal amount of each loan will be repaid over the twelve year term of the loan.

**Terminal Leases**

We entered into a master agreement with the British Columbia Transportation Financing Authority ("BCTFA") effective March 31, 2003, as part of the restructuring of our Company. In return for the transfer of ownership interest in all ferry terminals from the former British Columbia Ferry Corporation to the BCTFA at the time of the corporate restructuring, we received recognition of prepayment of rent under terminal leases.

The leases grant us exclusive access and use of ferry terminal properties for a period of 60 years commencing April 1, 2003. The leases are renewable for an additional period of 20 years at a total cost of $20 per lease if the Coastal Ferry Services Contract is renewed. We must manage, maintain and develop the terminals at our own cost.

In fiscal years 2006 and 2005, we added a total of $1.1 million and $3.9 million, respectively, of additional lands at Horseshoe Bay and Swartz Bay to the existing terminal leases in exchange for highway improvements.

If we fail to meet our obligations under the terminal leases or default under the Coastal Ferry Services Contract, the BCTFA may at its option re-enter and take possession of the ferry terminal properties and at its option terminate the leases. The BCTFA has entered into an acknowledgement agreement with the Bondholders’ Trustee which sets out certain limitations of the use of this option.

**Other Long-Term Liabilities**

Other long-term liabilities consist primarily of accrued post-retirement and post-employment benefits.

**Sources & Uses of Cash**

Our liquidity needs are met through a variety of sources, including cash generated from operations and borrowings under our credit facility. Our primary uses of funds
are operational expenses, capital asset acquisitions and upgrades and interest payments on our long-term debt.

Sources and uses of cash and cash equivalents for fiscal years 2006 and 2005 are summarized in the table below.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Fiscal year ended March 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
</tr>
<tr>
<td>Net income for the period</td>
<td>49.9</td>
</tr>
<tr>
<td>Items not involving cash:</td>
<td></td>
</tr>
<tr>
<td>Amortization</td>
<td>53.1</td>
</tr>
<tr>
<td>Other non-cash charges</td>
<td>1.2</td>
</tr>
<tr>
<td>Fuel costs deferred</td>
<td>(14.8)</td>
</tr>
<tr>
<td>Change in operating working capital</td>
<td>9.0</td>
</tr>
<tr>
<td>Cash provided by operating activities</td>
<td>98.4</td>
</tr>
<tr>
<td>Cash (used) provided by financing activities</td>
<td>(6.7)</td>
</tr>
<tr>
<td>Cash used in investing activities</td>
<td>(130.9)</td>
</tr>
<tr>
<td>Total (decrease) increase in cash</td>
<td>(39.2)</td>
</tr>
</tbody>
</table>

Cash provided by operating activities was $98.4 million for fiscal year 2006. Included in these results was a decrease in non-cash working capital of $9.0 million. This working capital decrease was primarily due to:

- $13.7 million increase in payables and accrued liabilities, partially due to the higher level of capital projects and vessel refits done during the latter part of fiscal year 2006;
- $6.1 million increase in GST payable. Effective April 2, 2003, we became subject to GST but are limited in our ability to obtain input tax credits ("ITCs") because certain of our services are exempt under the Excise Tax Act. In fiscal 2006, we reviewed the options available to us and filed an amended ITC claim for the period April 2, 2003 through June 30, 2005. Canada Revenue Agency ("CRA") has completed an audit of our GST filings, including review of our amended claims. Although CRA determined the methods used in our revised filings to be generally fair and reasonable, they have denied us the ability to file the amended claim which totalled $3.2 million. In addition, CRA has taken the position that vessel fuel and lubricants used for propulsion supports only GST exempt lines of business resulting in denial of ITC claims of approximately $2.2 million for the period April 2, 2003 through March 31, 2006. In April 2006, we paid all amounts related to the denied ITC claims. However, we disagree with CRA's interpretation of the law in this instance and intend to vigorously pursue recovery through the appeal process.

The working capital decrease was partially offset by:

- $6.6 million increase due to insurance proceeds receivable in connection with the Queen of the North incident described above; and
- $6.9 million increase in property tax receivable resulting from the favourable settlement of the 2004 and 2005 property tax appeals.
Cash used for financing activities was primarily $6.0 million dividends paid on preferred shares.

Cash used in investing activities was $130.9 million. This was primarily due to capital expenditures, on a cash basis, of $129.7 million and $1.1 million reflecting the increase in lands under long-term lease. The significant capital transactions this fiscal year are described below in “Investing in Our Capital Assets”.

Investing in our Capital Assets
Capital expenditures in fiscal year 2006 totalled $136.0 million. This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures included:

- $82.1 million in vessel upgrades and modifications including:
  - $26.1 million of a $39.5 million mid-life upgrade which includes safety, structural and mechanical improvements to the Queen of Surrey;
  - $15.4 million for life saving and fire protection upgrades on the Queen of Nanaimo;
  - $13.5 million for life saving upgrades on the Spirit of Vancouver Island;
  - $11.9 million of a $35.1 million mid-life upgrade of safety, structural and mechanical improvements on the Queen of Oak Bay;
  - $4.2 million for upgrading systems to increase fuel efficiency and provide greater durability and reliability on the MV Kwuna;
  - $3.5 million on the Super C new vessel construction project; and
  - $2.8 million of the $11.8 million project to reconstruct Hull 259, formerly the MV John Atlantic Burr, for service;
- $7.3 million in terminal and building upgrades, including $2.0 million of the $7.3 million retail building completed this year at Tsawwassen terminal;
- $36.9 million in marine structures of which $17.7 million is for berth reconstruction at Swartz Bay terminal;
- $9.0 million in software development which will enhance customer service in areas such as reservations, provide improvements in retail and food service management and operational efficiencies in crew scheduling.

Major vessel upgrades
The Queen of Surrey, which provides service on our Langdale-Horseshoe Bay route, was removed from service on November 16, 2005, for an extensive $39.5 million mid-life upgrade. The 25-year-old vessel will undergo significant upgrades to prepare it for another 20 years of service. The upgrades include safety, structural and mechanical improvements as well as improved and expanded passenger amenities. The Queen of Surrey is the fourth of five “C-class” vessels identified for mid-life upgrade. The Queen of Coquitlam completed its mid-life upgrade in June 2003 and the Queen of Cowichan completed its mid-life upgrade in May 2004. The third C-class vessel, Queen of Oak Bay, which provides service on our Nanaimo-Horseshoe Bay route, completed its extensive, six-month upgrade at a total cost of $35.1 million and returned to service in June 2005. The mid-life upgrade on the remaining C-class vessel, the Queen of Alberni, will be completed in fiscal year 2008.

The Queen of Nanaimo, which provides service to the Southern Gulf Islands from Vancouver, returned to service on January 14, 2006 following a four month, $16.3 million refurbishment. This project is expected to add ten years to the life of this vessel. The project included installing a new life-saving system comprised of four marine evacuation slides and rafts; surveying and painting the hull; replacing
structural steel; renewing the deck plating; updating structural fire protection;
renewing and upgrading boilers; installing a new oily-water separator; and rebuilding
the main propeller shafts and controllable pitch propellers. This project also included
improvements to customer amenities.

The Spirit of Vancouver Island, which provides service on our Tsawwassen-Swartz
Bay route, returned to service on March 23, 2006 following a $13.5 million upgrade.
The improvements included new lifesaving equipment and passenger service
improvements. These passenger service improvements, part of a major initiative to
revitalize the fleet, included an upgraded cafeteria, a redesigned buffet, renovated
washrooms, new sitting, flooring and carpeting.

