

**Management's Discussion & Analysis
of
Financial Condition
and
Results of Operations**

**For the three months ended June 30, 2008
Dated July 30, 2008**

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**Management's Discussion & Analysis
of Financial Condition and Results of Operations
For the three months ended June 30, 2008
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The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of July 30, 2008. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three month periods ended June 30, 2008 and 2007, and our annual audited consolidated financial statements and related notes together with our fiscal 2008 Management's Discussion and Analysis. These documents are available on SEDAR at www.sedar.com and on our Investor webpage at <http://www.bcferrys.com/about/investors/index.html>.

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, providing frequent year-round transportation service on 25 routes, supported by 37 vessels and 47 terminals. 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 June 30, 2008 (the first quarter of fiscal 2009), we provided more than 46,000 sailings, carrying over 5.4 million passengers and 2.1 million vehicles.

Significant events during or subsequent to our first quarter of fiscal 2009:

- On July 22, 2008, the British Columbia Ferries Commissioner (the Commissioner) amended the automatic fuel surcharge/rebate mechanism to allow for the early implementation of a fuel surcharge as a result of the dramatic rise in fuel prices. Fuel surcharges of 10.3% on our major routes; 9.2% on our Horseshoe Bay-Langdale route and 17.6% on our other routes (excluding the northern routes) will go into effect on August 1, 2008. Fuel surcharges on our northern routes are not required at this time as a result of an agreement with the Province (See "Outlook-Fuel Costs" below for more detail). All of the Commissioner's Orders can be viewed at www.bcferrycommission.com.

New Vessels (See "Investing in our Capital Assets" below for more detail):

- On June 16, 2008, the second of three new Super C-class vessels, the *Coastal Inspiration*, commenced service on the Duke Point-Tsawwassen route following crew training and familiarization in the operation of this state-of-the-art vessel.

On June 18, 2008, the third and final Super C-class vessel, the *Coastal Celebration*, arrived in British Columbia following a 10,000 nautical mile journey from Germany. The vessel is expected to enter service on the Swartz Bay-Tsawwassen route in the fall of 2008.

These vessels are the largest double-ended ferries in the world, with each vessel measuring 160 metres in length and having a capacity of 1,650 passengers and crew and approximately 370 vehicles. They feature a diesel-electric propulsion system that is one of the largest and most economical of its kind in the world. This propulsion system and other technological and environmental features of the *Coastal Renaissance* contributed to winning the prestigious ShipPax¹ award for outstanding ferry technology for 2008.

These new ships are replacing aging vessels which provided service on our major routes. The construction program is complete and the project for the three vessels was on schedule and under the \$542 million budget.

- On June 16, 2008, the keel for the new *Northern Expedition* was officially laid. The *Northern Expedition* will replace the 42-year-old *Queen of Prince Rupert*, operating on our northern routes. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 55 staterooms and will accommodate 130 vehicles and 600 passengers. The total project budget for this vessel is \$200 million. The project is currently on schedule and on budget.
- We expect to take delivery of the *Island Sky*, our new intermediate class ferry, this summer. The *Island Sky* will allow for the retirement of the 48-year-old *Queen of Tsawwassen*. A \$46 million contract with Vancouver Shipyards constitutes the majority of the total project budget of \$57 million.

Other items:

- On May 23, 2008, a Purchase and Sale Agreement with Dalian Golden Sun I/E Co. Ltd. of China was completed for the sale of the *Queen of Esquimalt* which served on our major routes. The agreement states that the buyer cannot sell or scrap the vessel for five years from the date of the agreement and the vessel will be kept in active service during that period. Delivery took place on May 29, 2008. We also intend to retire the *Queen of Vancouver*, *Queen of Saanich*, and *Queen of Tsawwassen* from service prior to the end of 2008 and have offered these vessels for sale.
- In May 2008, to coincide with conditional acceptance of the *Coastal Celebration*, we received \$90 million in proceeds under the loan agreement with KfW, a German export credit bank. This is a 12-year amortizing loan, at a fixed interest rate of 4.98%. The agreement defers the principal payments for the first three years to a second tranche on which interest only is payable at a floating rate. This principal is due at June 2020.

¹ ShipPax Information is an internationally recognized marine industry publisher with the largest database of passenger shipping information in the world.

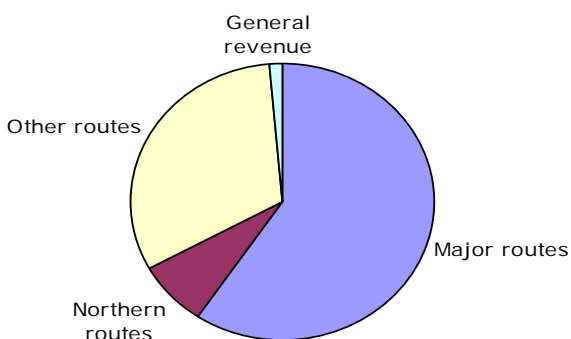
FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three months ended June 30, 2008 and 2007.

(\$millions)	Three months ended June 30			Variance
	2008	2007		
Total revenue	171.9	159.8	12.1	7.6%
Expenses	(153.6)	(137.7)	(15.9)	(11.5%)
Earnings from operations	18.3	22.1	(3.8)	(17.2%)
Interest and other	(9.9)	(7.7)	(2.2)	(28.6%)
Net earnings and comprehensive income	8.4	14.4	(6.0)	(41.7%)

Revenue

Our total revenues in the three months ended June 30, 2008 increased over the previous year as shown in the table below.



During the three months ended June 30, 2008, the greatest portion of our revenues, 61%, was earned on our three major routes connecting Vancouver Island to Vancouver and the Lower Mainland. The revenue from the northern routes contributed 7% and other routes contributed 31%. General revenue, 1%, consists mainly of marketing rights and interest earned.

