

**Management's Discussion and Analysis  
of Financial Condition and Results of Operations  
For the six months ended September 30, 2006  
Dated November 1, 2006**

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of November 1, 2006. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three and six-month periods ended September 30, 2006 and 2005, and our annual audited consolidated financial statements and related notes together with our fiscal 2006 Management's Discussion and Analysis. These documents are available on the SEDAR web site at [www.sedar.com](http://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 (the "Province") 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.

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.

We are a versatile company, providing a wide range of ferry services for our customers. During the three months ended September 30, 2006 (the second quarter of fiscal 2007), we provided over 49,000 sailings, carrying 7.5 million passengers and 2.7 million vehicles.

Significant events during or subsequent to our second quarter of fiscal 2007:

- In July 2006, we announced the signing of a \$45.5 million contract with Vancouver Shipyards, a Washington Marine Group company, to build a new 125-car intermediate size ferry. This contract constitutes the majority of the total project budget of \$57 million. Construction on the 100 metre vessel will begin later this year. The new vessel is expected to enter service by the summer of 2008. See "Investing in our Capital Assets" below for more detail.
- In July 2006, we commissioned an independent review of our safety policies, procedures and practices. This comprehensive safety review is underway and a report is expected to be available in late 2006. It is our intention to carry out a major review of this nature every five years as part of our ongoing commitment to ensuring the safety of our passengers and employees.
- In August 2006, following a rigorous competitive bidding process, we signed a €91.8 million Euro or \$133 million Canadian contract with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany to build a new vessel to replace the 40-year-old *Queen of Prince Rupert*, operating on our northern routes. This contract forms the majority of the total project budget of \$200 million. The 150-metre vessel will accommodate 130 vehicles and 600 passengers and is expected to be in service in the spring of 2009. See "Investing in our Capital Assets" below for more detail.

- In August 2006, construction began on the first of three new Super C-class vessels, *Coastal Renaissance*, after nearly two years of design work and testing. The Super C-class vessels will be the largest double-ended ferries in the world. They will feature a diesel-electric propulsion system that is the largest and most fuel efficient of its kind. The *Coastal Renaissance* will take approximately 12 months to build, with delivery expected in late 2007. Delivery of the other two Super C-class vessels is expected in mid 2008. The total project budget for the three vessels is \$542 million. See "Investing in our Capital Assets" below for more detail.
- In September 2006, after an extensive international search, we reached an agreement to purchase a two-year-old vessel, currently named the *Sonia*, for €35.7 million Euros or approximately \$50.9 million Canadian to replace the *Queen of the North*. We formally took ownership of the vessel on October 6, 2006. In November 2006, Victoria Shipyards was awarded a \$9 million contract to perform major modifications to improve customer amenities and meet safety requirements to operate in Canadian waters. The total project budget for acquisition and modification is \$103 million. The vessel is expected to enter service on our northern routes in the spring of 2007. See "Investing in our Capital Assets" below for more detail.
- In October 2006, we officially opened our new berth at Swartz Bay terminal on Vancouver Island. This \$25 million project was undertaken to replace the outdated counter-weighted ramp lift system and old marine structures and brings a new level of technology to our berthing arrangements for our largest vessels. See "Investing in our Capital Assets" below for more detail.

## FINANCIAL OVERVIEW

This section provides an overview of our financial performance for the three months ended September 30, 2006 compared to the three months ended September 30, 2005 as well as the six months ended September 30, 2006 (year-to-date) compared to the six months ended September 30, 2005.

Our consolidated net earnings before extraordinary gain in the three months ended September 30, 2006 grew \$7.7 million or 12.6% from the three months ended September 30, 2005 (\$8.2 million or 10.8% year-to-date).

(\$ millions)	Three Months Ended September 30				Six Months Ended September 30			
	2006	2005	Variance		2006	2005	Variance	
			\$	%			\$	%
Total revenue	202.7	198.3	4.4	2.2%	349.0	343.4	5.6	1.6%
Expenses	(129.7)	(131.0)	1.3	1.0%	(255.8)	(255.0)	(0.8)	(0.3%)
Earnings from operations	73.0	67.3	5.7	8.5%	93.2	88.4	4.8	5.4%
Interest and other	(4.1)	(6.1)	2.0	32.8%	(9.4)	(12.8)	3.4	26.6%
Net earnings before extraordinary gain	68.9	61.2	7.7	12.6%	83.8	75.6	8.2	10.8%
Extraordinary gain	0.0	0.0	0.0		61.3	0.0	61.3	
Net earnings	68.9	61.2	7.7	12.6%	145.1	75.6	69.5	91.9%

### ***Northern Service***

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. Two passengers remain unaccounted for and are presumed to have perished.

An emergency environmental plan was implemented in conjunction with external authorities. 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 any fuel and lubricants that may remain in the vessel.

The Transportation Safety Board, as the lead investigation agency, along with Transport Canada and the RCMP, are conducting investigations related to 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 the busy summer period, we augmented service provided by the *Queen of Prince Rupert* with additional tug and barge and air service.