The MV Kwuna, which provides service between Alliford Bay and Skidegate,
underwent a major $4.2 million betterment that focused on upgrading ship systems
to increase fuel efficiency and provide greater durability and reliability. This included
the installation of new engines, replacement of generators and upgrade of the
hydraulic system for the ship’s ramps.

"Super C" Class new vessel construction
On September 17, 2004 we entered into contracts with Flensburger Schiffbau-
Gesellschaft ("FSG") of Germany to build three new major vessels. These contracts,
with a total value of €206.4 million or approximately $325 million, form the majority
of the total project budget of $542 million. The Coastal Renaissance, Coastal
Inspiration and Coastal Celebration, scheduled for delivery in late 2007 through mid-
2008, will replace aging vessels which currently provide service on our major routes.
These are design-build, fixed price contracts that provide us with substantial
guarantees related to delivery dates, performance criteria, cost certainty and quality
of construction. The detailed design will continue until September 2006 when steel
cutting starts for the first vessel, which is expected to be delivered in December
2007. Foreign currency based payments in this project have been hedged in
Canadian dollars to manage the foreign exchange risk. We expect this project to be
completed on schedule and within budget.

New intermediate vessel construction
On July 20, 2005, the British Columbia Ferries Commissioner issued a declaration
that a new intermediate-class ferry to replace the 45-year-old Queen of Tsawwassen
is reasonably required. We are currently discussing requirements with Vancouver
Shipyards of the Washington Marine Group for the construction of a new 125-car
ferry. Vancouver Shipyards is developing a new design that will undergo model
testing and simulation demonstrations to satisfy certain manoeuvring criteria prior to
contract award. Assuming final agreement and contract award by July 2006, the
new vessel is expected to be in service by the summer of 2008.

Hull 259 – vessel yet to be named
In August 2005, we acquired a ferry from the State of Utah for $200,000 (US)
through a competitive bid process. This vessel, originally the MV John Atlantic Burr,
is similar in design to our three "K-class" vessels, the MV Kahloke, the MV Klitsa and
the MV Kwuna. It was designed in Victoria in 1985 and was substantially upgraded
with its hull and superstructure lengthened in 1996. The vessel was disassembled in
Utah and trucked and barged in pieces to Vancouver. It is currently undergoing
major reconstruction to upgrade it to our standards and the requirements of
Transport Canada and to expand its vehicle carrying capacity. The new vessel, yet
to be named, is expected to be ready for service in November 2006.
Tsawwassen Quay
In June 2005, the new $7.3 million, 16,000 square-foot retail building opened at Tsawwassen, our largest terminal. Tsawwassen Quay offers 18 food, beverage, service and retail outlets. In addition, there are new washroom facilities, bank machines, pay telephones, seven indoor mobile retail kiosks and four outdoor kiosks featuring seasonal crafts and gifts. The Tsawwassen terminal, on average, serves over four million passengers each year. The retail facility is managed by Lonsdale Quay Market Corp. under a 10-year lease agreement. This partnership is an example of the long-term business associations we seek to develop.

Tsawwassen Terminal Marine Structures
In fiscal year 2006, we spent $8.1 million to complete upgrades at our Tsawwassen terminal. This completes the projects at two berths which included replacing marine and vehicle ramp structures, constructing a new foot passenger waiting lounge, tower and access walkway as well as upgrading the electrical service at a total cost of $20.1 million. The design work on further upgrades at a third berth at Tsawwassen terminal is underway. This project will have an estimated cost of $13.2 million and includes the replacement of deteriorated marine structures and vehicle ramp as well as upgrades to the hydraulic system. This project is expected to be complete by the end of the first quarter of fiscal year 2008.

Swartz Bay Terminal Marine Structures
In fiscal year 2006, we spent $17.7 million of a total project estimated at $25.0 million for the construction of a new trestle and ramp at berth 2 at Swartz Bay terminal. This berth reconstruction is expected to be complete by the end of the first quarter of fiscal year 2007.

Information Technology
In June 2005, we launched our new stored value card on our major routes. The "Coast Card" is a plastic card with a magnetic strip, similar to a bank card. Assured loading tickets are the first product to be offered on the card. In the future other services may be available through this card. Our Coast Card introduces online account management features so customers can review travel activity, purchase new assured loading tickets and take advantage of other services including loss protection and automatic purchase or renewal options.

We have undertaken a new project to improve communications technology services, replace obsolete technology, reduce costs and manage growth as our business demands change. This project is expected to improve ship-to-shore data communications and provide a more stable, secure and faster network for internal business needs and for our customers.

We have implemented a new catering and retail system that will improve efficiency and reduce costs. This system replaces a manual inventory system and will provide additional information and improved controls. As a result, we will achieve better management of our food inventory and will be able to reduce waste.

To meet the increased need for enhanced public and employee security, we introduced a new employee photo identification program. The new cards have multi-function technology which will increase access control points on terminals and vessels and allow for expansion to other applications.
Further implementation of crew scheduling software was instituted, allowing efficiencies and providing more focus on longer term scheduling.

**FOURTH QUARTER RESULTS**

This section provides an overview of our financial performance for the three months ended March 31, 2006 compared to the three months ended March 31, 2005.

Our quarterly results are affected by the seasonality of leisure travel patterns. The second quarter, covering the summer period, experiences the highest traffic levels and the highest earnings. The third and fourth quarters reflect a seasonal downturn in traffic. We utilize these periods to perform upgrades and major maintenance and refit programs as well as to undertake mandatory inspections on the majority of our vessels.

Our consolidated net loss for the three months ended March 31, 2006 was a $6.5 million or 20.8% improvement over the net loss of the three months ended March 31, 2005.

<table>
<thead>
<tr>
<th></th>
<th>Three Months Ended March 31</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($ millions)</td>
<td>2006</td>
<td>2005</td>
<td>Variance</td>
<td>%</td>
</tr>
<tr>
<td>Total revenue</td>
<td>109.7</td>
<td>106.9</td>
<td>2.8</td>
<td>2.6%</td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>(128.4)</td>
<td>(130.7)</td>
<td>2.3</td>
<td>1.8%</td>
<td></td>
</tr>
<tr>
<td>Earnings from operations</td>
<td>(18.7)</td>
<td>(23.8)</td>
<td>5.1</td>
<td>21.4%</td>
<td></td>
</tr>
<tr>
<td>Interest and other</td>
<td>(6.1)</td>
<td>(7.5)</td>
<td>1.4</td>
<td>18.7%</td>
<td></td>
</tr>
<tr>
<td>Net loss</td>
<td>(24.8)</td>
<td>(31.3)</td>
<td>6.5</td>
<td>20.8%</td>
<td></td>
</tr>
</tbody>
</table>