Total Revenue

Revenue (\$millions)	Three months ended June 30			
	2008	2007	Increase (Decrease)	
Direct Route Revenue				
Vehicle traffic (volume)	2,153,998	2,191,013	(37,015)	(1.7%)
Vehicle tariff	69.4	60.4	9.0	14.9%
Passenger traffic (volume)	5,410,996	5,538,928	(127,932)	(2.3%)
Passenger tariff	38.5	34.6	3.9	11.3%
Social program fees	5.4	4.7	0.7	14.9%
Catering & on-board	19.3	19.3	0.0	0.0%
Other revenue	5.2	5.4	(0.2)	(3.7%)
Total Direct Route Revenue	137.8	124.4	13.4	10.8%
Indirect Route Revenue				
Ferry service fees	26.2	26.5	(0.3)	(1.1%)
Federal-Provincial subsidy	6.6	6.5	0.1	1.5%
Total Route Revenue	170.6	157.4	13.2	8.4%
Other general revenue	1.3	2.4	(1.1)	(45.8%)
Total Revenue	171.9	159.8	12.1	7.6%

Our largest revenue source is vehicle and passenger tariffs. The price cap increase authorized by the Commissioner was 7.3% on the major routes and 4.0% on all other routes effective April 1, 2008, starting from a level which included fuel surcharges in place at March 31, 2008. On April 1, we implemented tariff increases in line with these price cap adjustments. On each subsequent April 1 of the four-year term, the price cap will increase by 2.7% plus 0.49 times the latest reported annual increase in the Consumer Price Index (British Columbia) on the major routes and 5.7% plus 0.73 times the Consumer Price Index (British Columbia) on all other routes. From time to time, we utilize promotional fare incentives designed to stimulate growth in traffic or direct traffic towards our less busy sailings. In calculating the price cap, vehicle and passenger tariffs are combined. The utilization of promotional fare incentives and the effects of being over or under the price cap may cause the average vehicle and passenger tariff rate to be under or over the statutory increase in any one period.

Year to year changes for the three months ended June 30 for the major, northern and other routes are discussed separately below.

Major Routes

Direct Route Revenue (\$ thousands)	Three months ended June 30			
	2008	2007	Increase (Decrease)	
Vehicle traffic (volume)	977,463	997,778	(20,315)	(2.0%)
Vehicle tariff	52,695	45,924	6,771	14.7%
Passenger traffic (volume)	2,768,114	2,865,283	(97,169)	(3.4%)
Passenger tariff	28,294	25,659	2,635	10.3%
Social program fees	2,703	2,401	302	12.6%
Catering & on-board	15,882	16,026	(144)	(0.9%)
Reservation fees	3,040	3,240	(200)	(6.2%)
Parking	754	742	12	1.6%
Assured loading	488	609	(121)	(19.9%)
Other revenue	309	189	120	63.5%
Total Direct Route Revenue	104,165	94,790	9,375	9.9%
Gross margin - catering & on-board	9,802	10,014	(212)	(2.1%)

Revenue on the major routes is from customers and related social program fees, and includes no ferry service fees.

Both vehicle traffic and passenger traffic decreased over the prior year. The increase in average tariff revenue per vehicle was \$7.88 or 17.1% while the increase in average tariff revenue per passenger was \$1.27 or 14.1%. A significant portion of these increases represents fuel surcharges previously paid by customers and credited to fuel cost deferral accounts, which are now included in tariff revenue by order of the Commissioner. During the first quarter of fiscal 2008, these surcharges paid by customers amounted to \$6.2 million. The April 1, 2008 price cap increase on the major routes was 7.3% starting from a level which included fuel surcharges in place at March 31, 2008. The higher average fares, partially offset by the decrease in traffic and significant use of promotional discount fares during this period, resulted in a total increase of \$9.4 million in tariff revenue.

Social program fees are reimbursements from the Province of discounts provided on fares for BC seniors, students travelling to and from school, persons with disabilities and persons travelling under the Medical Travel Assistance Program. These fees have increased mainly as a result of higher fares.

All of our vessels that provide service on our major routes have a gift shop and options for food service. Food service revenue increased \$0.2 million (\$0.1 million increase in gross margin) as a result of higher spending per passenger. This increase was more than offset by a decrease in gift shop sales as a result of the lower number of passengers carried. In June 2008, we joined the Health Check BC Dining Program, making it easier for travellers to make healthy food choices onboard our vessels.

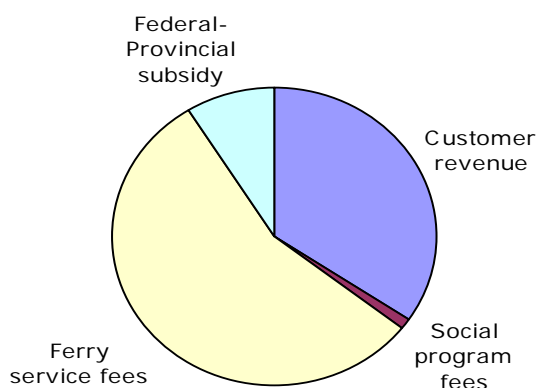
The lower fees for reservations and assured loading revenue reflect the lower traffic levels.

Other revenue has increased, mainly as a result of higher commissions from the Tsawwassen Quay market place.

Northern Routes

Direct Route Revenue (\$ thousands)	Three months ended June 30			
	2008	2007	Increase (Decrease)	
Vehicle traffic (volume)	8,009	8,107	(98)	(1.2%)
Vehicle tariff	2,149	1,750	399	22.8%
Passenger traffic (volume)	22,056	23,325	(1,269)	(5.4%)
Passenger tariff	1,730	1,434	296	20.6%
Social program fees	193	130	63	48.5%
Catering & on-board	521	538	(17)	(3.2%)
Reservation fees	16	19	(3)	(15.8%)
Stateroom rental	196	179	17	9.5%
Hostling ²	45	45	0	0.0%
Other revenue	14	12	2	16.7%
Total Direct Route Revenue	4,864	4,107	757	18.4%
Indirect Revenue				
Ferry service fees	6,433	7,196	(763)	(10.6%)
Federal-Provincial subsidy	1,118	1,097	21	1.9%
Total Route Revenue	12,415	12,400	15	0.1%
Gross margin - catering & on-board	389	235	154	65.5%

Our northern routes consist of three regulated routes operating on the British Columbia coast north of Port Hardy on Vancouver Island.