We maintain commercial insurance coverage for incidents of this nature. Insurance proceeds, net of deductible, of \$67.9 million were received in May 2006 in settlement of the claim under the hull and machinery policy. In accordance with generally accepted accounting principles, \$6.6 million of the insurance proceeds were recorded as a receivable to offset insurable losses in fiscal 2006. We reported an extraordinary gain of \$61.3 million for this event in the first quarter of fiscal 2007. These funds are being utilized to partially fund the acquisition of the *Sonia*, a replacement vessel for the *Queen of the North*. See "Investing in our Capital Assets" below for more detail. Claims for personal belongings of passengers and passenger automobiles are substantially complete. Other types of claims are still in progress. We expect that substantially all passenger claims, claims from other parties and costs incurred for environmental containment or cleanup 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. This has been largely offset by \$1.2 million of interest income earned to date on invested insurance proceeds.

After an extensive international search to lease or purchase a replacement vessel for the *Queen of the North*, an agreement to purchase a two-year-old vessel, currently named the *Sonia*, for €35.7 million Euros or approximately \$50.9 million Canadian was reached. In November 2006, Victoria Shipyards was awarded a \$9 million contract to perform major modifications this winter to improve customer amenities and meet safety requirements to operate in Canadian waters. The total project budget for acquisition, modifications, import duties and taxes is \$103 million. The *Sonia* is expected to enter service next spring, in time to relieve the *Queen of Prince Rupert* for its annual refit.

We have also commissioned the building of a new vessel, to replace the 40-year-old *Queen of Prince Rupert*, which we expect to be in service in the spring of 2009. The contract to build the new vessel is with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany. Its total value of €91.8 million Euros or approximately \$133 million Canadian, together with related import duties and taxes of approximately \$43 million Canadian, constitute the majority of the total project budget of \$200 million. Negotiations have been concluded with

the Provincial government resulting in increases to service fees to support the deployment of these two vessels on the northern routes.

We anticipate a third replacement vessel for the northern service will be acquired and in service during our next performance term (April 1, 2008 to March 31, 2012). Negotiations with the Provincial government with respect to this vessel are ongoing.

In accordance with the terms of the Coastal Ferry Services Contract with the Province, we filed a notice of force majeure. At this time the Province has not yet agreed that the events surrounding the loss of the *Queen of the North* constitute an event of force majeure and it is uncertain what the impact of this incident will be on related ferry service fees. The impact, if any, is expected to be known by the end of the fiscal year.

### Revenue

Traffic levels increased in the three and six months ended September 30, 2006 over the same periods in the prior year despite challenges including the loss of the *Queen of the North*, a strong Canadian dollar, high motor fuel prices and the implementation of three fuel surcharges.

Our total revenues for the three months ended September 30, 2006 have increased \$4.4 million or 2.2% over the three months ended September 30, 2005 (\$5.6 million or 1.6% year-to-date), as shown in the table below.

(\$ millions)	Three Months Ended September 30				Six Months Ended September 30			
	2006	2005	Increase		2006	2005	Increase	
			\$	%			\$	%
Tariff - vehicles	79.7	78.0	1.7	2.2%	136.0	134.9	1.1	0.8%
Tariff - passengers	51.3	50.5	0.8	1.6%	84.6	83.3	1.3	1.6%
Ferry service fees	31.5	31.2	0.3	1.0%	58.6	58.2	0.4	0.7%
Federal-provincial subsidy	6.3	6.2	0.1	1.6%	12.6	12.4	0.2	1.6%
Retail	25.1	24.5	0.6	2.4%	42.7	41.8	0.9	2.2%
Other income	8.8	7.9	0.9	11.4%	14.5	12.8	1.7	13.3%
<b>Total revenue</b>	<b>202.7</b>	<b>198.3</b>	<b>4.4</b>	<b>2.2%</b>	<b>349.0</b>	<b>343.4</b>	<b>5.6</b>	<b>1.6%</b>

The improvement in vehicle tariff revenue in the three and six months ended September 30, 2006, compared to the three and six months ended September 30, 2005, is a result of increased vehicle traffic volumes on the major routes and higher overall tariff rates. The annual average tariff rate increase was 2.8% on our three major routes connecting Vancouver Island to the mainland and 4.4% on the remaining routes, as permitted by the *Coastal Ferry Act*.

Vehicle Traffic Volume	Three Months Ended September 30			
	2006	2005	Increase (Decrease)	
			#	%
Major routes	1,281,890	1,270,931	10,959	0.9%
Northern routes	8,779	15,979	(7,200)	(45.1%)
Other routes	1,460,619	1,455,323	5,296	0.4%
Total	2,751,288	2,742,233	9,055	0.3%
	Six Months Ended September 30			
	2006	2005	Increase (Decrease)	
			#	%
Major routes	2,251,817	2,237,929	13,888	0.6%
Northern routes	14,090	25,157	(11,067)	(44.0%)
Other routes	2,673,358	2,672,847	511	0.0%
Total	4,939,265	4,935,933	3,332	0.1%

Vehicle traffic volume on our major routes increased 0.9% in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 (0.6% year-to-date). The vehicle traffic volume on the northern routes decreased 7,200 (11,067 year-to-date) as a result of the loss of the *Queen of the North*. With the exclusion of the northern routes, the system-wide average increase was 0.6% (0.3% year-to-date).