**Revenue**

Our total revenues for the three months ended March 31, 2006 have increased over the three months ended March 31, 2005, as shown in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Three Months Ended March 31</th>
<th>Increase(Decrease)</th>
<th>2006</th>
<th>2005</th>
<th>$</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tariff – vehicles</td>
<td>39.3</td>
<td>38.9</td>
<td>0.4</td>
<td>0.4</td>
<td>1.0%</td>
<td></td>
</tr>
<tr>
<td>Tariff – passengers</td>
<td>21.5</td>
<td>21.5</td>
<td>0.0</td>
<td>0.0</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Ferry service fees</td>
<td>24.6</td>
<td>24.7</td>
<td>(0.1)</td>
<td>(0.1)</td>
<td>-0.4%</td>
<td></td>
</tr>
<tr>
<td>Federal-provincial subsidy</td>
<td>6.2</td>
<td>6.0</td>
<td>0.2</td>
<td>3.3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>12.3</td>
<td>11.9</td>
<td>0.4</td>
<td>3.4%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other income</td>
<td>5.8</td>
<td>3.9</td>
<td>1.9</td>
<td>48.7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue</td>
<td>109.7</td>
<td>106.9</td>
<td>2.8</td>
<td>2.6%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The improvement in vehicle tariff revenue in the three months ended March 31, 2006, compared to the three months ended March 31, 2005, is a result of higher tariff rates, partly offset by lower traffic volume on our major routes. Tariff revenue reflects an increase in our rates of an average of 2.8% and 4.4% as permitted by the Coastal Ferry Act.
<table>
<thead>
<tr>
<th>Vehicle Traffic Volume</th>
<th>Three months ended March 31</th>
<th>Increase(Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
<td>2005</td>
</tr>
<tr>
<td>Major routes</td>
<td>725,119</td>
<td>728,883</td>
</tr>
<tr>
<td>Other routes</td>
<td>989,753</td>
<td>981,804</td>
</tr>
<tr>
<td>Total</td>
<td>1,714,872</td>
<td>1,710,687</td>
</tr>
</tbody>
</table>

Passenger tariff revenue in the three months ended March 31, 2006, is equal to the three months ended March 31, 2005, is a result of higher tariff rates, offset by lower traffic volumes. Passenger traffic volumes decreased 1.6% on the major routes and 1.3% on the other routes. We believe that reduced levels of tourism, as well as the timing of Easter weekends, has contributed to this decline.

<table>
<thead>
<tr>
<th>Passenger Traffic Volume</th>
<th>Three months ended March 31</th>
<th>(Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
<td>2005</td>
</tr>
<tr>
<td>Major routes</td>
<td>1,951,018</td>
<td>1,983,203</td>
</tr>
<tr>
<td>Other routes</td>
<td>2,109,200</td>
<td>2,137,534</td>
</tr>
<tr>
<td>Total</td>
<td>4,060,218</td>
<td>4,120,737</td>
</tr>
</tbody>
</table>

Other revenue in the three months ended March 31, 2006 increased compared to the three months ended March 31, 2005 due to inclusion of a $2.0 million write down of the deferred revenue liability relating to historical sales of paper assured loading tickets ("ALTs"). Sales of paper ALTs ceased in May, 2005 upon introduction of the "Coast Card".

**Expenses**
Expenses for the three months ended March 31, 2006 totalled $134.5 million, $3.7 million less than the three months ended March 31, 2005, as shown in the following table.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Three months ended March 31</th>
<th>(Increase)Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2006</td>
<td>2005</td>
</tr>
<tr>
<td>Operations</td>
<td>63.3</td>
<td>70.9</td>
</tr>
<tr>
<td>Maintenance</td>
<td>27.1</td>
<td>26.9</td>
</tr>
<tr>
<td>Administration</td>
<td>18.7</td>
<td>14.5</td>
</tr>
<tr>
<td>Cost of retail goods sold</td>
<td>5.1</td>
<td>4.8</td>
</tr>
<tr>
<td>Amortization</td>
<td>14.2</td>
<td>13.6</td>
</tr>
<tr>
<td>Loss (gain) on foreign exchange</td>
<td>0.0</td>
<td>(0.2)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>5.8</td>
<td>7.4</td>
</tr>
<tr>
<td>Loss on disposal of capital assets</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Total expense</td>
<td>134.5</td>
<td>138.2</td>
</tr>
</tbody>
</table>

Operations reflects a $9.8 million decrease in property tax expense resulting from settlement of appeals as described above.

This decrease was partially offset by an increase in administration costs, the majority of which represents increases in wages and benefits. These costs include additional
pension costs due to past service purchases as well as severance and restructuring costs.

QUARTERLY FINANCIAL PERFORMANCE
Quarterly results are affected by the seasonality of leisure travel patterns. The second quarter, covering the summer period, experiences the highest traffic levels and the highest net earnings. The third and fourth quarters reflect a seasonal downturn in traffic. We utilize these periods to perform upgrades and major maintenance and refit programs as well as to undertake mandatory inspections on the majority of our vessels.

The table below compares earnings by quarter for the most recent eight quarters.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Quarter Ended (unaudited)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mar 06</td>
</tr>
<tr>
<td>Total revenue</td>
<td>109.7</td>
</tr>
<tr>
<td>Earnings (loss) from operations</td>
<td>(18.7)</td>
</tr>
<tr>
<td>Net earnings (loss)</td>
<td>(24.8)</td>
</tr>
</tbody>
</table>

Net losses in the quarters ended March 2006 and December 2005 and net earnings in the quarter ended June 2005 were better than the same quarter in the previous year ranging from $2.1 million to $6.5 million. In the quarter ended September 2005, compared to the quarter ended September 2004, net earnings were lower by $1.8 million. The average increase in net earnings for the latest four quarters was $2.5 million or 25.2%.

Total revenue in each of the latest four quarters was higher than the corresponding quarter from the previous fiscal year. The most significant contributing factors to the trend were higher tariff revenue as a result of increases in tariff rates and growth in retail and other income. As mentioned earlier in this report, the Coastal Ferry Act permits an annual average tariff increase of 2.8% on the three major routes and 4.4% on the remaining routes. Vehicle traffic decreased 2.5% in the quarter ended December 2005 compared to the quarter in the previous year. In all remaining quarters, we experienced a modest increase, resulting in a net four-quarter decrease of 0.2%. We believe that the lower than expected traffic levels are primarily due to reduced levels of tourism. The following graph shows the relationship of the quarters over the past three years.
Passenger traffic in all four quarters of fiscal year 2006 was lower than the corresponding quarters in the previous year. The average decrease was 1.3%. There has been a downwards trend in the number of tour buses. As previously mentioned, we believe the decrease in passenger traffic is primarily due to reduced levels of tourism. Following is a graph showing the relationship of the quarters over the past three years.

**OUTLOOK**

**Traffic**

Although both passenger and vehicle traffic were lower in fiscal year 2006 than fiscal year 2005, they both are trending upwards.
Ferry traffic levels are affected by a number of factors including high fuel costs, a strong Canadian dollar, the public’s concerns regarding security and health, disposable personal income, the local economy and population growth. While we anticipate only modest traffic volume increases over the next few years, we do see opportunities for growth in our markets.

**Market Growth**
We see many opportunities for growth. We received approximately 2.4 million unique visitors to our website in fiscal year 2006, up 21% from the previous fiscal year. With the increasing use of the Internet by travellers planning and booking trips, we are presented with an ongoing opportunity to maximize the role of our website as not only an information source, but also a sales point and distribution channel.

We have identified a market development opportunity with the growth in the volumes of commercial semi-trailer and container traffic. Container traffic to Vancouver Island is expected to expand as overseas container movements to the Vancouver Gateway increase and large “big box” retailers continue to locate on Vancouver Island.

We have experienced a steady growth in ancillary revenues. We see continuing opportunities to improve the revenue from our ancillary services including reservations, food and retail and assured loading.

**Asset Renewal Program**
Although we have one of the largest fleets in the world, the average age of our assets is currently among the highest of major ferry operators worldwide. To address this we will continue with our fleet and asset renewal program. We expect to spend more than $900 million over the next three years to upgrade and replace our aging assets. Until we are able to upgrade and replace a large share of our fleet through new vessel acquisitions and our revitalization program, we expect that reliability issues may continue to challenge our operations.