In the three months ended June 2008 revenue from our northern routes consists of 38% from customers, 2% from social program fees, 51% from ferry service fees paid by the Province and 9% from payments under the Federal-Provincial subsidy agreement.

² Loading and unloading of commercial trailers that are dropped off for transportation on a ferry route.

Northern Routes, continued

The average tariff revenue per vehicle increased \$52.46 or 24.3%. The average passenger tariff revenue increase was \$16.96 or 27.6%. A significant portion of these increases represents fuel surcharges previously paid by customers and credited to fuel cost deferral accounts, which are now included in tariff revenue by order of the Commissioner. During the first quarter of fiscal 2008, these surcharges paid by customers amounted to \$0.5 million. The April 1, 2008 price cap increase on the northern routes was 4.0% starting from a level which included fuel surcharges in place at March 31, 2008. The higher average tariff, partially offset by lower traffic, resulted in a total tariff revenue increase of \$0.7 million.

We receive ferry service fees for these routes under the Coastal Ferry Services Contract. The decrease in fees reflects a change in the timing of the payment of ferry service fees in the second performance term which better reflects the seasonality of our business.

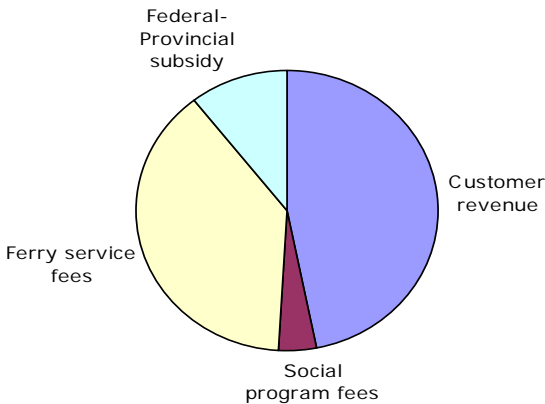
Reimbursements from the Province for social program fees increased mainly as a result of increased usage and higher fares.

Other Routes

Direct Route Revenue (\$ thousands)	Three months ended June 30			
	2008	2007	Increase (Decrease)	
Vehicle traffic (volume)	1,168,526	1,185,128	(16,602)	(1.4%)
Vehicle tariff	14,597	12,761	1,836	14.4%
Passenger traffic (volume)	2,620,826	2,650,320	(29,494)	(1.1%)
Passenger tariff	8,531	7,535	996	13.2%
Social program fees	2,532	2,137	395	18.5%
Catering & on-board	2,734	2,731	3	0.1%
Reservation fees	307	317	(10)	(3.2%)
Parking	69	62	7	11.3%
Other revenue	36	13	23	176.9%
Total Direct Route Revenue	28,806	25,556	3,250	12.7%
Indirect Revenue				
Ferry service fees	19,788	19,336	452	2.3%
Federal-Provincial subsidy	5,455	5,367	88	1.6%
Total Route Revenue	54,049	50,259	3,790	7.5%
Gross margin - catering & on-board	1,771	1,743	28	1.6%

Our other routes consist of 19 regulated routes and eight small unregulated routes primarily serving the northern and southern Gulf Islands and the Sunshine Coast. One of the regulated routes and all of the unregulated routes are operated under contract by alternative service providers. We receive fees from the Province for the provision of service on the unregulated routes, which are included in the ferry service fees in the above table.

Other Routes, continued



In the three months ended June 30, 2008 revenue from our other routes consisted of 48% from customers, 5% from social program fees, 37% from ferry service fees paid by the Province and 10% from payments under the Federal-Provincial subsidy agreement.

We experienced a decrease in vehicle and passenger traffic levels on our other routes in the three months ended June 2008.

The increase in average tariff revenue per vehicle was \$1.72 or 16.0% while the average passenger tariff revenue increase was \$0.41 or 14.5%. A significant portion of these increases represents fuel surcharges previously paid by customers and credited to fuel cost deferral accounts, which are now included in tariff revenue by order of the Commissioner. During the first quarter of fiscal 2008, these surcharges paid by customers amounted to \$3.6 million. The April 1, 2008 price cap increase on our other regulated routes was 4.0% starting from a level which included fuel surcharges in place at March 31, 2008. The increased average fares, partially offset by the reduction in traffic levels, resulted in a total tariff revenue increase of \$2.8 million.

Reimbursements from the Province for social program fees increased, as a result of higher fares and increased usage.

During fiscal 2008, the Province agreed to reimburse us a maximum of \$1.6 million for the refit of the 48-year-old *Nicola*, which provides service on our unregulated Prince Rupert-Lax Kwala'ams route. During the three months ended June 30, 2008, we recorded a \$1.1 million reduction of maintenance expense (\$0.5 million in fiscal 2008), equal to the refit costs incurred to that date.

We receive ferry service fees for these routes under the Coastal Ferry Services Contract. The increase in fees reflects a change in the payment of ferry service fees in the second performance term which better reflects the seasonality of our business.

Fees for reservations have decreased as a result of lower traffic. The increase in other income is mainly a result of additional revenue from charters.

Expenses

Expenses for the three months ended June 30, 2008 and 2007 are summarized in the table below.

(\$ millions)	Three months ended June 30			
	2008	2007	(Increase)Decrease	
			\$	%
Operations	95.9	81.9	(14.0)	(17.1%)
Maintenance	18.3	21.4	3.1	14.5%
Administration	11.9	11.2	(0.7)	(6.3%)
Cost of retail goods sold	7.2	7.3	0.1	1.4%
Amortization	20.3	15.9	(4.4)	(27.7%)
Total expenses	153.6	137.7	(15.9)	(11.5%)
Interest and other				
(Gain) loss on foreign exchange	(0.1)	(0.1)	(0.0)	0.0%
Interest expense	11.2	7.8	(3.4)	(43.6%)
(Gain) on disposal of capital assets	(1.2)	0.0	1.2	
Total interest and other	9.9	7.7	(2.2)	(28.6%)

The \$14.0 million increase in operations expenses reflects:

- \$10.4 million increase in fuel expense reflecting the increase in the per litre cost of fuel, partially offset by \$0.5 million due to a reduction in litres consumed as a result of our fuel reduction strategy. For Performance Term 2, the Commissioner increased the price of fuel to be included in the determination of price caps by 81.3% from the prior year in order to reflect higher fuel prices;
- \$3.0 million increase in wages and benefits, including:
 - Approximately \$1.1 million in bargaining unit wage rate increases averaging about 3%;
 - \$1.1 million increase in benefit costs; and
 - \$0.8 million in additional training costs (an increase in operational training from approximately 5,960 to 6,800 person days); and
- \$0.7 million increase in safety and security costs as we continue with our SailSafe program — a joint initiative with the BC Ferry & Marine Workers' Union to identify areas and methods for enhancing current safety practices.