Passenger Traffic Volume	Three Months Ended September 30			
	2006	2005	Increase (Decrease)	
			#	%
Major routes	4,021,718	3,983,218	38,500	1.0%
Northern routes	30,829	55,473	(24,644)	(44.4%)
Other routes	3,485,883	3,481,618	4,265	0.1%
Total	7,538,430	7,520,309	18,121	0.2%
	Six Months Ended September 30			
	2006	2005	Increase (Decrease)	
			#	%
Major routes	6,841,018	6,776,067	64,951	1.0%
Northern routes	45,870	82,850	(36,980)	(44.6%)
Other routes	6,178,411	6,179,163	(752)	0.0%
Total	13,065,299	13,038,080	27,219	0.2%

Total passenger traffic in the three and six months ended September 30, 2006 increased by 0.2% compared to the same periods in the prior year. The passenger traffic volume on the northern routes decreased 24,644 (36,980 year-to-date) as a result of the loss of the *Queen of the North*. With the exclusion of the northern routes, the system-wide average increase was 0.6% (0.5% year-to-date).

Ferry service fees were higher in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 mainly due to an increase of \$0.2 million (\$0.4 million year-to-date) in social program fees. These programs include discount fares for BC seniors, students traveling to and from school, persons with disabilities 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 generally the same each year. Social program fees are based on usage. It is

uncertain at this time what the impact of the loss of the *Queen of the North* will be on related ferry service fees. The impact, if any, is expected to be known by the end of the fiscal year.

The Federal-Provincial subsidy, which we receive from the Province of British Columbia pursuant to the Coastal Ferry Services Contract, is adjusted each year in accordance with changes in the Vancouver Consumer Price Index.

Retail revenue includes food and other retail merchandise sales. Retail revenue grew \$0.6 million in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 (\$0.9 million year-to-date). This was despite a revenue reduction of \$1.2 million (\$1.8 million year-to-date) relating to the loss of the *Queen of the North*. The total year-to-date increase of 2.2% is attributable to a 1.8% year-over-year increase in spending per passenger and a 0.4% increase in passenger traffic on routes providing catering service. The largest increases were on the major routes, which had a \$1.5 million increase for the three months ended September 30, 2006 (\$2.2 million year-to-date).

The increase in other income reflects reservation revenues that were \$0.3 million higher in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 (\$0.7 million year-to-date). This increase was due to higher seasonal usage on our major routes and the Horseshoe Bay-Langdale route. We also experienced a \$0.2 million (\$0.4 million year-to-date) increase in assured loading ticket premiums and a \$0.2 million (\$0.3 million year-to-date) increase in parking fees at the terminals serving our major routes.

### Expenses

Expenses for the three months ended September 30, 2006 decreased \$3.3 million or 2.4% over the three months ended September 30, 2005 (\$2.6 million or 1% year-to-date), as shown in the table below.

(\$ millions)	Three Months Ended September 30				Six Months Ended September 30			
	2006	2005	(Increase)Decrease		2006	2005	(Increase)Decrease	
			\$	%			\$	%
Operations	83.2	84.9	1.7	2.0%	159.0	160.0	1.0	0.6%
Maintenance	13.4	13.1	(0.3)	(2.3%)	31.3	31.2	(0.1)	(0.3%)
Administration	9.8	10.5	0.7	6.7%	22.4	22.4	0.0	0.0%
	106.4	108.5	2.1	1.9%	212.7	213.6	0.9	0.4%
Cost of retail goods sold	9.7	9.0	(0.7)	(7.8%)	16.5	15.8	(0.7)	(4.4%)
Amortization	13.6	13.5	(0.1)	(0.7%)	26.6	25.6	(1.0)	(3.9%)
	129.7	131.0	1.3	1.0%	255.8	255.0	(0.8)	(0.3%)
Gain on foreign exchange	(0.2)	(0.1)	0.1		(0.2)	(0.2)	0.0	
Interest expense	4.3	6.2	1.9	30.6%	9.6	13.0	3.4	26.2%
	0.0	0.0	0.0		0.0	0.0	0.0	
	4.1	6.1	2.0	32.8%	9.4	12.8	3.4	26.6%
Total expense	133.8	137.1	3.3	2.4%	265.2	267.8	2.6	1.0%

The total decrease in operations expenses for the three months ended September 30, 2006 to the three months ended September 30, 2005 was \$1.7 million (\$1.0 million year-to-

date). The most significant changes include: a \$1.5 million (\$2.5 million year-to-date) reduction in costs due to the loss of the *Queen of the North*, a reduction of \$1.2 million (\$2.9 million year-to-date) in property taxes and \$0.5 (\$1.0 million year-to-date) for a planned reduction in advertising costs. These decreases are partially offset by an increase of \$2.5 million (\$5.0 million year-to-date) in wages and benefits (due to wage increases, Transport Canada requirements and timing of Easter weekend).

Maintenance expenses which include expenditures for vessel refit and maintenance as well as terminal maintenance activities were \$0.3 million higher in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 (\$0.1 million year-to-date).

Administration expenses decreased \$0.7 million in the three months ended September 30, 2006 compared to the three months ended September 2005. The decrease was primarily due to a reduction in overall wages, benefits and other employee related costs, partially offset by a planned increase in corporate information technology support resulting from the many new initiatives and upgrades in our computer systems. This brings the year-to-date administration expense to the same level as the prior year.