**Regulation**
Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. It is expected that a revised Act and new regulators will be introduced in the near future and will include more stringent regulations. Given the age of our fleet, these revised regulations may significantly affect the useful life of some of our vessels or drive the requirement for upgrades. We are addressing this changing regulatory environment through our planning processes and asset renewal initiatives. As always, the safety and security of our customers and employees remain priority one.

Our first performance term ends March 31, 2008. We must provide the British Columbia Ferries Commissioner with the information required under the *Coastal Ferry Act* in order for the Commissioner to set price caps for the next performance term. We expect to file our submission by September 30, 2006. This process will set the price caps for the second performance term ending March 31, 2011.

**Competition**
New competitors have emerged in both the passenger only market as well as the commercial traffic market in the past few years. To date, passenger only
competitors have not been successful at sustaining operations. We expect competition may increase in these markets with the potential emergence of private sector vehicle and passenger ferry services. We remain mindful of these potential changes in the market, and we are constantly seeking ways to improve operational efficiency and customer service.

We are also exploring opportunities with additional or alternative service providers, in an effort to reduce costs and provide services on our regulated routes, as mandated by the Coastal Ferry Act. While we maintain responsibility for the long-term delivery of ferry services, we are required to test the market to determine if another operator, under contract to us, can provide a more cost-effective service offering. We expect to issue a Request for Proposal to two proponents on the Brentwood Bay-Mill Bay route later this year. We also expect to issue a Request for Proposals regarding the operation of our four routes north of Port Hardy. However, due to the loss of the Queen of the North, the timing of this request is uncertain.

FINANCIAL INSTRUMENTS
Fair market 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.

Derivatives
We hedge our exposure to fluctuations in fuel prices and foreign currency exchange rates through the use of derivative instruments. The table below indicates the change in valuation of the derivative instruments for the year ended March 31, 2006.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>March 31, 2006</th>
<th>March 31, 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of swaps</td>
<td>Term to maturity (years)</td>
</tr>
<tr>
<td>Commodity Fixed Price Swaps</td>
<td>9</td>
<td>Up to 0.4</td>
</tr>
<tr>
<td>Foreign Exchange Forward Transactions</td>
<td>26</td>
<td>2.1</td>
</tr>
</tbody>
</table>

*FMV (fair market value)*

The commodity derivatives fair market value reflects only the value of the commodity derivatives and not the offsetting change in value of the underlying future purchase of fuel. These fair market values reflect the estimated amounts that we would receive or pay should the contracts be terminated at the stated dates. Any gains or losses related to fuel commodity swaps are charged to our deferred fuel cost accounts. At March 31, 2006 we have recorded a receivable of $0.9 million as the estimated gain to terminate the contracts as at this date.

The foreign exchange derivative value reflects only the value of the foreign exchange derivatives and not the offsetting change in value of the underlying future purchase of currency. These fair market values reflect the estimated amounts we would receive or pay to terminate the contracts at the stated dates. These derivatives are
accounted for using hedge accounting and therefore estimated gains and losses are not recorded in our financial statements.

We are exposed to credit risk in the event of non-performance by counterparties to derivative instruments. Because we deal with high credit quality institutions in accordance with established credit approval practices, we believe it to be unlikely that any counterparties will fail to meet their obligations.

RISK MANAGEMENT
We have processes in place throughout our company to manage risks that inevitably arise in the normal course of business.

We are implementing an Enterprise Risk Management program which will address risk management from an organization-wide perspective and will complement existing strengths. This will be a comprehensive approach that incorporates organization-wide awareness, prioritized risk identification and risk mitigation strategies that target the highest risk areas.

Understanding and managing risk are important parts of our business. The following are some of the risk factors that we have considered.

Safety
The safety of the public, our employees and the protection of the environment are our highest priorities.

We were an early voluntary adopter of the International Safety Management ("ISM") code that forms an international standard for the safe management and operation of ships and terminals and for pollution prevention. The ISM code places the responsibility for the safety of ships and the prevention of pollution within the company management structure. This means that the entire organization is responsible for safety, not just the ship’s master or shore based managers.

We provide extensive formal training for our employees on safety and operational topics in response to internal safety policies and practices and external regulations. These programs cover a wide range of topics including:

- marine emergency duties (survival craft, marine and vehicle fire fighting);
- shipboard fire and boat drills;
- safe evacuation of passengers (restricted proficiency in survival craft, marine evacuation systems, rescue shepherd boat, passenger control);
- occupational first aid (automatic external defibrillators, cardio pulmonary resuscitation for infants);
- occupational safety and health (asbestos contingency, confined space rescue, musculoskeletal injury prevention, prevention of violence in the workplace);
- transportation of dangerous goods; and
- terminal operations (small boat operator, safe forklift operations).

Besides shipboard drills, we have over 8,800 training days planned for safety and operational training in fiscal year 2007.

We are regulated by the provincial Workers’ Compensation Board and Transport Canada to ensure safety on our vessels and at our other facilities.
**Accident/Casualty Loss**

The occurrence of a vessel related accident or mishap could have a material adverse effect on our business prospects, financial condition or results of operations, and could result in a default under the Coastal Ferry Services Contract unless such accident or mishap qualified as an event of force majeure.

Due to the nature of our business, we may be subject to liability claims arising out of accidents or disasters involving vessels on which our customers are travelling, including claims for serious personal injury or death.

Apart from well established safety programs, we have a sound conventional insurance program to insure both our physical assets and legal liability for injuries and damage. This is designed to mitigate the financial impact of serious incidents. There can be no guarantee, however, that the insurance coverage will be sufficient to cover all such accidents or disasters.

In addition to conventional insurance, we have recently established our own wholly owned insurance subsidiary, BCF Captive Insurance Company Ltd., which commenced operations April 1, 2005. Its prime purpose is to absorb a large proportion of the deductibles payable under our commercial insurance programs. The objective is to spread the cost of random events among all routes and protect direct route financial results from unnecessary volatility.

**Asset Risk**

We operate in a capital-intensive industry that requires a substantial amount of capital expenditures. We plan to spend approximately $1.9 billion in capital expenditures over the next decade, with approximately 70% related to new vessel acquisitions, vessel upgrades and component replacement. Our plan is to replace approximately 25% of our vessels before the end of fiscal year 2011.

At March 31, 2006, we have total long-term debt of $500 million. Future indebtedness is subject to certain limitations. The level of indebtedness could increase our vulnerability to general adverse economic and industry conditions, and limit our flexibility in planning for, or reacting to, changes in business. Also, there can be no guarantee that we will have access to sufficient resources or will be able to maintain our fleet by extending the economic life of existing vessels through major refurbishment.

**Fuel Price Risk**

The risk of fuel price volatility is currently managed through fuel deferral accounts and partial fuel hedges. There remains a risk that all fuel costs may not be recovered. The Commissioner may not approve fuel surcharges sufficient to recover increases resulting from high fuel prices. High fuel surcharges may have an adverse impact on traffic levels. See Regulatory Risk and Traffic Level and Tariff Revenue Risk below.

**Regulatory Risk**

There is a risk that the British Columbia Ferries Commissioner will interpret the Coastal Ferry Act in a manner unfavourable to us.

Our operations are subject to a wide variety of national and local laws and regulations, all of which may change at any time. There is the potential that the
Introduction of new safety or other regulations, including new taxes, or the interpretation of existing regulations, may impose a new, unexpected and significant cost burden. There can be no guarantee that regulatory changes in the future will not have an adverse effect on us.