Maintenance costs decreased \$3.1 million. We plan to undertake 20 vessel refits in fiscal 2009, compared to 26 in the prior year.

Administration expenses increased \$0.7 million mainly as a result of additional planned costs relating to information technology initiatives.

Amortization increased a total of \$4.4 million; \$3.2 million as a result of additional assets coming into service, including \$2.0 million reflecting the Coastal Renaissance entering service in March 2008; and \$1.2 million in amortization of deferred fuel cost balances. The Commissioner has included \$18.5 million of deferred performance term one fuel costs in determination of the price caps set for the four year second performance term commencing April 1, 2008.

Interest expenses increased \$3.5 million primarily due to:

- \$2.8 million additional interest relating to our \$200 million bond series issued in January 2008;
- \$1.8 million additional interest relating to the two \$90 million KfW loans;
- \$0.8 million reduction in funds received from the Structured Financing Facility Program offered by the Government of Canada; and
- \$0.4 million reduction in interest on deferred fuel cost accounts.

These increases were partially offset by \$2.3 million of additional interest capitalized reflecting our investment in revitalizing our fleet and terminal facilities.

We reported a \$1.2 million gain from the sale of the *Queen of Esquimalt* in the three months ended June 30, 2008.

LIQUIDITY AND CAPITAL RESOURCES

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 five years, 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, 2008.

In May 2008, we negotiated an extension of the \$155 million credit facility by one year. The new maturity of this facility is May 12, 2013. There were no draws on this facility at June 30, 2008.

In May 2008, to coincide with conditional acceptance of the *Coastal Celebration*, we received \$90 million in proceeds under the loan agreement with KfW, a German export credit bank. This is a 12-year amortizing loan, at a fixed interest rate of 4.98%. The agreement defers the principal payments for the first three years to a second tranche on which interest only is payable at a floating rate. This principal is due June 2020.

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 months ended June 30, 2008 and 2007 are summarized in the table below.

(\$ millions)	Three months ended June 30	
	2008	2007
Net income	8.4	14.4
Items not involving cash:		
Amortization	20.3	15.8
Other non-cash charges	(0.8)	0.1
Regulatory costs deferred	(1.0)	0.5
Change in operating working capital	(21.2)	(11.2)
Cash provided by operating activities	5.7	19.6
Cash provided (used) by financing activities	89.6	(24.8)
Cash used in investing activities	(203.8)	(74.7)
Total decrease in cash	(108.5)	(79.9)

In the three months ended June 30, 2008, cash provided by operating activities includes an increase in non-cash working capital of \$21.2 million. This increase was primarily due to:

- \$7.8 million decrease in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- \$7.6 million increase in prepaid expenses primarily due to increases of:
 - \$2.7 million in property taxes;
 - \$2.9 million seasonal increase in prepaid fuel;
 - \$1.8 million in insurance and other contracts as a result of annual remittances made in the first quarter; and
 - \$0.2 million in other prepaid costs;
- \$3.6 million decrease in regulatory liabilities reflecting the return to customers through discount fare promotions of the tariff revenues collected in excess of price caps in the last quarter of fiscal 2008;
- \$3.1 million increase in accounts receivable resulting mainly from increases of:
 - \$1.3 million in fuel hedge proceeds;
 - \$1.1 million for the Nicola refit costs recoverable;
 - \$0.9 million in commercial travel cards receivable; and
 - \$0.8 million in social program fees recoverable.These increases were partially offset by decreases of:
 - \$0.8 million reflecting receipt of GST on duty remission for the Northern Adventure; and
 - \$0.2 million in other receivables.
- \$1.6 million seasonal increase in fuel inventories;
- \$1.4 million decrease in interest payable due to timing of interest payments; and
- \$0.8 million decrease in accrued employee costs.

The working capital increase was partially offset by:

- \$4.7 million increase in deferred revenue as a result of:
 - \$3.2 million increase in reservation liability reflecting the seasonal nature of our traffic;
 - \$0.9 million increase in prepaid fare media; and
 - \$0.6 million in other deferred revenues.

Cash provided by financing activities reflects issuance of the second \$90 million loan agreement with KfW, a German export credit bank.

Cash used in investing activities consists mainly of \$195.6 million used to purchase capital assets. The significant capital transactions are described below in "Investing in Our Capital Assets".

INVESTING IN OUR CAPITAL ASSETS

Capital expenditures in the three months ended June 30, 2008 totaled \$190.0 million. This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Total capital expenditures were:

(\$ millions)	
New vessels, vessel upgrades and modifications	171.8
Terminal marine structures	8.3
Terminal and building upgrades and equipment	7.5
Computer hardware and software development	2.4
Total Capital Expenditures	<u>190.0</u>

New Vessels, Vessel Upgrades and Modifications

Capital expenditures for new vessels, vessel upgrades and vessel modifications in the quarter included the following:

(\$ millions)	
New <i>Coastal Inspiration</i> and <i>Coastal Celebration</i>	137.6
Life extension of the <i>Queen of New Westminster</i>	13.6
New northern vessel, the <i>Northern Expedition</i>	7.0
Upgrade and replacement of propulsion and safety equipment on the <i>Quinitsa</i>	5.5
Refurbishment of car deck on the <i>Powell River Queen</i>	4.6
Post-acquisition modifications of the <i>Northern Adventure</i>	1.1
New intermediate vessel, the <i>Island Sky</i>	0.7
Other projects	1.7
	<u>171.8</u>

Major Vessel Upgrades

The *Queen of New Westminster*, which usually operates on our Duke Point–Tsawwassen route, is currently undergoing a project to extend the life of the 44-year-old vessel for a further thirteen years of service. This \$55 million project will include significant upgrades for structural fire protection; a new marine evacuation system; major electrical upgrades; boiler, auxiliary generator and emergency generator renewal; and propulsion controls upgrade. The *Queen of New Westminster* is expected to return to service in the fall of 2008 and be redeployed on our Tsawwassen–Swartz Bay route.