The increase in cost of retail goods sold reflects the higher level of retail sales in the three months ended September 30, 2006.

Amortization increased by \$0.1 million in the three months ended September 30, 2006 compared to the three months ended September 2005 (\$1.0 million year-to-date). This reflects the additional assets that came into service during the past 12 months, the most significant being vessel upgrades and modifications.

Interest expense for the three months ended September 30, 2006 compared to the three months ended September 2005 decreased a total of \$1.9 million (\$3.4 million year-to-date). This reflects a \$1.8 million recapture of interest through the Government of Canada structured financing facility program (\$2.6 million year-to-date) and \$0.5 million higher capitalized interest year-to-date.

#### ***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. At the start of each fiscal year, the set prices increase by the Consumer Price Index (Vancouver). The first such increase, effective April 1, 2005, was 2.0%. The Commissioner ordered an additional 5% increase in the set price per route group effective July 24, 2005. On April 1, 2006 our set prices increased a further 1.9%.

Differences in fuel costs arising from our actual price paid per litre being higher or lower than the unit set price are charged or credited to the deferred fuel cost accounts.

Continuing high fuel costs have caused increases in the balances of the deferred fuel cost accounts. We filed applications with the British Columbia Ferries Commissioner under Section 42 of the *Coastal Ferry Act* requesting extraordinary price cap increases to allow for fuel surcharges in order to reduce or eliminate these balances. After receiving approval, we implemented fuel surcharges on July 25, 2005, February 1, 2006 and June 22, 2006. Proceeds from the fuel surcharges are credited against balances in the deferred fuel cost accounts. Despite these actions, and fuel savings measures taken, the balances in our

deferred fuel cost accounts totalled \$25.5 million at September 30, 2006 (\$22.7 million at March 31, 2006).

The Commissioner has also 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. We filed our fuel savings plan with the Commissioner in June 2006. This plan is available on our website at [www.bcferrys.com](http://www.bcferrys.com).

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 and fuel monitoring systems on others. At this time we are on track to meet or exceed the fuel consumption target set by the Commissioner. We have decreased our annual consumption by over 7 million litres (5.6%) from the level of fuel consumed three years ago.

All of the Commissioner's orders can be viewed on the Commissioner's website at [www.bcferrycommission.com](http://www.bcferrycommission.com).

### 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 40% of the capital expenditures over the next decade, with the balance funded by borrowings. Our liquidity and capacity to access capital markets to maintain operations and fund growth remains substantially unchanged since March 31, 2006.

### 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 the three and six months ended September 30, 2006, and the three and six months ended September 30, 2005, are summarized in the table below.

(\$ millions)	Three Months Ended September 30		Six Months Ended September 30	
	2006	2005	2006	2005
Net earnings before extraordinary gain	68.9	61.2	83.8	75.6
Extraordinary gain	0.0	0.0	61.3	0.0
Net earnings for the period	68.9	61.2	145.1	75.6
Items not involving cash:				
Amortization	13.6	13.5	26.6	25.6
Other non-cash charges	0.3	0.2	0.5	0.2
Regulatory costs deferred	(1.2)	(3.3)	(2.4)	(8.5)
Change in operating working capital	(10.4)	(7.8)	(41.2)	(20.2)
Cash provided by operating activities	71.2	63.8	128.6	72.7
Cash used by financing activities	(0.1)	0.0	(0.2)	0.0
Cash used in investing activities	(42.4)	(13.3)	(74.2)	(47.2)
Total increase in cash	28.7	50.5	54.2	25.5

Cash provided by operating activities was \$71.2 million for the three months ended September 30, 2006 (\$128.6 million year-to-date). The year-to-date figure includes an extraordinary gain of \$61.3 million from insurance proceeds regarding the loss of the *Queen of the North*. Also included in cash from operating activities was an increase in non-cash working capital of \$10.4 million (\$41.2 million year-to-date). This working capital increase for the three months ended September 30, 2006 was primarily due to:

- \$6.2 million increase in accounts receivable relating to timing of the receipt of ferry transportation fees (\$3.3 million) and social program fees (\$1.8 million) and an increase in insurance claims receivable from third-party insurers (\$1.4 million);
- \$5.2 million decrease in deferred revenue, mainly due to use of prepaid reservations during the busy summer season. The reservation liability was reduced from \$4.7 million at June 30, 2006 to \$0.7 million at September 30, 2006;
- \$6.4 million decrease in accounts payable and accrued liabilities, including \$2.9 million reduction in contract holdbacks; and
- \$1.0 million increase in general inventories in preparation for the upcoming refit season.

The working capital increase was partially offset by:

- \$7.6 million increase in interest payable (semi-annual interest payments to be made in October and November); and
- \$0.8 million decrease in prepaid expenses mainly due to a decrease in fuel costs (\$1.4 million), partially offset by an increase in property taxes (\$1.1 million).

Regulatory costs deferred are mainly comprised of a \$1.6 million increase in deferred fuel costs partially offset by \$0.4 million proceeds from the sale of a financial derivative instrument.

Cash used in investing activities for the three months ended September 30, 2006 was \$42.4 million (\$74.2 million year-to-date) representing capital expenditures. The significant capital expenditures for the six months ended September 30, 2006 are described below in "Investing in Our Capital Assets".