Traffic Level and Tariff Revenue Risk
Future vehicle and passenger traffic on our vessels will be affected by, among other things, population levels and economic conditions in British Columbia and also by tariff rates. No assurance can be given as to the level of traffic on our system and the tariff revenue that will result.

There is a risk that over the long term a general decline in travel (or a reduction in the growth rate) may occur as a result of compounding increases in tariffs. Under the Coastal Ferry Act, we are permitted to increase tariffs on major routes by 2.8% and on the remaining routes by 4.4% each year during the first performance term. In addition to these permitted annual increases, we have applied and may again apply to the Commissioner for other tariff increases, the need for which results from extraordinary situations. In fiscal year 2006, we applied to the British Columbia Ferries Commissioner for extraordinary price cap increases to allow for the implementation of fuel surcharges.

To date, the price increases we have implemented have not caused an obvious decrease in demand. However, elasticity could change as prices increase, thereby resulting in an increasing negative impact of tariff increases.

A relatively high percentage of our customers travel for leisure purposes - approximately 77% on major routes; 82% on northern routes and 63% for other routes. Traffic on our vessels may decline, or fail to increase as expected, if world or local events, including major health concerns, have a negative effect on tourism or other leisure travel.

Competition Risk
While there are significant barriers to entry, we face the risk of competitors entering the vehicle and passenger ferry market and potentially eroding our market share. This risk is greater on the most profitable routes, potentially from other ferry service providers in addition to other forms of transportation.

Environmental Risk
Our operations are subject to various environmental laws and regulations dealing with the transportation, storage, presence, use, disposal and handling of hazardous materials and hazardous wastes, discharge of storm water and vessel fuel delivery.

If we were to be involved in an environmental accident or be found in material violation of applicable law and regulations, we could be responsible for material clean-up costs, property damage, and fines or other penalties, any of which could have a material adverse effect. Although we believe we maintain adequate environmental insurance, there can be no guarantee that the insurance coverage will be sufficient to cover all such losses.

Labour Disruption Risk
The majority of our employees are members of the B.C. Ferry and Marine Workers' Union. On October 15, 2004, the collective bargaining agreement was settled through binding arbitration by Arbitrator Vince Ready which set out a seven year
term to October 31, 2010. This award is expected to provide us with seven years of labour stability. However, there can be no guarantee that other labour disturbances will not occur and have a material adverse effect on our operations.

**Terrorism Risk**
Since the September 11, 2001 terrorist attacks, there has been a heightened concern about terrorism in the minds of the travelling public. The occurrence of a major terrorist attack, either domestic or international and whether it was within the transportation industry or not, could have a material adverse effect on demand for ferry services. It could also lead to a substantial increase in insurance and security costs. Any resulting reduction in tariff revenues and/or increases in costs could have a material adverse impact on our business, results from operations and financial condition.

**Income Tax Risk**
We received an advance income tax ruling from Canada Revenue Agency ("CRA") that, provided the facts and other statements set out therein are accurate, we are a "Tax Exempt Corporation" described in paragraph 149(1)(d.1) of the *Income Tax Act*. This ruling is subject to a proposed amendment to subsection 149(1.3) of the *Income Tax Act* announced by the Department of Finance on December 20, 2002, the essential elements of which are now included in a February 27, 2004 release from the Department of Finance of draft amendments to the *Income Tax Act*. We have received a non-binding opinion from CRA that proposes subsection 149(1.3), if amended as proposed on December 20, 2002, will not cause us to cease to be a Tax Exempt Corporation. There can be no assurance that subsection 149(1.3) of the *Income Tax Act* will be amended as proposed, or that we are and will continue to be a Tax Exempt Corporation.

**Risk of Default under Material Contracts**
There is a risk that we will default under the Coastal Ferry Services Contract or the Terminal Leases. The consequences of such default could include, among other things, an adjustment to service fees from the Province or the forced sale of our vessels to the Province for net book value and termination of the Terminal Leases.

**Aboriginal Land Claims**
Canadian courts have recognized that aboriginal peoples may possess rights at law in respect of land used or occupied by their ancestors where treaties have not been concluded to deal with these rights and where treaties between aboriginal peoples and the Crown set out express rights. These rights may vary from limited rights of use for traditional purposes to a right of aboriginal title and will depend upon, among other things, the nature and extent of the prior aboriginal use and occupation of lands. The courts have encouraged the Canadian federal and provincial governments and aboriginal peoples to resolve rights claims through the negotiation of treaties.

Aboriginal groups have claimed substantial portions of land in British Columbia over which they assert aboriginal title or in which they have a traditional interest.

A process is now in place within British Columbia to deal with aboriginal land claims under the British Columbia treaty process. These negotiations have been and will likely remain ongoing for a number of years, depending on the commitment of the parties involved and the precedents set by the outcomes of the first settlement agreements. Under evolving jurisprudence, Canadian governments have a duty to consult and accommodate aboriginal peoples where Crown approvals or licences are
required in respect of existing or new terminal facilities or operations at such facilities and could affect or impact aboriginal interests.

Under the master agreement, the Province retains its liability, to the extent any exists, for the acts and omissions of the Province that occurred prior to our possession of the ferry terminal properties leased under the Terminal Leases and will reimburse us for any damages we suffer as a result.

In addition, the Province will reimburse us for damages suffered if there is a final court decision or a treaty settlement that recognizes or confers upon aboriginal peoples a proprietary or other interest in the ferry terminal properties which right or interest interferes with our quiet enjoyment of the ferry terminal properties as set out in the Terminal Leases.

ACCOUNTING PRACTICES
Critical Accounting Policies and Estimates
Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with Canadian generally accepted accounting principles.

Our significant accounting policies are contained in note 1 to our consolidated financial statements. Certain of these policies involve critical accounting estimates because they require us to make particularly subjective or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts could be reported under different conditions or using different assumptions. These estimates and assumptions are subject to change as new events occur, as more experience is acquired, as additional information is obtained and as the general operating environment changes.

We believe the following are the most critical accounting policies and estimates that we have used in the preparation of our financial statements.

Workers’ Compensation Claims Liability
Our financial statements include an estimate of residual liability for workers’ compensation claims arising from the Workers’ Compensation Board (“WCB”) deposit class coverage system, in which our predecessor entity participated on or prior to March 31, 2003.

The WCB provided our predecessor company with an actuarial valuation of the unfinalized claims remaining to be paid that relate to incidents on or prior to March 31, 2003. This estimate totalled $9.3 million at March 31, 2003 and is drawn down as claims are paid out. The remaining balance at March 31, 2006 of $6.5 million ($6.5 million at March 31, 2005) is included in accrued employee future benefits in our financial statements.

Public Service Pension Plan
Our employees are members of the Public Service Pension Plan (the “Plan”), a defined benefit, multiemployer pension plan. In April 2003, we were converted from a Crown corporation into an independent company incorporated under the provincial Company Act. In February 2004, our company and the union representing our employees jointly submitted a formal application for all our employees and our
company to remain within the Plan. In March 2004, the Public Service Pension Board of Trustees agreed to the proposal.

The Plan is exempt from the requirements under the provincial Pension Benefits Standards Act to use the "solvency" method in conjunction with the "going concern" method for valuation purposes. As such, the Plan is currently valued solely by the going concern method. The most recent valuation of the total Plan, as at March 31, 2005, indicated an unfunded liability in the Basic Account of $767 million.

Effective April 1, 2006, the Public Service Pension Board of Trustees increased contribution rates for plan members and employers by 1.88% each, effectively eliminating the actuarial liability.