Coastal Renaissance, Coastal Inspiration and Coastal Celebration

In September 2004 we entered into contracts with Flensburger Schiffbau-Gesellschaft (FSG) to build three new Super C-class vessels that are the largest double-ended vessels in the world. Each vessel measures 160 metres in length and has a capacity of 1,650 passengers and crew and approximately 370 vehicles. These new vessels feature a diesel-electric propulsion system that is one of the largest and most economical of its kind in the world. This propulsion system and other technological and environmental features of the *Coastal Renaissance* contributed to winning the prestigious ShipPax award for outstanding ferry technology for 2008. These Super C-class vessels are replacing aging vessels that have been providing service on our major routes.

The contracts with FSG were design-build and fixed price, totalling \$325 million. The contracts should provide us with substantial guarantees related to delivery dates, performance criteria, cost certainty and quality of construction. These contracts, together with import duties and taxes of approximately \$112 million, formed the majority of the total project budget of \$542 million. We are currently seeking a remission of the import duties and related GST of approximately \$86 million, but are uncertain as to the outcome of this application. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk. The project for these three new state-of-the-art vessels is on schedule and under budget.

Construction of the *Coastal Renaissance* started in August 2006 and the vessel was launched in Germany in April 2007. It commenced service on the Departure Bay-Horseshoe Bay route on March 8, 2008, following crew training and familiarization in the operation of this new vessel.

Construction of the *Coastal Inspiration* commenced in November 2006 and the vessel was launched in August 2007. On June 16, 2008, it commenced service on the Duke Point-Tsawwassen route, following crew training and familiarization.

Construction of the *Coastal Celebration* began in April 2007 and the vessel was launched in December 2007. It arrived in British Columbia on June 18, 2008. The vessel is expected to commence service on the Swartz Bay-Tsawwassen route in the fall of 2008.

Northern Expedition

We signed a \$133 million contract with FSG to build a new vessel which is expected to replace the 42-year-old *Queen of Prince Rupert* currently operating on our northern routes. The import duties and taxes on this contract will total approximately \$43 million. We will be seeking a remission of the import duties and related GST of approximately \$35 million, but are uncertain as to the outcome of our application. 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. The official keel-laying of the vessel was on June 16, 2008. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 55 staterooms and will accommodate 130 vehicles and 600 passengers.

Island Sky

We expect to take delivery of the *Island Sky*, our new intermediate class ferry, this summer. The \$46 million contract with Vancouver Shipyards constitutes the majority of the total project budget of \$57 million. The new intermediate vessel will allow for the retirement of the 48-year-old *Queen of Tsawwassen*. The new vessel measures 102 metres in length and has a capacity of approximately 600 passengers and 125 vehicles. It features a new state-of-the-art lifesaving system as well as a variety of amenities, including a lounge and snack bar for passengers.

Terminal Marine Structures

We continued to reinvest in our terminal infrastructure in the first three months of fiscal 2009. We made significant upgrades to many of our terminals and made preparations for the arrival of the new Super C-class vessels. Over the next five years, we plan to invest approximately \$250 million in our terminals for building and marine structure upgrades.

Capital expenditures on terminal marine structures during the quarter included the following:

(\$ millions)		
<u>Terminal</u>	<u>Description</u>	
Bear Cove	New pontoon, ramp and ramp abutment	1.2
Duke Point	Berth upgrades to accommodate Super C-class vessels	1.7
McLoughlin Bay	Modifications to existing pontoon and new floating lead	0.2
Prince Rupert	New pontoon, ramp, ramp abutment and dolphin	1.2
Skidegate	New pontoon, ramp, ramp abutment and two dolphins ³	2.2
Various	Other projects	<u>1.8</u>
		<u>8.3</u>

Marine upgrades at Skidegate, Prince Rupert, Bear Cove and McLoughlin Bay have a total budget of \$31 million of which \$7.5 million was completed in the prior year. These projects are expected to be completed by spring 2009.

³ A cluster of pilings firmly fixed to the sea bed and used to assist vessels during docking.

Terminal and Building Upgrades and Equipment

Besides upgrades to terminal marine structures, many other terminal upgrades are underway to provide better service to our customers and improve operational efficiencies. The most significant activity in the first quarter of fiscal 2009 has been at our Departure Bay terminal. Capital expenditures on terminal and building upgrades and equipment included the following:

(\$ millions)	
Departure Bay terminal	5.3
Swartz Bay terminal	0.5
Security upgrades	0.2
Other terminal projects	1.5
	<u>7.5</u>

At Departure Bay terminal, the holding compound, pick-up and drop-off area, and the short term parking are being expanded. A new retail building, ticket building, waiting room and washrooms are being built. The foot passenger walkway will be improved and the intersection realigned. The new retail building, the Departure Bay Quay, opened on July 4, 2008.

At Swartz Bay terminal, the holding compound and pre-ticket area are being expanded, new ticket booths built, the radar maintenance building relocated and the exit re-aligned.

At nine terminals, mainly serving our major and northern routes, we continue our multi-year project to upgrade our security. This project primarily involves fencing, gating, lighting, access controls and closed circuit television as well as upgrades to foot passenger ticketing areas and baggage screening.

Information Technology

Capital expenditures in information technology include computer hardware and software development to improve operational data capture and reporting and database security.

Other ongoing projects include enhanced reporting initiatives, better external and internal communications, and replacement of obsolete technology and security projects. These projects focus on obtaining efficiencies, improving safety and security and providing better service to our customers.