The \$41.2 million increase in non-cash working capital for the six months ended September 30, 2006 was primarily due to:

- \$32.0 million decrease in accounts payable and accrued liabilities. In April 2006 we paid \$6.1 million of goods and services tax resulting from a notice of reassessment of input tax credit claims. We disagree with the reassessment and continue to pursue recovery through the appeal process. The majority of the remainder is related to vessel refits done during the latter part of fiscal year 2006;
- \$2.3 million decrease in deferred revenue, mainly as a result of summer usage of prepaid reservations and assured loading tickets. The reservation liability was reduced from \$2.2 million at March 31, 2006 to \$0.7 million at September 30, 2006;
- \$4.4 million increase in prepaid expenses relating to an increase in trade contracts (\$1.7 million), property taxes (\$1.1 million), insurance premiums (\$0.9 million) and fuel costs (\$0.7 million); and
- \$2.7 million increase in general inventories in preparation for the upcoming refit season.

These working capital increases were partially offset by a small change (\$0.2 million) in accounts receivable.

Regulatory costs deferred are mainly comprised of a \$2.8 million increase in deferred fuel costs partially offset by \$0.4 million proceeds from the sale of a financial derivative instrument.

### **Investing in our Capital Assets**

Capital expenditures totalled \$38.6 million in the three months ended September 30, 2006. The more significant expenditures included:

- \$28.9 million in vessel upgrades and modifications including:
  - \$7.0 million of the \$200 million project for the construction of a new northern vessel to replace the *Queen of Prince Rupert*;
  - \$6.4 million of the \$542 million Super C-class new vessel construction project;
  - \$6.2 million of the \$57 million project to build a new intermediate vessel to replace the *Queen of Tsawwassen*;
  - \$5.6 million of the \$103 million project for the purchase and modification of the *Sonia*, a replacement vessel for the *Queen of the North*; and
  - \$1.5 million of the \$12 million project to reconstruct the *Kuper*, formerly the *John Atlantic Burr*.
- \$5.7 million in marine structures at many of our terminals;
- \$3.0 million in terminal and building upgrades and equipment; and
- \$1.0 million in software development which will enhance customer service in areas such as automated ticketing, provide improvements in retail and food service management and allow operational efficiencies in crew scheduling.

Capital expenditures totalled \$62.1 million in the six months ended September 30, 2006. This level of expenditure reflects significant investment in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures included:

- \$44.2 million in vessel upgrades and modifications including:
  - \$10.9 million of the \$38.2 million mid-life upgrade which includes safety, structural and mechanical improvements to the *Queen of Surrey*;
  - \$7.0 million of the \$200 million project for the construction of a new northern vessel to replace the *Queen of Prince Rupert*;
  - \$7.3 million of the \$542 million Super C-class new vessel construction project;
  - \$6.3 million of the \$57 million project to build a new intermediate vessel to replace the *Queen of Tsawwassen*;
  - \$5.6 million of the \$103 million project for the purchase and modification of the *Sonia*, a replacement vessel for the *Queen of the North*; and
  - \$2.9 million of the \$12 million project to reconstruct the *Kuper*, formerly the *John Atlantic Burr*.
- \$11.3 million in marine structures at many of our terminals, including \$6.0 million to complete a new berth at Swartz Bay terminal;
- \$4.3 million in terminal and building upgrades and equipment; and
- \$2.3 million in software development which will enhance customer service in areas such as automated ticketing, provide improvements in retail and food service management and allow operational efficiencies in crew scheduling.

### **Major Vessel Upgrades**

The *Queen of Surrey*, which provides service on our Langdale-Horseshoe Bay route, returned to service on June 27, 2006, following an extensive \$38.2 million mid-life upgrade. The 25-year-old vessel underwent significant upgrades to prepare it for another 20 years of service. The upgrades included 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. Similar upgrades have already been undertaken

on the *Queen of Coquitlam*, *Queen of Cowichan* and *Queen of Oak Bay*. The remaining C-class vessel, the *Queen of Alberni*, is scheduled to undergo its mid-life upgrade in fiscal 2008.

### ***Kuper - Hull 259 Renamed***

In August 2005, we acquired a ferry from the State of Utah for \$200,000 (US) through a competitive bid process. The *Kuper*, originally the *John Atlantic Burr*, is similar in design to our three "K-class" vessels, the *Kahloke*, the *Klitsa* and the *Kwuna*. 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 *Kuper* is expected to be ready for service in December 2006.

### ***Queen of the North Replacement***

After an extensive international search to lease or purchase a replacement vessel for the *Queen of the North*, an agreement to purchase a two-year-old vessel, currently named the *Sonia*, for €36 million Euros or approximately \$51 million Canadian was reached. The import duty and taxes on this agreement to purchase total approximately \$17 million Canadian. The vessel will undergo significant modifications this winter to improve customer amenities and meet safety requirements to operate in Canadian waters. This 117-metre vessel has 70 state rooms and will accommodate over 600 passengers and 101 vehicles. The total project budget for the acquisition and modification of this vessel is \$103 million. The vessel, which will be renamed, is expected to enter service next spring, in time to relieve the *Queen of Prince Rupert* for its annual refit.