Retirement Bonus Liability
We sponsor a plan that provides a post-retirement benefit for long service employees. The valuation of this plan is estimated based on complex actuarial calculations using several assumptions. These assumptions are determined by management with significant input from our actuary. The valuation of the obligation depends on such assumptions as discount rate, projected salary increases, retirement age and termination rates. An actuarial valuation was obtained in March 2005 and the accrued benefit obligation estimated at $10 million. The liability included in accrued employee future benefits in our financial statements at March 31, 2006 was $9.8 million ($9.5 million at March 31, 2005).

We have adopted the corridor method of recognizing actuarial gains and losses. Any gains and losses in excess of 10% of the obligation balance will be amortized over the average remaining service period of employees expected to receive benefits under this plan.

Rate Regulation
We follow generally accepted accounting principles which, as we are a regulated entity, may differ from those otherwise expected in non-regulated businesses. These differences occur when the regulator issues orders and generally involve the timing of revenue and expense recognition. The principles we follow ensure that the actions of the regulator, which create assets and liabilities, have been reflected in the financial statements.

The accounting for these items is based on an expectation of the future actions of the regulator. As of March 31, 2006, we have three regulatory assets or liabilities:
- Deferred fuel costs: the difference between amounts allowed by the regulator in operating expense and those actually incurred with recovery expected through future tariffs or surcharges;
- Performance term submission costs: costs for incremental contracted services relating to our second performance term submission based on the expectation that our regulator will approve the recovery of these costs over our second performance term that begins April 1, 2008;
- Tariffs in excess of price caps: the amount by which average annual tariffs collected at a specific date exceed established price caps set under the terms of the Coastal Ferry Act. The excess amounts collected will be returned to customers through future tariffs.
If the regulator's future actions are different from our expectations, the timing and amount of the recovery of deferred costs could be substantially different from that reflected in our financial statements.

**Amortization Expense**
Our capital assets, including assets under capital leases, are amortized on a straight-line basis at varying rates. Amortization rates require the use of estimates of the useful lives of the assets and of salvage to be realized upon asset retirement.

We periodically review asset lives in conjunction with our longer term asset deployment, replacement and upgrade strategies. When we determine that asset lives do not reflect the expected remaining period of benefit, we make prospective changes to the remaining period over which they are amortized. There are a number of uncertainties inherent in estimating our asset lives and changes in these assumptions could result in material adjustments to our financial statements.

As disclosed in note 1 to our financial statements, we review and evaluate our long-lived assets for impairment when events or changes in circumstances indicate that the related amounts may not be recoverable.

**Hedging Relationships**
In April 2005 the Canadian Institute of Chartered Accountants ("CICA") issued Handbook Section 3865, replacing Accounting Guideline 13 which we had adopted on April 1, 2004. The new standard addresses the identification, designation, documentation and effectiveness of hedging transactions for the purpose of applying hedge accounting. It also identifies situations where hedge accounting is to be discontinued. Under this guideline, we are required to prepare formal documentation for each individual derivative at inception in order to apply hedge accounting for positions hedged with derivatives. We have elected to apply hedge accounting on currency derivatives. We have elected not to apply hedge accounting on fuel commodity derivatives, and therefore, we have recorded the $0.9 million fair market value of commodity derivatives in our balance sheet at March 31, 2006 (nil at March 31, 2005).

**Rate Regulation**
In May 2005, the CICA issued Accounting Guideline 19 to establish financial statement guidelines for entities subject to rate regulation. This guideline requires disclosure of general information regarding the nature and economic effects of rate regulation, as well as additional information on how rate regulation has affected the financial statements. The guideline does not address recognition and measurement issues associated with the accounting for rate-regulated operations.

**Asset Retirement Obligations**
On April 1, 2004, we adopted the CICA new standard for recognition, measurement and disclosure of liabilities for asset retirement obligations and the associated asset retirement costs. Under the new standard the fair value of a liability for an asset retirement obligation must be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value is added to the carrying amount of the associated asset, which is then expensed over the asset's estimated useful life. The liability is accreted over the estimated useful life of the asset through charges to expenses.
As we are not aware of any future liabilities associated with the retirement of our assets, the adoption of this policy does not result in the recording of an asset retirement liability and therefore our financial statements have not been impacted by this new standard. In addition, as our operations are regulated, there is a reasonable expectation that any significant asset retirement costs would be recoverable through future tariffs.

**Future Accounting Changes**

We anticipate that we will be required to adopt, on April 1, 2007, the new accounting rules for comprehensive income as set out in the CICA Handbook Section 1530 "Comprehensive Income" and Section 3251 "Equity". These sections introduce the concept of Comprehensive Income and Accumulated Other Comprehensive Income. We are currently assessing the impact of adoption of these new requirements.

**DISCLOSURE CONTROLS**

In 2004, the Canadian Securities Administrators ("CSA") issued an instrument requiring our CEO and CFO ("certifying officers") to certify that they are responsible for:

- establishing and maintaining disclosure controls;
- ensuring the disclosure controls are designed to provide reasonable assurance that material information is made known to them and is properly recorded, disclosed and reported;
- evaluating the effectiveness of the disclosure controls; and
- disclosing their conclusions about the effectiveness at the end of the period covered by the annual filings.

Our certifying officers have evaluated the effectiveness of our disclosure controls as of March 31, 2006, and as a result of that evaluation have concluded that our disclosure controls and procedures were effective for the year ended March 31, 2006.

**CORPORATE STRUCTURE AND GOVERNANCE**

Our Board of Directors and Management consider good corporate governance to be central to the effective, efficient and prudent operation of the Company. Both Management and the Board have monitored and, where appropriate, responded to regulatory developments aimed at improving corporate governance practices, increasing corporate accountability and enhancing the transparency of public company disclosure and will continue to monitor the developments in corporate governance practices.

In 2005, National Instrument 58-101 Disclosure of Corporate Governance Practices (the "Instrument") and a related National Policy 58-201 Corporate Governance Guidelines (the "Guidelines") issued by the Canadian Securities Administrators came into effect. The Guidelines and Instrument require reporting issuers to disclose annually their approach to corporate governance with reference to specific matters. The following disclosure is in accordance with the Instrument.

**Board of Directors**

The Board has assumed responsibility for the stewardship of the Company by overseeing the conduct of the business, supervising Management, which is responsible for the day-to-day conduct of the business and endeavoring to ensure
that all major issues affecting the business and affairs of the Company are given proper consideration.

The Board Governance Manual articulates the governance framework under which the Board fulfills its stewardship responsibilities. The Manual assembles in one document the essential elements for providing an appropriate level of governance for the organization. It includes, among other things, terms of reference for the Board, Chair, Directors, Committees and Committee Chairs and serves as a practical guide for the Board and Management in fulfilling their respective duties and responsibilities. The governance framework is a product and responsibility of the Board.

The Board is committed to the principles of independence and accountability. The Board has adopted policies and practices that ensure it has the capacity, independent of Management, to fulfill the Board's responsibilities, make objective assessments of Management and assess the merits of Management initiatives. The Governance and Human Resources Committee has an ongoing responsibility to ensure that the governance structures and processes continue to enable the Board to function independently.

The Board and Management recognize that there is a regular need for the Board to meet without Management in attendance. It is general practice to conduct a portion of every Board meeting with only independent directors present.

The Board and its Committees each have the authority to retain any outside advisor, at the Company's expense, that it determines to be necessary to permit it to carry out its duties.