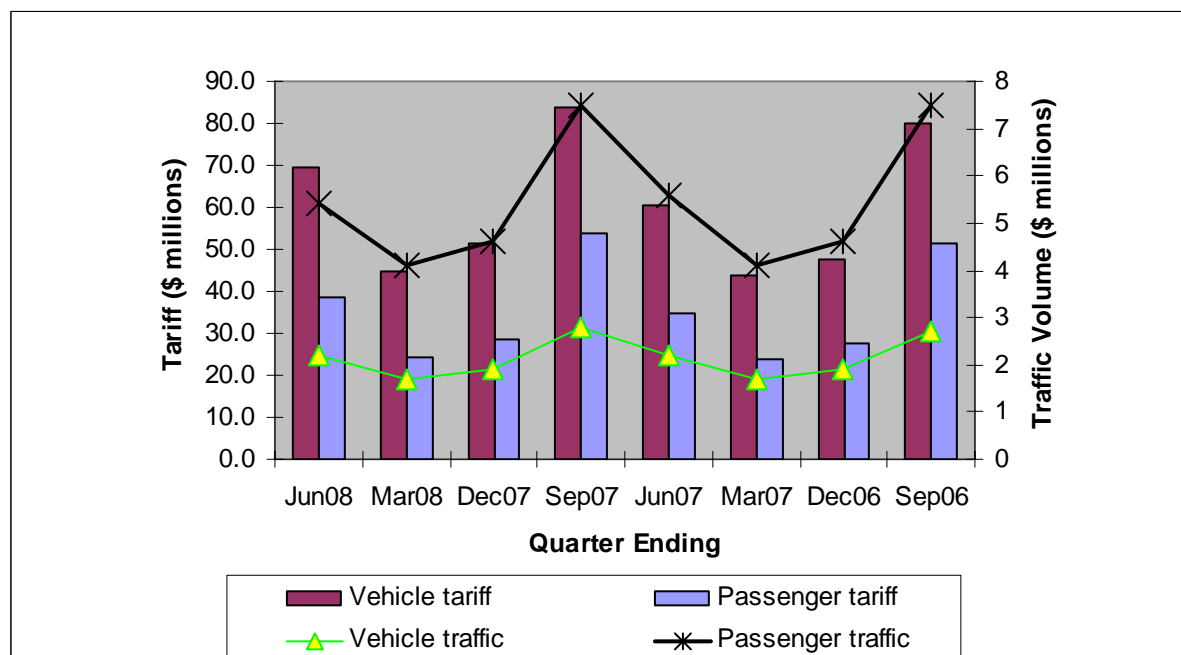
SUMMARY OF QUARTERLY RESULTS

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

(\$ millions)	Quarter Ended (unaudited)							
	Jun 08	Mar 08	Dec 07	Sep 07	Jun 07	Mar 07	Dec 06	Sep 06
Total revenue	171.9	124.2	136.5	220.2	159.8	119.0	128.4	202.7
Earnings (loss) from operations	18.3	(20.0)	(0.4)	69.4	22.1	(27.7)	2.5	73.0
Net earnings (loss) and comprehensive income	8.4	(30.5)	(7.8)	61.0	14.4	(33.2)	(1.8)	68.9

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 following graph demonstrates the seasonality of our revenue and shows the relationship of traffic volume and tariff revenue over the most recent eight quarters.



OUTLOOK

Fuel Costs

Fuel is a major cost of our operations. It has increased significantly over the past few years and there is uncertainty of future pricing. We use deferred fuel cost accounts to mitigate the effect of volatility in fuel oil prices on earnings.

For the northern routes, the per litre cost of fuel included in the determination of price caps (the set price) and one-half of the first 5 cents per litre of difference between the actual price paid per litre and the set price are recorded in expense. The remaining one-half of the first 5 cents per litre of difference is recorded in the deferred fuel cost accounts. Any difference beyond 5 cents per litre is recovered from or paid to the Province. The receivable from the Province relating to fuel costs on the northern routes was \$0.7 million at June 30, 2008.

For all other routes, differences in fuel costs arising from our actual price paid per litre being higher or lower than the unit set price included in base tariffs less one-half of the first 5 cents per litre of difference are charged or credited to the deferred fuel cost accounts.

The balances in our deferred fuel cost accounts totaled \$5.0 million at June 30, 2008 (\$11.9 million at March 31, 2008). Included in the June 30, 2008 balance is \$8.5 million in unrealized fuel hedge gains on fuel forward contracts entered into to fix the price of future purchases.

In performance term one, to reduce the increasing balances of the deferred fuel cost accounts, the Commissioner approved extraordinary price cap increases to allow for fuel surcharges which were implemented from time to time, beginning in July 2005. In performance term two, there is an automatic mechanism in place to allow price cap increases to provide for implementation of fuel surcharges.

As fuel costs continue a dramatic rise, we requested and received approval from the Commissioner to allow for the early implementation of fuel surcharges, effective on August 1, 2008 on all but the northern routes.

Traffic

Ferry traffic levels are affected by a number of factors, including transportation costs, the value of the Canadian dollar, weather, global security, levels of tourism, disposable personal income, the local economy, demographics and population growth. We experienced a decrease in traffic in the three months ending June 30, 2008 compared to the prior year. Tourism Vancouver reports a six per cent reduction in US visitors for the five months ending May 30, 2008 as compared to the prior year. With the increase in transportation costs as a result of fuel prices, the tariff rate increase of April 1, 2008 and the August 1 fuel surcharge implementation, we are uncertain as to the cumulative impact these events may have on our traffic. As a result of this uncertainty, we are taking measures to reduce our costs from previously planned levels over the remainder of fiscal 2009.

We experienced an increase in both total passenger and total vehicle traffic in fiscal 2008, following two years of moderate decreases. In fiscal 2008, we experienced increased traffic levels on our major and northern routes and an overall decrease in traffic levels on our other routes.

During fiscal 2007, traffic levels were negatively affected by the loss of capacity on our northern routes, an unprecedented number of severe wind and snow storms in November and December 2006, and the implementation of fuel surcharges. With the introduction of the *Northern Adventure* into service in March 2007, we anticipated that traffic on our northern routes would return to former levels. Since the resumption of full service, traffic levels have not yet reached the levels experienced in fiscal 2006.