### ***New Northern Vessel***

Following a rigorous competitive bidding process, we signed a €91.8 million Euro or \$133 million Canadian contract with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany to build a new vessel to replace the 40-year-old *Queen of Prince Rupert*, operating on our northern routes. The import duty and taxes on this contract total approximately \$43 million Canadian. This design-build, fixed price contract (the majority of the total project budget of \$200 million) provides us with substantial guarantees for delivery dates, performance criteria, cost certainty and quality of construction. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk. This 150-metre vessel, which is expected to be in service in the spring of 2009, will accommodate 130 vehicles and 600 passengers.

### ***"Super C" Class New Vessel Construction***

On September 17, 2004 we entered into contracts with FSG of Germany to build three new major vessels that will be the largest double ended vessels in the world. These contracts, totalling €206.4 million Euros or approximately \$325 million, together with the related import duty and taxes of approximately \$106 million Canadian, form the majority of the total project budget of \$542 million. The *Coastal Renaissance*, *Coastal Inspiration* and *Coastal Celebration* 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. Steel cutting for the first of the three vessels commenced on August 29, 2006. This first vessel is expected to be delivered in December 2007 while the others are expected in mid 2008. 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 5, 2006, we signed a \$45.5 million contract with Vancouver Shipyards, a Washington Marine Group company, to build a new 125-car ferry to replace the 46-year-old *Queen of Tsawwassen*. Under the fixed price contract, the shipyard is responsible for the detailed design and construction of the vessel and guarantees performance related to speed, carrying capacity, manoeuvrability, fuel consumption and delivery. This contract constitutes the majority of the total project budget of \$57 million. Construction of the 100 metre vessel will begin later this year and the vessel is expected to be in service by the summer of 2008.

### ***Terminal Marine Structures***

In October 2006 we officially opened a new state-of-the-art berth at Swartz Bay terminal on Vancouver Island. This \$25 million project was undertaken to replace the outdated counter-weighted ramp lift system and old marine structures and brings a new level of technology to our berthing arrangements for our largest vessels. The improved design of this new floating berth will speed up the loading and unloading process with fewer ramp adjustments as the ramp rises and falls with the tide. This berth is now able to accommodate our Spirit-class vessels and will also be able to service the new Super C-class vessels.

In addition, berth upgrades are currently underway at Departure Bay and Horseshoe Bay as we reinvest in our terminal infrastructure and prepare for the arrival of the new Super C-class vessels.

### ***Information Technology***

In September 2006, we implemented an automated ticketing pilot project at our Tsawwassen and Swartz Bay terminals on our major routes. Foot passengers at these terminals now have the option of using the automated ticketing kiosks or a staffed ticket booth to purchase tickets. Passengers have the option to pay with either a debit or credit card at the kiosks. It is expected that this technology will be implemented at other locations in the future.

We have also completed \$1.8 million (\$0.5 million in fiscal 2007) of a \$4.4 million project to improve communication 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.

Other ongoing projects include a new time collection system and enhanced reporting initiatives, enhanced crew scheduling system, improved voice recognition system for reservations and security projects. These projects focus on obtaining efficiencies, improving safety and security and providing better service to our customers.

### ***Quarterly Financial Highlights***

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.

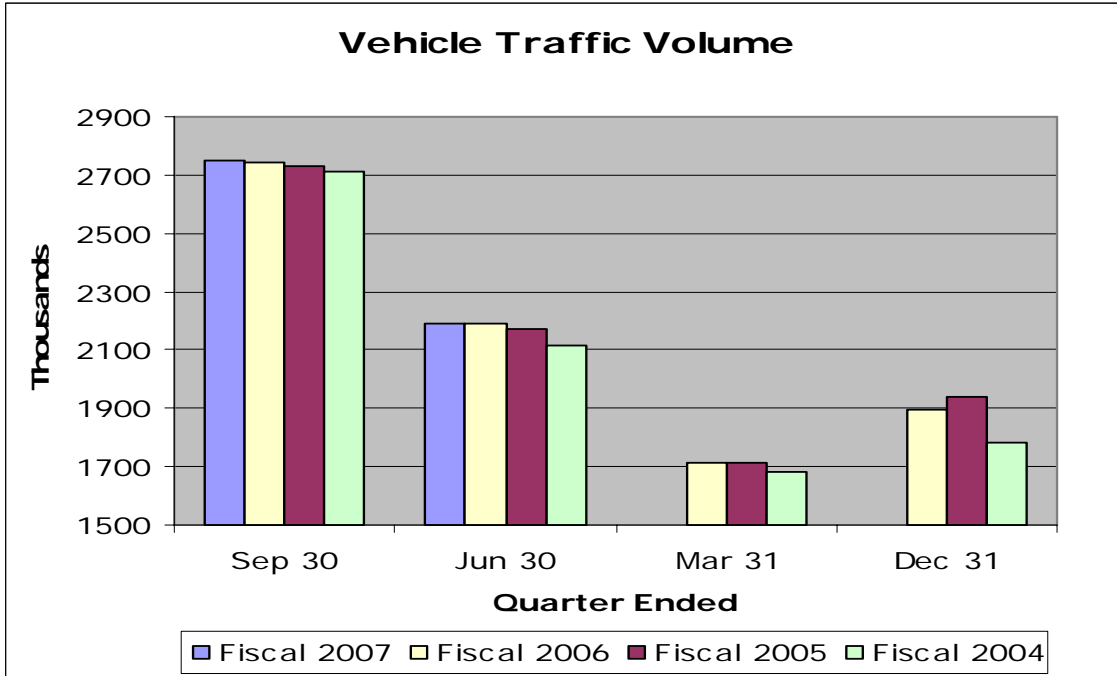
(\$millions)	Quarter Ended (unaudited)							
	Sep 06	Jun 06	Mar 06	Dec 05	Sep 05	Jun 05	Mar 05	Dec 04
Total revenue	202.7	146.2	109.7	126.0	198.3	145.2	107.0	122.7
Earnings (loss) from operations	73.0	20.2	(18.7)	5.4	67.3	21.1	(23.8)	3.6
Net earnings (loss) before extraordinary gain	68.9	14.9	(24.8)	(0.9)	61.2	14.4	(31.3)	(4.2)
Extraordinary gain	0.0	61.3	0.0	0.0	0.0	0.0	0.0	0.0
Net earnings (loss)	68.9	76.2	(24.8)	(0.9)	61.2	14.4	(31.3)	(4.2)