The recruitment of directors is undertaken with the objective of ensuring the Board is composed of a majority of strong, qualified independent directors. The Board supports the concept that the role of the Board Chair is separate from that of the President & CEO and that the Board Chair should be an independent Director. These principles are reflected in the Board Governance Manual.

The Board has adopted a definition of an independent Director for members of the Audit and Finance Committee consistent with the definition of independence in Multilateral Instrument 52-110. This definition, with some modification that is consistent with Multilateral Instrument 52-110, also applies to determining the independence of other members of the Board.

The Board is responsible for determining whether directors are independent pursuant to the definition of independence adopted by the Board. To do this the Board requires members to disclose their relationships with the Company and its subsidiaries. These disclosures are reviewed by the General Counsel, the Corporate Secretary, the Chair of the Board and the Chair of the Governance and Human Resources Committee. Any director who is deemed independent and whose circumstances change such that he or she might be considered to no longer be an independent director is required to promptly advise the Board of the change in circumstances. Directors are required annually to attest to their independence in writing.

Mr. David L. Hahn, President & CEO, is the only director who is a member of Management of the Company. By virtue of his being a member of Management, Mr. Hahn is not independent. The other eleven directors of the Company, including the
Chair of the Board, have been determined by the Board to be independent pursuant to the definition of independence adopted by the Board.

**Directorships**
The following were directors of another issuer, other than British Columbia Ferry Services Inc. ("BCFS"), which is a reporting issuer (or the equivalent) in Canada or a foreign jurisdiction:

Elizabeth J. Harrison, Q.C.: Director, Unilens Vision Inc.
Graham M. Wilson: Director, ITRON Inc.

Trustee and Director, Hardwoods Distribution Trust
Trustee, Sequoia Oil & Gas Ltd.

Peter R. B. Armstrong: Director, Pacific Insight Electronics Corporation
Director, Versacold Income Fund

**Orientation and Continuing Education**
The Company has a variety of orientation and education programs in place for directors. These programs are aimed at increasing the directors' familiarity with the operation of the Company and its governance practices.

All new directors are provided with the opportunity to participate in an orientation program. The orientation program is tailored to the individual director's needs and areas of interest. The program generally involves a full day session, held prior to a new director attending his/her first BCFS Board meeting, during which the new director is briefed by members of senior management and receives written information about the business and operations of BCFS and Board governance practices, including the duties and obligations of directors. All new directors receive a copy of the Board Governance Manual. This provides a comprehensive overview of the roles and responsibilities of the Board, its Committees and the contributions expected by each director.

The Board recognizes the importance of ongoing director education and the need for each Director to take personal responsibility for this process. To facilitate ongoing education, the Board Chair and the Chair of the Governance and Human Resources Committee periodically canvas the directors to determine their training and education needs and interests; arrange ongoing visits by directors to the Company’s facilities and operations; arrange for the attendance of directors at seminars or conferences of interest and relevance to their position as a director of the Company; and encourage and facilitate presentations by outside experts to the Board or Committees on matters of particular import or emerging significance. Directors are also provided with memberships in the Institute of Corporate Directors which provides them with opportunities to attend programs and courses relevant to corporate governance.

Responsibility for ensuring that orientation and ongoing education are provided to directors rests with the Chair of the Board. The Governance and Human Resources Committee has responsibility for reviewing the orientation and education programs to ensure they are effective and meet the needs of directors.

**Ethical Business Conduct**
The Board of Directors approved and adopted a Code of Business Conduct and Ethics ("Code") on November 10, 2004. Notice of adoption of the Code as Company policy was communicated to the Company's personnel by intra-Company information
bulletin widely distributed throughout the Company. In addition, the Code has been posted on the Company's intranet website for Company personnel, and on the Company's internet site. The Code was filed on SEDAR on March 1, 2006. The Board has also adopted a Corporate Disclosure and Securities Trading Policy, which is also posted on the Company's intranet and internet sites.

As part of the Company's disclosure controls process, in conjunction with quarter-end financial reporting, appropriate Managers are required to make representations regarding compliance with the Code and the Corporate Disclosure and Securities Trading Policy.

As part of the communication process for the reporting of questionable accounting and auditing matters, a secure telephone line and a secure email address, each monitored by the Executive Director of Internal Audit, have been established and this has been communicated to Company employees by intra-Company information bulletin. The contact particulars are also posted with the Code on the Company’s intranet site.

The Board, through the Audit and Finance Committee, monitors compliance with the Code through review of compliance reports received quarterly from Management, the External Auditors, and the Internal Auditors.

Directors and officers review the Code and acknowledge their support and understanding of the policy by signing an annual disclosure statement.

The Code requires that directors and officers disclose potential conflicts of interest at the time of their appointment and immediately upon a situation of a conflict of interest or potential conflict of interest arising. Such disclosures are communicated to and reviewed by the General Counsel, the Corporate Secretary, the Chair of the Board and the Chair of the Governance and Human Resources Committee.

Nomination of Directors
The Governance and Human Resources Committee has responsibility for the director nomination process. The Committee is composed entirely of independent directors. The responsibilities, powers and operations of the Committee are described in the Board Governance Manual.

The B.C. Ferry Authority (the "BCFA"), through its Board of Directors, selects the Board of Directors of British Columbia Ferry Services Inc. ("BCFS") by March 31 each year. While not a requirement, it is current practice that the directors of BCFA will also be directors of BCFS. Additional members may be appointed to the Board of BCFS by BCFA.

The appointment process for BCFS directors occurs concurrently with the BCFA Director appointment process because of the overlap of the Boards of BCFA and BCFS. The Articles of Incorporation of BCFS permit a total of 20 directors of BCFS, hence directors may be appointed to the Board of BCFS in addition to those who are also directors of BCFA. It is viewed as desirable to maintain consistency between the two Boards so that the interests of BCFA and BCFS are properly aligned. However, the ability to appoint additional directors to the Board of BCFS gives flexibility in ensuring adequate skill sets and experience are available within the members of the Board of BCFS.
Each year the skill sets and experience of the incumbents and any retiring directors of BCFS are reviewed by the BCFS Governance and Human Resources Committee in the context of the skills and experience profile adopted by the BCFS Board and the ongoing governance needs of BCFS. Any gaps are identified. Potential conflicts of interest and other extenuating circumstances are also identified.

The skill sets and experience of the candidates for the BCFA Board that are put forward by the nominating entities and the Province are reviewed by the BCFS Governance and Human Resources Committee to ascertain if there will be any gaps in the skill sets and experience of the Board of BCFS, assuming BCFA directors also become BCFS directors. If gaps are identified, the Chair of the BCFS Board, in consultation with the Chair of the BCFS Governance and Human Resources Committee and the President & CEO, seeks out suitable candidates for nomination as directors of BCFS to fill such gaps.

The BCFS Governance and Human Resources Committee reviews the nominees and makes recommendations to the Board of Directors. These recommendations take into account the talents of the existing BCFS Board, and the talents of all nominees (including BCFA Board nominees and appointees who may become BCFS Board members, if applicable), taking the skills and experience profile established for BCFS directors into account.

The BCFS Board makes the decision on prospective directors and forwards its recommendations to the BCFA Board Chair. The BCFA Board then determines the directors of BCFS and causes BCFA, as the sole holder of the single voting share of BCFS, to appoint such directors to the Board of BCFS.

Compensation
The Governance and Human Resources Committee reviews the compensation of directors and the President & CEO annually. The Committee is composed entirely of independent directors and operates under terms of reference adopted by the Board.