Safety and Environmental Protection

The safety of the public and our employees and the protection of the environment are our highest priorities. Part of our safety plan was to increase the level of annual operational training we conduct. We increased training from approximately 11,000 person days in fiscal 2007 to 14,200 in fiscal 2008. We expect to increase this training further, to 15,900 person days, in fiscal 2009. We are on target to accomplish this with 6,800 days complete to June 30.

In October 2007, we officially launched SailSafe — a joint initiative with the BC Ferry & Marine Workers' Union that builds on our current safety practices and reflects our common commitment to safety as an essential part of our business and our daily work. This initiative will involve employees in identifying areas and methods for enhancing current safety practices. In the first phase of the action plan, we expect to implement 48 recommendations, of which two are complete at the end of June 2008.

We are proactive in ensuring environmental regulations are met or exceeded and in developing strategies that demonstrate our commitment to sound environmental management. We have programs in place to protect the environment and reduce greenhouse gas emissions and are introducing new initiatives to further mitigate our environmental impact. Besides recycling beverage containers, cardboard and newsprint, we are also:

- using biodegradable hydraulic oils;
- using low sulphur fuel in all vessels;
- replacing chemical products with more environmentally friendly solutions;
- recycling used cooking oil, spent fluorescent tubes and batteries;
- reviewing environmental performance of selected contractors;
- replacing gasoline powered terminal vehicles with electric vehicles; and
- replacing gasoline powered baggage vans with propane powered tugger units.

We have a fuel reduction strategy that is designed to improve fuel efficiency and reduce emissions from our vessels. To date, we have implemented 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 and designing and building our new vessels to meet or exceed current environmental standards.

Asset Renewal Program

We have one of the largest fleets in the world. The average age of our assets was among the oldest of major ferry operators worldwide. To address this, we instituted a major fleet and asset renewal program. As part of this, in March 2007, we added the *Northern Adventure* and the *Kuper* to our fleet. The first two Super C-class vessels, the *Coastal Renaissance* and the *Coastal Inspiration* commenced service in March and June, respectively and we have taken possession of the third and last Super C-class vessel. In addition to this last Super C-class vessel, the *Coastal Celebration*, over the five-year period ending June 2013, we will bring the following three vessels into service:

- a northern vessel, the *Northern Expedition*;
- an intermediate class ferry, the *Island Sky*; and
- a minor vessel to replace the *Tenaka*.

Upgrading and replacing a large share of our fleet through new vessel acquisitions and our revitalization program will also assist in maintaining operational reliability.

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 increase. We expect this will cause a decrease in our earnings in the near term.

Market Growth

Notwithstanding the pressure on traffic volumes, we see opportunities for growth.

In March 2007, we established Pacific Marine Ventures Inc. (PMV) as a wholly owned subsidiary to pursue strategic business opportunities, including terminal management opportunities outside our routes. In September 2007, PMV assumed management of the Sidney International Ferry terminal. Under a 40-year lease, PMV is managing and developing the town's ferry terminal with a focus on developing new business opportunities. Washington State Ferries continues to be the primary user of the facility with its service to Anacortes, Washington. At the same time, PMV is pursuing other management services opportunities.

To increase our profile in the Lower Mainland, expand our new market reach and further develop travel and tourism partnerships, in February 2008 we signed a lease to develop a 2,700 sq ft travel centre in the new Fairmont Pacific Rim property currently under construction in downtown Vancouver. We anticipate our travel centre will open in late 2009.

During fiscal 2008, we realized a 12.5% increase in commercial traffic revenue compared to the previous year. To increase our capacity in the commercial sector, we have assigned one new Super C-class vessel to each major route between the Lower Mainland and Vancouver Island. As a result, the *Coastal Inspiration* has joined the recently upgraded *Queen of Alberni* on our Duke Point–Tsawwassen route – the route most frequently used by commercial truckers. Additionally, our commercial sales team is continuing to actively pursue new business and is implementing new integrated sales solutions and enhanced services for our commercial customers.

Regulation

Transport Canada regulates the safety of our vessels by authority of the *Canada Shipping Act 2001*, which came into effect on July 1, 2007. This is the principal legislation governing the activities of Canadian vessels in all waters and of all vessels in Canadian waters. The impact of the revised regulations on the useful life of some of our vessels and/or the requirement for vessel upgrades is not well defined. There may also be an impact on required crew levels, training and certification which could increase our operating costs. We are addressing the changing regulations through our planning processes and asset renewal initiatives as information becomes available. As always, the safety of our customers and employees remains our highest priority.

In 2001, the federal government enacted the *Marine Transportation Security Act*. Initially the legislation and the associated regulations were limited to international ports and vessels. Amendments to the existing regulations have been proposed, the intent of which is to include domestic ferries and facilities within the *Marine Transportation Security Act* framework. If these amendments are enacted, we will be required to satisfy a specific level of security on our vessels and at our terminals servicing our major and certain other routes. Considerable security investments will be required in the areas of fencing, cameras, closed circuit TV, better access controls and screening. We have developed a corporate security strategy and completed location-specific security plans on the major routes and northern routes that are required to comply with the regulations. Through the Marine Security Contribution Program, we received \$3.8 million of federal funding under our first application to help offset the costs of perimeter security, access control measures and training. We have applied for a further \$1.0 million and anticipate making future applications to offset costs of security upgrades to vessels and terminals.

Our tariffs are regulated and our service levels are monitored by the Commissioner. The Commissioner regulates our tariffs by establishing price caps over a performance term. Our first performance term ended March 31, 2008 and our second performance term ends March 31, 2012. The core ferry service fees and service levels for the second term have been set and the Commissioner released a final second performance term price cap order. Under this order, the price cap increase (starting from a level which includes fuel surcharges in place at March 31, 2008) was 7.3% on the major routes and 4.0% on all other routes effective April 1, 2008. On each subsequent April 1 of the four-year term, the price cap will increase by 2.7% plus 0.49 times the latest reported annual increase in the Consumer Price Index (British Columbia) on the major routes and 5.7% plus 0.73 times the Consumer Price Index (British Columbia) on all other routes.