Net earnings (loss) before extraordinary gain in each of the latest four quarters were better than the corresponding quarters in the previous year, ranging from \$0.5 million to \$7.7 million.

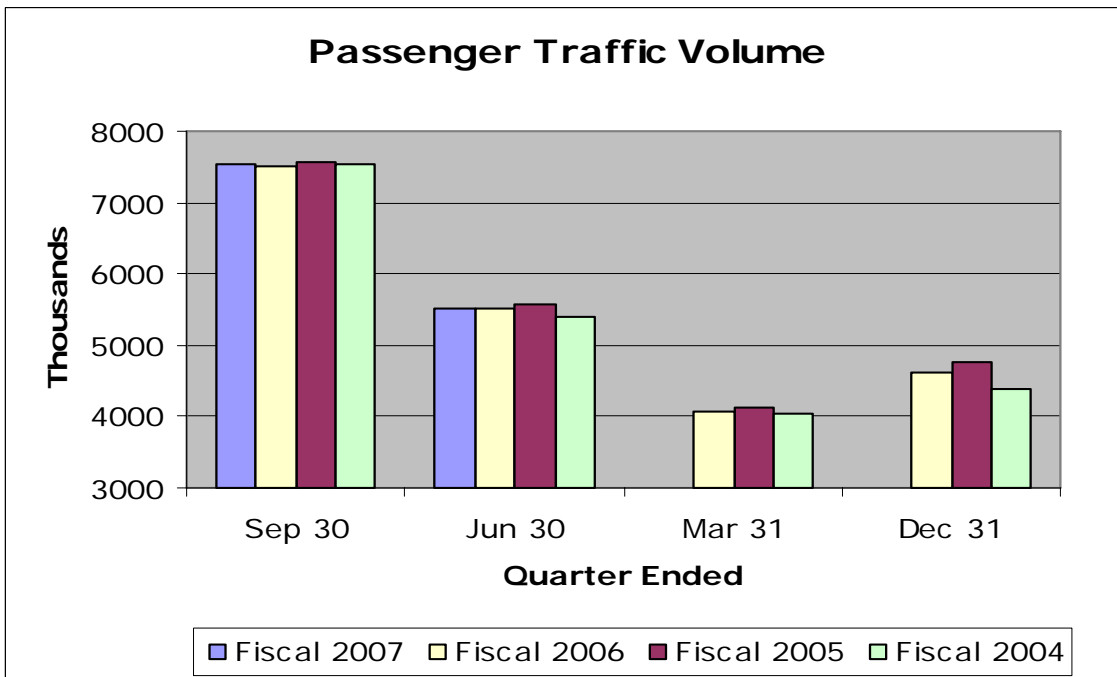
Total revenue in each of the latest four quarters was higher than the corresponding quarters from the previous fiscal year. The most significant contributing factors to the trend were higher tariff revenue as a result of increases in tariff rates and growth in retail and other income. The *Coastal Ferry Act* permits an annual average tariff increase of 2.8% on the three major routes and 4.4% on the remaining routes.

Traffic levels this fiscal year are being maintained or are showing a moderate increase despite challenges including the loss of the *Queen of the North*, a strong Canadian dollar, high motor fuel prices and the implementation fuel surcharges in July 2005, February 2006 and June 2006.

Vehicle traffic decreased 2.5% in the quarter ended December 2005 compared to the quarter ended December 2004. The quarter ended June 2006 was substantially the same as the quarter ended June 2005. In the quarters ended March 2006 and September 2006, we experienced a modest increase from the corresponding quarters in the previous year, resulting in a net four-quarter decrease of 0.5%. We believe that the fluctuations in traffic levels are primarily due to changes in levels of tourism. The following graph shows the relationship of the quarters over the past few years.



Passenger traffic in the quarters ended September 2006 and June 2006 increased 0.2% over the corresponding quarter in the previous year. Passenger traffic in the quarters ended March 2006 and December 2005 were lower than the corresponding quarters in the previous year. The average decrease of the latest four quarters was 0.7%. We believe the fluctuations in passenger traffic are primarily due to changes in levels of tourism. Following is a graph showing the relationship of the quarters over the past few years.