The Committee engages an external compensation advisor to research and provide independent advice to the Committee on the level and types of compensation for directors and the President & CEO. In making its recommendations to the Board, the Committee takes into account the types of compensation and the amounts paid by other comparable companies.

Board Committees
Audit and Finance Committee (at March 31, 2006):
Chair: Graham M. Wilson
Members: Douglas E. Allen; Thomas W. Harris; John R. Henderson, Maureen V. Macarenko

The Audit and Finance Committee ("Committee") is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:
- Review the financial reports and other financial information provided by the Company to its security holders;
- Review the annual operating and capital budgets, modifications thereto, and details of any proposed financing;
- Monitor the integrity of the financial reporting process and the system of internal controls that the Board and our management have established;
• Monitor the management of the principal risks that could impact the financial reporting of the Company, and the Company’s compliance with legal and regulatory requirements as they relate to the Company’s financial statements;
• Review and approve the audit plan, process, results, and performance of the Company’s external auditors and the internal audit department (“the internal auditor”) while providing an open avenue of communication between the Board, management, external auditors, and the internal auditor;
• Assess the qualifications and independence of the external auditors, and recommend to the Board the nominations of the external auditors and the compensation to be paid to the external auditors.

The Committee has the authority to conduct any investigation appropriate to fulfilling its responsibilities, and it has direct access to the external auditors as well as anyone in the organization. The Committee has the authority to retain special legal, accounting, and other advisors or experts it deems necessary in the performance of its duties.

Each of the members of the Committee has been determined by the Board of Directors to be independent, that is, without any direct or indirect relationship with the Company that could reasonably interfere with the exercise of the member’s independent judgment. Douglas E. Allen acted as interim Chief Executive Officer of the Company from October 16, 2002 until May 5, 2003.

All members of the Committee are financially literate within the meaning of Multilateral Instrument 52-110, that is, each has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the Company’s financial statements.

Since April 1, 2005, all recommendations of the Committee to nominate or compensate an external auditor have been adopted by the Board.

The aggregate fees billed by our external auditor in each of the last two fiscal years were:

<table>
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<tr>
<th>External Auditor Billings ($thousands)</th>
<th>Year ended March 31</th>
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<tr>
<td>Audit (including involvement in bond prospectus)</td>
<td>121.8</td>
</tr>
<tr>
<td>Tax services (mainly commodity related)</td>
<td>176.8</td>
</tr>
<tr>
<td>All other fees</td>
<td></td>
</tr>
<tr>
<td>Advisory services (including internal audit support)</td>
<td>65.2</td>
</tr>
<tr>
<td>Enterprise Risk Management project</td>
<td>111.4</td>
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<tr>
<td></td>
<td>298.4</td>
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<td>190.2</td>
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Pursuant to its terms of reference, the Committee must pre-approve retaining the external auditors for any non-audit service to be provided to the Company or its subsidiaries, provided that no approval shall be provided for any service that is
prohibited under the rules of the Canadian Public Accountability Board or the Public Company Accounting Oversight Board, or the Independence Standards of the Canadian Institute of Chartered Accountants.

Before retaining the external auditors for any non-audit service, the Committee must consider the compatibility of the service with the external auditors' independence. The Committee may pre-approve retaining of the external auditors for the engagement of any non-audit services by establishing policies and procedures to be followed prior to the appointment of the external auditors for the provision of such services. To date no such policies and procedures have been established. In addition, the Committee may delegate to one or more members the authority to pre-approve retaining of the external auditors for any non-audit services to the extent permitted by applicable law.

In addition to the Audit and Finance Committee, the Board has appointed the following two Committees, both of which are composed entirely of independent directors:

**Governance and Human Resources Committee (at March 31, 2006):**

Chair: Douglas E. Allen

Members: Peter R.B. Armstrong, John R. Henderson, Robert W. McCaskill, Graham M. Wilson

Effective April 1, 2006, Peter R.B. Armstrong ceased to be a member of the Governance and Human Resources Committee and Doreen J. Hewitt became a member of the Committee.

The Governance and Human Resources Committee is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:
- review the policies and practices of the Board;
- ensure the Board’s continuing ability to fulfill its legislative mandate;
- implement effective due diligence over the operations of the Company;
- review the human resources strategies of the Company, including management recruitment, development, retention, compensation, and succession planning;
- identify and recommend to the Board suitable candidates for nomination as directors of the Company, and otherwise fulfills the responsibilities of a nominating committee; and
- review and recommend to the Board appropriate compensation for directors, the President & CEO and senior executive, and otherwise fulfill the responsibilities of a compensation committee.

**Safety, Health, Environment and Security Committee (at March 31, 2006):**

Chair: G. Raymond Whitehead

Members: Sandy M. Fulton, Doreen J. Hewitt, Maureen Macarenko, Robert W. McCaskill

Effective April 1, 2006, Doreen J. Hewitt ceased to be a member of the Safety, Health, Environment and Security Committee and Peter R. B. Armstrong became a member of the Committee.
The Safety, Health, Environment and Security Committee is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:

- exercise due diligence over the safety, health, environmental and security operations of the Company;
- develop, review, and make recommendations, as required, on matters related to the Company’s safety, health, environmental and security policies and practices; and
- monitor compliance with Government regulations and with the Company’s commitment to these issues.

Assessments
As part of its dedication to best governance practices, the Board is committed to regular assessments of the effectiveness of the Board, the Board Chair, Committees, Committee Chairs and individual directors.

The Governance and Human Resources Committee annually reviews and makes recommendations to the Board on the method and content for annual evaluations.

The evaluation method varies from year to year. In the previous two years, the board has engaged an independent governance consultant to coordinate the evaluation. The consultant has collected information on individual director’s assessments of the performance of the board against its terms of reference, the Board Chair against the Board Chair’s terms of reference, and each Committee, including the Committee Chair, against its terms of reference. A detailed written questionnaire has been used for this purpose, as well as individual discussions between each director and the independent consultant. The consultant has presented the results of the evaluation to the Governance and Human Resources Committee and the Board and has prepared recommendations for action. Considering the consultant’s report and recommendations, the Governance and Human Resources Committee has prepared and implemented an action plan for the upcoming year. This action plan is reviewed and approved by the Board.

The Board also undertakes an assessment of individual director performance annually. This occurs through in-depth discussions between individual directors and the Board Chair.

FORWARD LOOKING STATEMENTS
This management’s discussion and analysis contains certain “forward looking statements”. These statements relate to future events or future performance and reflect management’s expectations regarding our growth, results of operations, performance, business prospects and opportunities and industry performance and trends. They reflect management’s current internal projections, expectations or beliefs and are based on information currently available to management.

In some cases, forward looking statements can be identified by terminology such as “may”, “will”, “should”, “expect”, “plan”, “anticipate”, “believe”, “estimate”, “predict”, “potential”, “continue” or the negative of these terms or other comparable terminology. A number of factors could cause actual events or results to differ materially from the results discussed in the forward looking statements. In evaluating these statements, prospective investors should specifically consider various factors including, but not limited to, the risks and uncertainties associated
with traffic volume and tariff revenue risk, the impact of competition, asset risk, accident/casualty loss risk, tax risk, environmental risk, regulatory risk, labour disruption risk, risk of default under material contracts and aboriginal land claims.

Actual results may differ materially from any forward looking statement. Although management believes that the forward looking statements contained in this management's discussion and analysis are based upon reasonable assumptions, investors cannot be assured that actual results will be consistent with these forward looking statements. These forward looking statements are made as of the date of this management's discussion and analysis, and British Columbia Ferry Services Inc. assumes no obligation to update or revise them to reflect new events or circumstances.