Competition

New competitors have emerged in both the passenger-only market and the commercial traffic market in the past few years. To date, passenger-only competitors have not been successful at sustaining operations.

We are witnessing increased competition in the commercial sector, where three companies, including ourselves, are now vying for differing segments of the freight transport business between Vancouver Island and the Lower Mainland. To maintain and potentially increase our market share, we plan on improving operational efficiency and customer service on our three major routes. To accomplish this, we have increased capacity for both commercial and passenger vehicle traffic on two of our major routes with the assignment of a Super C-class vessel to each route. The third Super C-class vessel will add capacity on the third major route. We are also improving traffic efficiency at the Departure Bay and Horseshoe Bay terminals and are investigating other new service offerings.

In an effort to reduce costs on our regulated routes and as mandated by the *Coastal Ferry Act*, we are exploring opportunities to have ferry services provided by additional or alternative service providers. 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 BC Ferries, could provide safe, reliable and high quality service that is more cost-effective.

A Request for Proposal (RFP) process has now been completed for the Brentwood Bay-Mill Bay route. We performed an extensive assessment of the proposal received from an alternative service provider and an external, independent party was engaged to review our evaluation. It was concluded that we can operate this route in a more cost-effective manner than that proposed by the potential alternative service provider and we continue to be the service provider for this route.

We are presently preparing to issue a Request for Expression of Interest (RFEOI) for alternative service delivery of the Campbell River-Quadra Island, Quadra Island-Cortes Island, and Port McNeill-Sointula-Alert Bay routes. We expect to issue the RFEOI in the summer of 2008 and will determine the next steps of the procurement process based on the responses we receive. Additionally, we expect to issue an RFP regarding the operation of our four routes north of Port Hardy; however, the timing of this request is uncertain.

FINANCIAL INSTRUMENTS

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgment.

The carrying value and fair value of our non-derivative financial instruments by class and of our derivative instruments by type are included in note 9 of our interim consolidated financial statements.

RISK MANAGEMENT

Understanding and managing risk are important parts of our business. We have processes in place throughout our company to manage risks that inevitably arise in the normal course of business.

A discussion of enterprise wide risk management can be found in our fiscal 2008 annual Management's Discussion & Analysis. Our risk profile is substantially unchanged during the three months ended June 30, 2008.

The management of the credit, liquidity and market risk arising from our financial instruments is discussed in note 8 of our interim consolidated financial statements.

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, 2008 and June 30, 2008 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.

Discussion of the most critical accounting policies and estimates that we have used in the preparation of our consolidated financial statements can be found on pages 40 through 42 of our fiscal 2008 Management's Discussion & Analysis. The following describes the changes to critical accounting policies we have used in the preparation of our consolidated financial statements for the three months ended June 30, 2008 or expect to use in the future.

Adoption of New Accounting Standards

Effective April 1, 2008, we adopted the following CICA Handbook Sections:

- Section 1535, *Capital Disclosures* establishes standards for disclosing information about our capital and how it is managed. The standard requires disclosure of our objectives, policies and processes for managing capital, the quantitative data about what we regard as capital, whether we have complied with any capital requirements and if we have not complied, the consequences of such non-compliance. Other than the additional disclosure in Note 10, the adoption of this section has had no impact on our consolidated financial statements.

- Section 3031, *Inventory*, replacing Section 3030 provides guidance on the determination of inventory cost, subsequent recognition as expense, and write-downs to net realizable value. Other than the change in disclosure in Note 1, the adoption of this section has had no impact on our consolidated financial statements.
- Section 3862, *Financial Instruments – Disclosure* requires disclosures, by class of financial instrument that enable users to evaluate the significance of financial instruments on financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk, and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net earnings and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable. Other than the additional disclosure in Notes 8 and 9, the adoption of this section has had no impact on our consolidated financial statements.
- Section 3863, *Financial Instruments – Presentation* carries forward existing requirements on presentation of financial instruments. Application of this section did not have any impact on our consolidated financial statements.

Future Accounting Changes

We have not yet adopted the following CICA Handbook Sections which will be effective for us beginning April 1, 2009:

- Section 3064, *Goodwill and Intangible Assets* does not substantively change the requirement pertaining to goodwill. The changes in requirements pertaining to intangible assets primarily relate to recognition criteria for purchased and internally developed assets which will result in few intangible assets being recognized on the balance sheet. We are assessing the impact of this section on our consolidated financial statements.
- To be applied prospectively, are amendments to Sections 1100 *Generally Accepted Accounting Principles*, 3465 *Income Taxes* and Accounting Guideline AcG-19 *Disclosures by Entities Subject to Rate Regulation*. With release of these amendments, a temporary exemption that permitted assets and liabilities arising from rate regulation to be recognized and measured on a basis other than in accordance with the primary sources of generally accepted accounting principles will be removed. In addition, accounting recommendations have been amended to require recognition of future income tax liabilities and assets as well as offsetting regulatory assets and liabilities at entities subject to rate regulation. We do not expect application of these amendments to have any impact on our consolidated financial statements. We will continue to monitor any additional implications on our financial reporting related to accounting for rate regulated operations.

In 2006, the Canadian Accounting Standards Board (AcSB) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian generally accepted accounting principles with International Financial Reporting Standards (IFRS) over an expected five year transitional period. During March 2008, the AcSB confirmed the transition dates for conversion to IFRS. Our transition date for the conversion to IFRS is April 1, 2011 and will require the restatement for comparative purposes of amounts reported by us for the year ended March 31, 2011. While we have begun assessing the adoption of IFRS, the financial reporting impact of the transition cannot be reasonably estimated at this time.

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. Some of the market conditions and factors that have been considered in formulating the assumptions upon which forward looking statements are based include traffic, the Canadian Dollar relative to the US Dollar, fuel costs and the fuel reduction program, construction costs, the state of the local economy, demographics, duty remission, GST reduction, and the requirements of the Coastal Ferry Services Contract.

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, safety and security, asset risk, accident 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.