## **OUTLOOK**

### **Traffic**

Ferry traffic levels are affected by a number of factors including high motor fuel costs, a strong Canadian dollar, the public's concerns regarding security and health, disposable personal income, the local economy and population growth. Overall, traffic levels this fiscal year are showing a moderate increase despite the implementation of three fuel surcharges among other challenges. We anticipate modest traffic volume increases to continue over the next few years.

### **Market Growth**

Notwithstanding the pressure on traffic volumes, we see some opportunities for growth. We received approximately 2.4 million unique visitors to our website in fiscal 2006, up 21% from the previous fiscal year. In the six months ended September 30, 2006 we had 1.5 million unique visitors which is an increase of 18% over the six months ended September 30, 2005. 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.

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.

### **Queen of the North**

Our hull and machinery insurance policies have been renewed with an increase in annual premium costs of approximately \$1.5 million as a direct result of the sinking of the *Queen of the North*. We expect that foregone revenues from the loss of the *Queen of the North* will be largely offset by avoided operating costs and interest income on invested insurance proceeds.

In accordance with the terms of the Coastal Ferry Services Contract with the Province, we filed a notice of force majeure. At this time the Province has not yet agreed that the events surrounding the loss of the *Queen of the North* constitute an event of force majeure, and it is uncertain what the impact of this incident will be on related ferry service fees. The impact, if any, is expected to be known by the end of the fiscal year.

### **Asset Renewal Program**

Although we have one of the largest fleets in the world, the average age of our assets is currently among the oldest of major ferry operators worldwide. To address this we will continue with our fleet and asset renewal program. Over the next five years, we expect to spend over \$1.3 billion, which includes bringing seven new vessels into service. 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.

We continue to reinvest our retained earnings into our asset renewal program. As the capital projects are completed and come into service, amortization and financing costs will climb. Consistent with our expectations, this will cause a decrease in our future earnings.

## **Regulation**

Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. It is expected that a revised Act and more stringent regulations will be introduced in the near future. 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 tariffs are regulated and our service levels are monitored by the British Columbia Ferries Commissioner. The Commissioner regulates our tariffs by establishing price caps over a performance term. Our first performance term ends March 31, 2008. We have provided the Commissioner with the information required under the *Coastal Ferry Act* to assist the Commissioner in setting price caps for the next performance term. The second performance term ends March 31, 2012.

In 2001, the federal government enacted the Marine Security Act. Initially, the legislation and the associated regulations were limited to international ports and vessels. However, in November 2005, the federal government announced that the regulations would be extended to include domestic marine services, including domestic ferries. The regulations are expected to come into force in the spring of 2007.

To comply with the regulations, all ferry operators will be required to make considerable security investments in the areas of fencing, cameras, better access controls and screening. We are in the process of defining the capital requirements and operating costs to comply with the upcoming regulations. This process is not expected to be completed until March 2007. We intend to apply for Federal funding to help offset these costs.

## **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. Competition may increase in these markets with the potential emergence of alternate 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 fiscal year. We also expect to issue a Request for Proposals regarding the operation of our four routes north of Port Hardy. However, 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 six months ended September 30, 2006.

(\$ millions)	September 30, 2006				March 31, 2006	
	Number of Swaps	Term to Maturity (years)	Carrying Value (\$ millions)	Fair Value	Carrying Value (\$ millions)	Fair Value
Commodity Fixed Price Swaps	6	Up to .5	(1.9)	(1.9)	0.9	0.9
Foreign Exchange Forward Transactions (Super C vessels)	25	Up to 2.0	0.0	(48.6)	0.0	(45.3)
Foreign Exchange Forward Transactions (New Northern vessel)	6	Up to 2.5	(3.8)	(3.8)	0.0	0.0

The commodity derivatives fair 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 values reflect the estimated amounts that we would receive or pay should the derivative 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 September 30, 2006 we have recorded a payable of \$1.9 million as the estimated loss to terminate the contracts as at this date.

The foreign exchange derivative fair 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 values reflect the estimated amounts we would receive or pay to terminate the derivative contracts at the stated dates. The derivatives relating to the Super C vessels contract are accounted for using hedge accounting and therefore estimated gains and losses are not recorded in our financial statements. The derivatives relating to the new Northern vessel were entered into in August 2006. These are accounted for using hedge accounting commencing October 16, 2006 when appropriate documentation was completed. Any gains or losses related to these foreign exchange forward contracts are charged to our regulatory asset accounts. At September 30, 2006 we have recorded a payable of \$3.8 million as the estimated loss to terminate the contracts as at this date.

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

Understanding and managing risk are important parts of our business. A discussion of enterprise wide risk management can be found on pages 22 through 26 of our fiscal 2006 annual Management's Discussion and Analysis. Our risk profile is substantially unchanged during the six months ended September 30, 2006.

In July 2006, we commissioned an independent review of our safety policies, procedures and practices. This comprehensive safety review is underway and a report is expected to be available in late 2006. It is our intention to carry out a major review of this nature every

five years as part of our ongoing commitment to ensuring the safety of our passengers and employees.

## **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 March 31, 2006 and September 30, 2006 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.

Further discussion of our most critical accounting policies and estimates that have been used in the preparation of our consolidated financial statements can be found on pages 26 through 29 of our fiscal 2006 annual Management's Discussion and Analysis.

## **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.